Basel III - challenges, impact and consequences
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In the wake of the financial crisis and the subsequent intervention by central banks and governments as well as criticism, at times massive, voiced by governments and the public on the business models and investments of the banking industry, the Basel Committee on Banking Supervision (BCBS), following the lead of the G20, as well as national supervisors are imposing substantial additional regulatory demands on the financial industry. The efforts aim at stabilizing the industry in the aftermath of the crisis and strengthening the banking system for the future, ensuring a more robust banking system that is able to absorb shocks independently.

The new Basel III framework issued by the BCBS forms the cornerstone of these initiatives. This regulatory framework follows the previous Basel II and Basel 2.5 initiatives and is intended to increase the stability of individual banks and the banking system alike. In particular, the framework addresses:

- Strengthening banks’ capitalization and the quality of the capital
- Promotion of an enhanced liquidity regime and more stable funding
- Deleverage of the balance sheet
- Reduction of procyclicality

Separate regulatory initiatives address in particular the treatment of systemically important banks. The main goal is to avoid or at least reduce further public-sector intervention (in the form of implicit governmental guarantees) and hence to reduce the problem of the “too big to fail” premise.

**Purpose of this brochure**

Banks will be affected in many different ways by these new regulations and an adverse impact on profitability is expected. In certain cases, even the strategic business models have to be reconsidered and business activities will need to be optimized. Against this background, this brochure aims to provide an overview of the challenges associated with the Basel III framework and the expected impact and consequences. Additionally, the brochure outlines how projects can be structured to help establish solutions reducing the effects of the regulatory changes and to align a bank’s strategic focus and business orientation with the impact and consequences deriving from the regulations. Finally, the brochure examines the impact of the Pillar II FINMA circular “Capital buffer and capital planning in the banking sector”, which has been issued in Switzerland and will impose further demands on capital levels, capital planning and risk management techniques.
1. Current challenges

The banking and financial industry is recovering from one of the most severe crises ever seen. With the introduction of Basel III, the resource of capital, which is already scarce, will be stretched even further and margins on both lending and saving activities will deteriorate, squeezing banks’ profitability yet more.

Additionally, the current threat of potential losses from European government bonds and indirectly from bank counterparties holding such assets imposes even more pressure on banks to increase capital to be adequately capitalized in case write-offs materialize.

Furthermore, professionals involved in the processes of addressing the new requirements confirmed the substantial operational burden and the considerable investments required to adapt a bank’s risk management framework.

Moreover, the regulatory framework provides for senior management as well as the Board of Directors to be more actively involved in the governance pertaining to risk management.

Finally, the risk dimensions have to be sufficiently reflected in strategic business planning and decisions. As a result, additional management attention has to be directed to this area.

Further requirements on the horizon

Regulators established criteria for the definition of systemically important financial institutions. Such institutions are subject to increased supervision and will need to comply with additional regulatory demands. Experience from several jurisdictions has shown that it is very likely that not only the largest and most international banks will be considered systemically important, but that national champions might be deemed relevant too.

In addition, various internationally renowned regulators have started to increase their requirements of stress testing and have also implemented the concept of reverse stress testing. This aims to identify previously undetected sources of material risks. While stress testing exercises of this type have been found to be helpful, they have also proven time-consuming and resource-intensive.
«The enhanced Basel III requirements on capital and liquidity as well as the current challenge of handling assets of countries with deteriorating creditworthiness puts enormous pressure on banks to recapitalize and ensure adequate liquidity.»
2. Basel III philosophy and structure and national regulations

The Basel framework represents a cornerstone in regulatory risk and capital management of financial institutions by setting minimum standards to align the application of risk measurement techniques and the calculation of capital requirements worldwide. As such, the framework supports a risk-adjusted allocation of regulatory capital.

Basel III targets a reform of the existing Basel II and 2.5 frameworks, taking into account previous criticism of the framework and its shortcomings with regard to capital adequacy and in terms of addressing the lack of sufficient stable liquidity and funding positions. The final text of Basel III was published in December 2010. As with Basel II, the transfer of the framework into binding national regulation falls within the competency of national regulators. (Exception: supranational requirements set by the European Union within the EEA).

The reform addresses the following levels of regulation:

- **Bank-level, microprudential:** regulation which will help to raise the resilience of individual banking institutions to periods of stress
- **Macroprudential:** regulation of system-wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time

To achieve these targets, the regulatory capital requirements have been tightened by reforming the risk weights to be applied, increasing the asset positions to be deducted from capital and through an envisaged strengthening of the capital basis (enlarged capital buffer and increased qualitative requirements regarding eligible capital). Additionally, new regulatory instruments have been introduced, namely liquidity and leverage ratios. The enhanced capital requirements and the expansion of the regulations to additional fields of business activities and risk management are intended to address the main loss drivers of the past crisis.

In particular, the framework addresses the following aspects and instruments:

- **Enhanced capital requirements:** additional capital and enhanced quality of capital to improve the capacity to absorb losses
- **In some cases, higher risk weights to be applied to calculate risk-weighted assets**
- **Additional deductions from capital:** goodwill, deferred tax assets, (other than from temporary differences), intangibles, holdings in other financial institutions and minority interests
- **Implementation of two liquidity ratios:** the liquidity coverage ratio and net stable funding ratio
- **New monitoring tools to be set in place to supervise liquidity risk in general and particular risk aspects of liquidity and funding positions**
- **Implementation of a new non-risk-based leverage ratio,** comprising on- and off-balance sheet exposures

Like previous versions of the Basel regulations, Basel III presents a global minimum standard to be adopted by national regulators. However, some national regulators had already reacted before the release of Basel III in December 2010 and are considering additional measures that go beyond the Basel III minimum requirements - in particular regarding large banking groups (systemically important financial institutions, SIFI).
Such measures comprise enhanced capital requirements for large banks, exceeding the Basel III minimum and additional organizational components, such as:

- Additional capital buffer (going beyond Basel III minimum requirements)
- Promoting living wills
  - Recovery plan to outline recovery actions in case of restructuring
  - Resolution plan to detail actions to be taken in case of a default
- Establishment of “firewalls” or “break lines”, defining vital banking services to a country and predetermining a separation of relevant business lines from a struggling bank. Such services may include payment services, domestic lending and mortgage business, offering of privileged deposits, etc.
- Promoting decoupling; reducing interdependencies between banks (as a prominent example: payment / clearing services, where larger banks often act as agents for smaller banks)
- Enforcement of operational separation of business lines, particularly by setting up a holding structure or by a legal separation of business and investment banking
In particular, regulators in Switzerland (FINMA), the UK (FSA) and the US (Fed) are currently the forerunners, prominently addressing enhanced capital requirements and organizational aspects for systemically relevant banks.

Finally, it has to be emphasized that the impact and consequences extend beyond restricting the ability to generate revenues and profits, even forcing banks to reconsider business strategy and business conduct in some cases. Overall, the impact and consequences are expected to be far reaching from a financial and a business perspective.

The figure below illustrates the most substantial types of impact expected:

Overview on direct impact of the new Basel III framework
Fig. 1

<table>
<thead>
<tr>
<th>Operational burden</th>
<th>Higher operational costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Increasing requirements on risk</td>
<td></td>
</tr>
<tr>
<td>management operations</td>
<td></td>
</tr>
<tr>
<td>• Substantial impact on related fields</td>
<td></td>
</tr>
<tr>
<td>like IFRS and accounting, data management, trading operations and tax</td>
<td></td>
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<tr>
<td>Capital requirements</td>
<td></td>
</tr>
<tr>
<td>• Increasing capital consumption</td>
<td></td>
</tr>
<tr>
<td>due to Basel III and Pillar II</td>
<td></td>
</tr>
<tr>
<td>• New risk-neutral leverage ratio</td>
<td></td>
</tr>
<tr>
<td>• Possibility of additional capital charges due to non-compliance with operational requirements</td>
<td></td>
</tr>
<tr>
<td>Liquidity requirements</td>
<td></td>
</tr>
<tr>
<td>• Increased requirements in liquidity risk management</td>
<td></td>
</tr>
<tr>
<td>• Change in asset allocation due to adjusted qualifying criteria</td>
<td></td>
</tr>
</tbody>
</table>

Losses due to asset reallocation
Margin pressure on lending activities
Margin pressure on saving activities
Restrictions on growth and economies of scale
Drop in profitability
The Basel framework represents the cornerstone in regulatory risk and capital management of financial institutions by setting minimum standards to align the application of risk measurement techniques and the calculation of regulatory capital requirements worldwide.
3. How Ernst & Young can help

The challenges involved in implementing Basel III into a bank’s organization and considering its impact on business are manifold. The fact that different risk aspects and business activities are affected and different approaches are used for capital calculation (risk-weighted calculation versus risk-neutral view) makes the implementation complex. Efforts to work towards a fully fledged and well adapted solution will not only call on input from risk management but also several other departments. For example, it will be necessary to consult with finance & accounting, IT services, data management services, tax, trading operations, etc.

A timely and structured project set-up will be crucial in order to identify all areas of activities and aspects to be considered. The challenge lies not only in the complexity of the regulatory requirements, but also in the implementation itself, the impact on business activities, the interaction and coordination of involved parties and the timely allocation of the resources needed (capital and manpower).

At Ernst & Young, our many years of experience in capital and liquidity management and implementation of regulatory reform projects, coupled with our broad knowledge of the banking industry, equip us to support any particular requirements in a way that is aligned to specific business needs. We can support you with project set-up and planning, which will then be complemented by a gap analysis and assistance implementing the necessary Basel III change initiatives. We are also on hand to assist on questions of capital optimization and allocation as well as business and ressource planning. Thanks to the involvement of our subject matter experts in all relevant areas of activities, such as risk management, finance & accounting, tax, IT, etc. and with our strong background in strategic business and balance sheet planning, our services will be tailored individually to your needs.

The scope of support can be chosen and combined from different building blocks to align with specific requirements.

### Scoping of projects - building blocks for tailored solutions

Fig. 2

<table>
<thead>
<tr>
<th>Optimize</th>
<th>Comply/minimize</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Optimum balance sheet management</strong></td>
<td>Liquidity calculations</td>
</tr>
<tr>
<td>• Growth</td>
<td></td>
</tr>
<tr>
<td>• Assets</td>
<td></td>
</tr>
<tr>
<td>• Liabilities</td>
<td></td>
</tr>
<tr>
<td>• Capital</td>
<td></td>
</tr>
<tr>
<td><strong>Optimum legal entity structure</strong></td>
<td>ICAAP</td>
</tr>
<tr>
<td>• Living wills</td>
<td></td>
</tr>
<tr>
<td>• Capital/liquidity</td>
<td></td>
</tr>
<tr>
<td>• Tax</td>
<td></td>
</tr>
<tr>
<td>• Supervisory intensity</td>
<td></td>
</tr>
<tr>
<td><strong>Optimal risk governance</strong></td>
<td>Leverage calculations</td>
</tr>
<tr>
<td>• Risk appetite</td>
<td></td>
</tr>
<tr>
<td>• Controls</td>
<td>Remuneration policies</td>
</tr>
<tr>
<td>• MI and transparency</td>
<td></td>
</tr>
<tr>
<td>• Stress testing</td>
<td></td>
</tr>
<tr>
<td>• Risk-based remuneration</td>
<td></td>
</tr>
<tr>
<td><strong>Optimum business strategy</strong></td>
<td>Project scope</td>
</tr>
<tr>
<td>• Core portfolios</td>
<td></td>
</tr>
<tr>
<td>• Core geographies</td>
<td></td>
</tr>
<tr>
<td>• Core products</td>
<td></td>
</tr>
</tbody>
</table>

### Aspects to consider

- Capital eligibility and structure
- Liquidity mgmt and asset allocation
- Living wills
- Regulatory expectations
- Tax considerations
- IT and data implications
- Accounting considerations
Finally, timely planning, consideration of change requirements and
development of strategic alternatives will help a bank secure its
position at an early stage of the regulatory change, saving time in
reallocation of businesses, assets and funding and the alignment of
balance sheet relations.

The modular set-up allows for full coverage of all relevant aspects,
while at the same time allowing us to focus on providing efficient
support.

The next sections of this brochure highlight each of the relevant
aspects of Basel III and detail how Ernst & Young can efficiently
support and reduce the impact of the new regulations.

Different phases and components of a regulatory change project
Fig. 3
4. The different aspects of Basel III, challenges and support from Ernst & Young

**Increase in capital level and enhanced qualitative requirements (need for enhanced loss-absorbing capacity of capital)**

The overall capital requirement increases to 10.5% (comprising total capital of 8% plus 2.5% of capital conservation buffer). The countercyclical buffer will come on top. In parallel, the loss-absorbing quality of capital has to be improved; to this end, the common equity tranche will have to be increased significantly from 2% to 7%, notwithstanding enhanced requirements from national supervisors. At the same time, the overall eligible Tier 1 and Tier 2 capital will be proportionately reduced and other capital components such as hybrid portions (Tier 3 capital components) are no longer eligible and will have to be phased out.

The additional countercyclical buffer is intended to reduce procyclicality of lending activities. The buffer will have to be built up in times of economic growth, when markets tend to overheat, and will be reduced during economic downturns. Overall, Basel III introduces a significant increase in capital requirements. The following chart shows the schedule and minimum capital requirements until final implementation by 1 January 2019.

**Increase in total capital requirements and strong focus on common equity Tier 1 capital**

Fig. 4

| Minimum capital requirements under Basel III; not considering national capital surplus |
|---------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Gradual increase of the         |               |                |                |                |                |                |                |                |
| - common equity Tier 1 ratio to 4.5% (after deductions), |               |                |                |                |                |                |                |                |
| - Tier 1 capital ratio to 6%    |               |                |                |                |                |                |                |                |
| Additional capital conservation buffer of 2.5%, consisting of common equity Tier 1. |               |                |                |                |                |                |                |                |
| Overall common equity Tier 1 ratio of 7% |               |                |                |                |                |                |                |                |
| Countercyclical capital buffer  |               |                |                |                |                |                |                |                |
| Capital conservation buffer     |               |                |                |                |                |                |                |                |
| Total capital                   | 8%            | 8%             | 8%             | 8%             | 8%             | 8%             | 8%             | 8%             |
| Tier 1 capital                  | 4%            | 4.5%           | 5.5%           | 6%             | 6%             | 6%             | 6%             | 6%             |
| Common equity Tier 1            | 2%            | 3.5%           | 4%             | 4.5%           | 4.5%           | 4.5%           | 4.5%           | 4.5%           |

The challenge is Tier 1 capital i.e., common Tier 1; subordinated debt and other Tier 2 instruments become less relevant.
4. The different aspects of Basel III, challenges and support from Ernst & Young

With the increased capital requirements and the need for improved quality of capital – mainly common equity Tier 1 capital – an increase in cost of capital and reduced pay-out to stakeholders must be expected, probably leading in turn to a drop in overall profitability (return on capital). Ernst & Young can help in different ways to ease the impact and to keep costs under control. In particular by assisting you with:

- Optimization of the risk-weighted asset calculation
- Planning the target capital structure (to switch capital components and to increase capital level) and related impact and gap analysis; support in implementation
- Optimization of capital consumption on a consolidated level as well as for legal entities
- Alignment of risk appetite with business planning and support in strategic repositioning and optimization of capital allocation

Overall, the financial burden to banks and the financial industry will be far-reaching. In December 2010, the CEBS published a quantitative impact study based on the new Basel III framework. For the participating banks within the EU, the demand for additional common equity capital alone has been estimated at up to EUR 300 billion to reach the required level of 7%.

The liquidity part consists of two ratios – the liquidity coverage ratio and the net stable funding ratio – and additional monitoring requirements

Holding a liquidity buffer (cash and highly liquid assets) is meant to ensure short-term liquidity under stressed conditions while, on the funding side, the net stable funding ratio is thought to support more sustainable funding of assets with a tenure of more than one year.
The required liquidity buffer in the balance sheet will result in reduced earnings due to the holding of the non-interest-bearing cash reserves and high quality assets with lower return rates. The market volume within qualifying asset classes will be rather limited, which might in some instances even lead to a shortage of available assets. In the process, prices for qualifying assets will most probably increase markedly, while values of assets not qualifying for liquidity ratios will drop, potentially leading to write-offs of such assets. Of particular interest to banks is the fact that banking bonds (obligations of financial institutions and of its affiliated entities) do not qualify as high quality assets under the new liquidity regime.

The impact on funding is expected to be more severe compared to the capital requirements. Meeting the demand for long-term financing (by issuing securities / bonds, attracting deposits / client money) requires considerable efforts on the part of the banks to raise enough long-term funds at adequate costs, given the expected reallocation need of around EUR 3.9 to 4.9 trillion for the EU and North America (figures based on a quantitative impact study by CEBS and a survey by Mc Kinsey on the US market). Particularly for the insurance industry, as the most substantial investor and buyer of banking bonds, it becomes less attractive under the new Solvency II regime to invest in such assets classes (due to risk weights to be applied and reduced duration). Consequently, the cost of funding is likely to increase.

Any alternatives, however, will also potentially lead to increased cost and reduced profitability (see figure below). However, it is important to note that not all asset positions need to be fully underpinned with long-term capital. For example, unencumbered residential mortgages will only require 65% coverage and highly rated specific bonds as little as 20%. Unsurprisingly, given the estimated impact on specific asset classes, a bank will reconsider parts of its business strategy and model in favor of higher investments and increased business activity in privileged asset classes and to promote deposit business as stable funding.

However, increased competitive pressure has to be expected in these areas, although an increase in lending spreads should be enforced, given the expected future increase in costs.

Cost pressure on the funding side, reduced attractiveness due to potentially increased costs
Fig. 5

<table>
<thead>
<tr>
<th>Demand for longer-term funding</th>
<th>Alternatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raising of longer-term capital</td>
<td>Increased competition and increased costs</td>
</tr>
<tr>
<td>Insurance companies (historically the most substantial buyers of banking bonds)</td>
<td>Promotion of deposits/long-term savings</td>
</tr>
<tr>
<td>Reduced attractiveness due to Solvency II</td>
<td>Securitization</td>
</tr>
<tr>
<td>Reduced/more selective appetite for banking bonds</td>
<td>Operational efforts and increased rate costs</td>
</tr>
<tr>
<td>Increased cost of funding</td>
<td>Reducing lending business</td>
</tr>
<tr>
<td>Increased cost of funding</td>
<td>Reduced economies of scale</td>
</tr>
</tbody>
</table>
Ernst & Young also has broad experience in liquidity and funding management and in asset and liability management in general. As such, we are well placed to offer support across the whole range of liquidity requirements. Additionally, Ernst & Young has developed a specific diagnostic tool to support benchmarking and gap analysis projects. Further relevant aspects may be supported as well, these include:

- Balance sheet optimization
- Implementation of the new liquidity ratios
- Liquidity and funding planning based on the current business activities as well as on the basis of the strategic planning; prioritization of measures to be taken
- Alignment of strategic planning to the expected increase in costs and competition and reduced possibilities to fund assets due to enhanced liquidity requirements
- Stress test calculations
- Implementation of monitoring requirements, adjusted to the size of operations and business activities

In August 2010, the Bank of International Settlement (BIS) published an assessment of the impact of enhanced capital and liquidity requirements. The study suggests that to neutralize the costs for the net stable funding ratio alone will require an increase of 14 to 25 basis points on lending spreads, depending on the reallocation of asset positions.

**Leverage ratio leading to a risk-neutral limitation of business operations**

The newly introduced leverage ratio aims to reduce leverage and strengthen the balance sheet relations. However, this can lead to a limitation of business activities and restrict opportunities, driven by a lack of sufficient available capital. Also, less risky business such as the traditional commercial and retail lending may be affected and face limitation like any other riskier business operations such as investment banking activities. Additionally, if a bank is already short on capital, this leverage ratio could result in credit rationing.

Ernst & Young can help in the planning and implementation of the new leverage ratio by performing related impact analysis and in the development of response and action plans.

**Involvement of senior management and owners / shareholders**

Senior management will have to be involved in the implementation of Basel III and kept informed in a timely manner. A bank will have to consider the overall impact and consequences in a consolidated way prior to taking decisions on what avenues to pursue. Not only do costs, margin situation and updates in the risk management organization have to be considered, but business plans, aligned risk appetite and capital allocation also need to be developed in close coordination with an adjusted business strategy.

Ernst & Young can provide support in performing senior management training, developing the necessary understanding and expertise and thus reducing the time required for implementing the regulations.

**Other regulatory initiatives**

Furthermore, Ernst & Young offers tailor-made solution packages regarding the establishment of recovery and resolution plans (if an additional requirement of the national supervisor) for systemically important banks. Finally, further offers include support in several business areas and activities, such as:

- Planning and supporting the implementation project for Basel III
- Adjusting product design and mix considering the new regulatory framework
- Reviewing business activities and areas as well as strategies
- Improving data management and data availability
- Strengthening risk management and governance structure
- Managing change processes
- Streamlining and optimizing internal processes
5. Outlook

The new framework is still subject to further discussion among national supervisors. Final national implementation is still to come. Of particular interest to the financial industry will be the question of national minimum capital requirements and the requirements for large, systemically important banks in different countries and in particular in the EU, as well as whether a level playing field can be expected.

Another unknown factor remains the leverage ratio. So far, only little guidance has been issued and the final approach and the size of the parameters themselves are not yet fixed. The results of the quantitative impact analysis and the updates of the current provisions have to be monitored closely. The final decision on the size of the ratio has the potential to influence business orientation and activities significantly.

Banks should start early to analyze the new framework and learn about the impact on their organization and business model and to work out gap analysis and implementation schemes. National implementation efforts need to be followed closely. Proactive scenario planning considering potential alternatives will help to prepare an institution to react to the challenges adequately and in a timely manner. The focus should be on how to gain competitive advantages (given the new framework) compared to other competitors.

Last but not least, timely planning and implementation allows a bank to avoid running into enhanced market pressure, when “everybody is moving” (e.g., reallocation of funding and asset positions ahead of competitors will most likely result in lower cost).

Overall, fully fledged multi-year planning should form the baseline and periodical checks of the planning are a “must”. Regular checks of achievements and updates on pending topics will help to focus on the significant and important aspects. Finally, the banks must be ready to look at the framework holistically, i.e., not only considering capital and liquidity management aspects, but also thinking about how to optimize the whole organization, reconsider business activities, strategy and capital allocation to reduce the impact and costs of the regulations to a minimum.

Excursus – new FINMA circular “Capital buffer and capital planning – banks”

In light of the financial crisis and following the selected stress testing reviews in 2009 with various Swiss banks, FINMA issued the new circular “Capital buffer and capital planning – banks”, which entered into force as of 1 July 2011 and addresses Pillar II requirements under the Basel II framework.
Capital planning as a structured process based on a modular and integrated process model

Fig. 6

<table>
<thead>
<tr>
<th>Current business conduct</th>
<th>FINMA requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Capital and dividend planning is conducted as part of good Corporate Governance</td>
<td>• BoD responsibility</td>
</tr>
<tr>
<td>• Capital planning is predominantly driven by the expected business development and based on the financial planning</td>
<td>• Risk appetite and risk attitude</td>
</tr>
<tr>
<td>• Often capital planning is geared towards the regulatory capital and only a limited set of risk drivers is reflected</td>
<td>• Senior mgmt. actions and remediations</td>
</tr>
<tr>
<td>• Capital planning and forecasting has not been explicitly regulated</td>
<td>• Capital planning</td>
</tr>
<tr>
<td></td>
<td>• Circumventing risk assessment</td>
</tr>
<tr>
<td></td>
<td>• Stress testing</td>
</tr>
</tbody>
</table>

The circular is rather concise and principle based. However, the core Pillar II requirements pertaining to the risk-adjusted and forward-looking capital planning prevail. As such, banks not only have to establish / document capital planning over a three-year horizon, reflecting their strategic developments and related capital requirements, but are also expected to take into account the effects of a severe but plausible economic downturn (stress test) in their planning. They must provide evidence that the bank is in a position to meet its capital adequacy requirements in such a scenario. As part of this planning, the banks are specifically requested to consider all relevant risks to which they are exposed. These will include non-Pillar I risks such as reputation and compliance risk or interest rate risk in the banking book.

Moreover, additional capital requirements are imposed on the banking system by a system of categorization according to various factors including size and business volume. The overall capital level increases from 8% at present to 10.5% (category 5 banks) and up to 13.6% - 14.4% (category 2 banks). Furthermore, the level also has to account for any risks not covered or insufficiently covered under
The new framework is still subject to further discussion among national supervisors. Final national implementation is still to come. Of particular interest to the financial industry will be the question of national minimum capital requirements and the requirements for large, systemically important banks in different countries, as well as whether a level playing field can be expected.

The Basel II Pillar I regime. Regarding the structure of the capital buffer, FINMA reserves the right to impose further requirements if the current solution is deemed inadequate. Finally, in case of insufficient capital holding, additional supervisory measures can be initiated.

The circular does not stipulate a minimum level of capital required after deduction of stress test losses. Therefore, the question remains as to how much capital a bank still needs to be able to disclose after having deducted the expected losses derived from the stress tests. However, it can be expected that, considering the stress scenarios chosen and a bank's business strategy, the regulator will ascertain whether the remaining level of capital can still be regarded as adequate to ensure continuation as a going concern. The adequate level would have to be defined depending on the expectations of the regulator, which should mean that intervention by the regulator is avoided and no additional requirements are imposed.

Depending of the stress scenario chosen, the necessary amount of capital calculated in the capital planning process can by far exceed the current capital requirement (if calculated for enhanced stress figures).

Figure 7 illustrates the two different views on capital. The left side shows the aggregation of all capital requirement components to arrive at the required capital based on the current situation of the bank. The right part shows the future impact of the stress tests on the capital level. The two calculations are not related.
Capital management – compliance with regulatory requirements and consideration of strategic planning

Fig. 7

Pillar II generally aims to bring a more risk-based view into the process of capital management. Historically, banks have often looked at capital management from a rather finance-based perspective, missing certain crucial elements of risk management.

Even though the transition phase to comply with the increased capital requirements lasts until December 2016, the capital planning for the first period, i.e., 2012 - 2014, needs to be prepared by end of March 2012 at the latest.
Ernst & Young has been supporting the implementation of Pillar II frameworks in banks worldwide. As a result, Ernst & Young can offer a wide range of support services, tailored to a bank and its specific requirements.

Services include:

- Optimization of risk weighted asset calculation
- Support in the adjustment of the capital calculation framework
- Optimization of capital consumption
- Structuring of the capital planning document
- Support on specific topics to be included in the capital planning document
- Support in the establishment of the capital planning document

Basel III as well as the new Swiss regulatory guidance on enhanced capital and capital planning will require the attention of the banking industry for the foreseeable future, and will by its very nature absorb resources. The challenge will be to ensure thorough and forward-looking planning and decision-making in a changing market environment. Ernst & Young offers tailored support and assistance throughout the change process.
Ernst & Young

Basel III – challenges, impact and consequences
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