COURSE: COMESA WORKSHOP ON BASEL III

TOPIC: CAPITAL CONSERVATION BUFFERS

DATE: JULY 13, 2016

VENUE: KENYA SCHOOL OF MONETARY STUDIES

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AGENDA

- Business Cycle
- Procyclicality
- Basel III and Procyclicality
- Capital Conservation Buffers
- Countercyclical Capital Buffers
- Buffer Guide and Transparency
- Basel III capital requirement
- Transitional Arrangement
A). BUSINESS CYCLE

- Business cycle is the fluctuations of economic expansion and contraction that occur over time. Also called boom and bust cycle.
B). PROCYCLICALITY

- Procyclical is a term used in economic to describe how an economic quantity is related to economic fluctuations. In business cycle, an economic quantity that is positively correlated with the overall state of the economic is said to be procyclical. (i.e. employment and GDP growth)

- Procyclicality is a self-reinforcing mechanisms within the financial system and between financial system and the real economy that can exacerbate boom and bust cycles.
  - Most prominent in downward phase
  - Most critical (but hidden) in expansion phase

Question
- Is procyclicality a good phenomena for the financial sector?
B). PROCYCLICALITY

How to address procyclicality?

- **General principle**
  - Build-up buffers in good times so as to run them down in bad times

- **Note**
  - Buffers are difference between actual levels of capital and regulatory minima
  - Need to allow buffers to be run down in bad times
C). BASEL III AND PROCYCLICALITY

- Basel III is introducing a range of measures to address procyclicality and increase resilience of the banking sector by conserving capital in the banking sectors during good times (economic boom) that can be utilized to cushion banks during the time of stress.

- Key objectives
  - Dampen any excess cyclicality of the minimum capital requirement
  - Promote more forward-looking provisions
  - Conserve capital to build buffers at individual banks and the banking sector that can be used in stress
  - Achieve the broader macroprudential goal of protecting the banking sector from periods of excess credit growth
D). CAPITAL CONSERVATION BUFFERS

Objective

- Build-up buffers that can be drawn down in periods of stress
- Promote the conservation of capital and provide mechanism to rebuild capital during recovery

Framework

- 2.5% capital buffer above the regulatory minimum capital requirement
  - Common Equity Tier 1
- Banks can use capital buffer, but if they fall short there are
  - constraints on the distribution of earnings or banks have to raise capital in the market
  - no constraints on day-to-day business decisions
E). COUNTERCYCLICAL CAPITAL BUFFERS

- Banking Sectors plays a critical role in economic growth of country such that economic recovery period in the business cycle is mainly accompanied by excess credit growth. So when economic moves to contraction period, banking sector is likely to witness losses.
- Losses incurred in the banking sector can be extremely large when a downturn in the economy is preceded by a period of excess credit growth.
- These losses can destabilise the banking sector and spark a vicious circle, whereby problems in the financial system can contribute to a downturn in the real economy that then feeds back on to the banking sector.
E). COUNTERCYCLICAL CAPITAL BUFFERS

Countercyclical Capital Buffer is deployed when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk to ensure the banking system has a buffer of capital to protect it against future potential losses.

Objective

- Achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth that have often been associated with the build up of system-wide risk
- Banking sector in aggregate should have capital on hand to help maintain the flow of credit in the economy without its solvency being questioned, when the broader financial system experiences stress
E). COUNTERCYCLICAL CAPITAL BUFFERS

Framework

- Countercyclical capital requirements extend size of capital conservation buffer in times of excessive credit growth.
- Buffer for exposures in jurisdiction set by national authorities
  - Guided discretion
  - Jurisdictional reciprocity
- Buffer for a particular bank is weighted average of the buffers deployed across all jurisdictions to which it has exposures.
- Transparency: Authorities should explain buffer decisions
E). COUNTERCYCLICAL CAPITAL BUFFERS

• Buffer
  • Ranges from 0%-2.5%
  • Common Equity Tier 1 (including other fully loss absorbing capital)

• Banks can use capital buffer
  • If buffer is on: Constraints on the distribution of earnings but no constraints on business decisions
### Calibration of the Capital Framework

**Capital requirements and buffers**

<table>
<thead>
<tr>
<th></th>
<th>Common Equity after deductions</th>
<th>Tier 1 capital</th>
<th>Total capital</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Minimum</strong></td>
<td>4.5%</td>
<td>6%</td>
<td>8%</td>
</tr>
<tr>
<td><strong>Conservation buffer</strong></td>
<td>2.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Minimum plus buffer</strong></td>
<td>7%</td>
<td>8.5%</td>
<td>10.5%</td>
</tr>
<tr>
<td><strong>Countercyclical buffer range</strong></td>
<td>0-2.5%</td>
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</tr>
</tbody>
</table>
### Phase-in arrangements
*(shading indicates transition periods)*

<table>
<thead>
<tr>
<th>All dates as of 1 Jan</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>As of 1 January 2019</th>
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</thead>
<tbody>
<tr>
<td>Leverage Ratio</td>
<td>Supervisory monitoring</td>
<td></td>
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<td></td>
<td>Migration to Pillar 1</td>
</tr>
<tr>
<td>Minimum Common Equity Capital Ratio</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
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<tr>
<td>Capital Conservation Buffer</td>
<td></td>
<td>0.625%</td>
<td>1.25%</td>
<td>1.875%</td>
<td>2.50%</td>
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</tr>
<tr>
<td>Minimum common equity plus capital conservation buffer</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>5.125%</td>
<td>5.75%</td>
<td>6.375%</td>
<td>7.0%</td>
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<tr>
<td>Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)</td>
<td>20%</td>
<td>40%</td>
<td>60%</td>
<td>80%</td>
<td>100%</td>
<td>100%</td>
<td></td>
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</tr>
<tr>
<td>Minimum Tier 1 Capital</td>
<td>4.5%</td>
<td>5.5%</td>
<td>6.0%</td>
<td>6.0%</td>
<td>6.0%</td>
<td>6.0%</td>
<td>6.0%</td>
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</tr>
<tr>
<td>Minimum Total Capital</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
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</tr>
<tr>
<td>Minimum Total Capital plus conservation buffer</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.625%</td>
<td>9.25%</td>
<td>9.875%</td>
<td>10.5%</td>
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<tr>
<td>Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital</td>
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<td>Phased out over 10 year horizon beginning 2013</td>
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*E). TRANSITIONAL ARRANGEMENT*
THANK YOU