World Council's Summary of the Basel III Final Standard
Updated December 8, 2017

On December 7, 2017, the Basel Committee on Banking Supervision issued the final version of the Basel III capital accord. The 158-page final Basel III standard includes significant regulatory burden reductions for community-based financial cooperatives including credit unions, mutual banks and building societies.

Basel III is expected to become the international capital and liquidity standard for depository institutions in most jurisdictions whether or not they operate on a cross-border basis. Most aspects of Basel III will phase-in in January 2019, however, the final standard delays the compliance dates for some aspects of Basel III until January 2022 or later.

The key aspects of the final Basel III standard of interest to community-based financial cooperatives include:

1) **Capital Requirements for Consumer and Small Business Loans Weighted at 75% of Face Value:** Most loans to consumers and small and medium enterprises (SMEs) will qualify for a 75% of face value "regulatory retail" risk weight, including personal signature loans, credit cards and other lines of credit, auto loans and leases, student and educational loans, and small business loan facilities and commitments. While Basel II had a similar 75% risk-weight for retail exposures, it was unclear previously whether the final version of Basel III would continue this favorable risk-weight.

2) **Capital Requirements Reduced for Most Residential Mortgages:** Basel III adopts a sliding scale for mortgage risk-weights based on loan-to-value (LTV) ratios. Loans with an 80% or lower LTV ratio—such as loans with a traditional 20% down payment as well as seasoned mortgages—will have lower capital requirements than Basel II's 35% risk-weighting for mortgages, as follows:

	LTV ≤ 50%	50% < LTV ≤ 60%	60% < LTV ≤ 80%	80% < LTV ≤ 90%	90% < LTV ≤ 100%	LTV > 100%
Risk Weight	20%	25%	30%	40%	50%	70%

Alternatively, an institution can split a mortgage into two or more separate exposures, such as to take into account mortgage insurance or a guarantee. Under this alternative approach, an institution can assign a 20% risk-weight to the part of the loan up to 55% of the residential property's value, and assign the remaining balance of the loan a risk-weight based of 75% for residential

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mortgages and/or a risk-weight based on the creditworthiness of the mortgage insurer or guarantor.

3) **Mortgage Guarantees/Insurance Provide Capital Relief:** Mortgage insurance and guarantees in the final version of Basel III receive a risk-weighting as though the insured/guaranteed amount were an unsecured claim on the guarantor, using the loan-splitting approach discussed in section 2, above.

   This approach, which was urged by World Council in our comments to the Committee, will significantly reduce mortgages' risk-based capital requirements, especially when the guarantee is from a government-sponsored enterprise such as the Canada Mortgage and Housing Corporation.

   For example, if the mortgage insurance is provided by a government-sponsored enterprise that is backed by the full faith and credit of a sovereign government that has very strong creditworthiness, the guaranteed amount of the mortgage would generally receive a 0% risk-weighting. Private mortgage insurance from a very creditworthy private-sector insurance company would generally receive a 20% risk-weighting.

4) **Mortgages for Second Homes and Investment Properties Receive Favorable Risk-Weightings:** As urged by World Council, the final version of the Basel III standard provides more favorable capital treatment for second-home and investment-property mortgages than the Committee originally proposed.

   Second-home and investment-property mortgages will be treated as owner-occupied residential mortgages—using the risk-weightings described in section 2 of this summary, above—unless the institution's underwriting process indicates that the loan is "materially dependent" on rental income from the property. "Materially dependent" is defined as the borrower only being able to afford the mortgage if more than 50% of the funds needed to pay for the mortgage come from rental income.

   Investment-property mortgages that are materially dependent on rental income will require some additional capital compared to owner-occupied mortgages, however, the Committee has not adopted the punitive 70% to 120% risk-weights it originally proposed. Instead, investment property mortgages that are materially dependent on rental income will be risk-weighted based on LTV ratios, as follows:

	LTV ≤ 50%	50% < LTV ≤ 60%	60% < LTV ≤ 80%	80% < LTV ≤ 90%	90% < LTV ≤ 100%	LTV > 100%
Risk Weight	30%	35%	45%	60%	75%	105%

5) **Operational Risk Reserve Requirements Reduced for Smaller Institutions:** The final Basel III standard implements a new approach to operational risk that sets three marginal rates based on a "business indicator" measure roughly equivalent the institution's total net income. Institutions with less than EUR 1 billion a year in net income would set their operational risk reserves at approximately 12% of net income, which is a significant reduction from the 15% of net income operational risk reserve required under Basel II's basic approach. Few, if any, community-based financial cooperatives have net annual income in excess of EUR 1 billion.

   Institutions with net income between EUR 1 billion and EUR 30 billion would reserve for operational risk at 15% of net income, and then increase this amount using a multiplier based on the institution's historical losses. Institutions with more than EUR 30 billion a year in net income would reserve for operational risk at 18% of net income and then increase it by the multiplier based on the institution's historical losses.

6) **Preserved Access to Interbank Lending for Institutions Without Credit Ratings:** The final Basel III standard preserves access to interbank lending for community-based depository institutions that do not have a credit rating. As urged by World Council, the Committee has established a risk-weighting framework for exposures to depository institutions that is based on whether or not the counterparty depository institution is well capitalized, adequately capitalized or undercapitalized under its applicable regulatory capital rules, as follows:

Credit risk assessment of counterparty	"Grade A" (Well Capitalized)	"Grade B" (Adequately Capitalized)	"Grade C" (Undercapitalized)
"Base" risk weight	40%	75%	150%
Risk weight for short-term exposures	20%	50%	150%

7) **Large Bank's Subject to "Capital Floor" that Levels the Regulatory Playing Field with Smaller Depository Institutions:** The final version of Basel III places new limits on the ability of large banks using "internal ratings based" approaches that in-effect allow the large banks to write their own capital rules. These banks will not be allowed to reduce their capital requirements lower than 72.5% of what the large bank's capital requirements would be under the Basel III standardized approach.

World Council advocated strongly in favor of establishing a capital floor requirement for large banks in order to reduce these large banks' regulatory capital arbitrage advantages over credit unions and other community-based financial cooperatives that follow the Basel III standardized approach.

This capital floor requirement phases in over several years with the floor being set a 50% of a standardized approach institution's capital requirement beginning in January 2022 and rising to 72.5% by January 2027.

8) **Systemically Important Banks' Leverage Ratio Increased:** The final version of Basel III also requires Global Systemically Important Banks (G-SIBs) to increase their minimum leverage ratio requirements. Basel III sets a generally applicable leverage ratio requirement of 3% relative to total assets, but G-SIBs will be required to have a higher minimum leverage ratio requirement with an add-on based on the banks' risk-based capital buffer requirements (i.e. the amount above the minimum capital level that the institution must hold in order to be considered to be well capitalized). The leverage ratio add on will be equivalent to 50% of the G-SIB's risk-based capital buffer requirements. The Financial Stability Board has previously set a minimum leverage ratio for G-SIBs of 6%.

9) **Delayed Compliance Dates for Revised Approaches to Credit Risk, Operational Risk, Etc.** Most aspects of Basel III will phase-in as the international standard for depository institution capital and liquidity rules around the world starting January 1, 2019. The final Basel III standard, however, delays until January 1, 2022 the compliance dates for the revised standardized approach for credit risk, the revised internal-ratings based approach to credit risk, the revised operational risk framework, and some aspects of the revised leverage ratio.

If you have questions regarding this summary, please contact World Council's VP & General Counsel Michael Edwards (medwards@woccu.org) or Regulatory Counsel Andy Price (aprice@woccu.org).