

Basel 2 & 3 Rules in the UEMOA Region

Overview and Perspectives



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Basel Rules: The Fundamentals

What?

Why?



How?

When?

Basel Rules – Historical background

- The Basel Committee on Banking Supervision has its origins in the financial market turmoil that followed the breakdown of the Bretton Woods system of managed exchange rates in 1973. After the collapse of Bretton Woods, many banks incurred large foreign currency losses.
- On 26 June 1974, West Germany's Federal Banking Supervisory Office withdrew Bankhaus Herstatt's banking license after finding that the bank's foreign exchange exposures amounted to three times its capital. Banks outside Germany took heavy losses on their unsettled trades with Herstatt, adding an international dimension to the turmoil. In October the same year, the Franklin National Bank of New York also closed its doors after incurring large foreign exchange losses.
- In response to these and other disruptions in the international financial markets, the central bank governors of the G10 countries established a Committee on Banking Regulations and Supervisory Practices at the end of 1974. Later renamed the Basel Committee on Banking Supervision, the Committee was designed as a forum for regular cooperation between its member countries on banking supervisory matters. Its aim was and is to enhance financial stability by improving supervisory knowhow and the quality of banking supervision worldwide.

Basel I – Core Principles

- The 1988 Basel Accord called for a minimum capital ratio of capital to risk-weighted assets of 8% to be implemented by the end of 1992. The focus of the Accord was Credit Risk.
- Assets (on-and off-balance sheet) of banks were classified and grouped in five categories according to credit risk, carrying risk weights of 0% (Cash, Bullion, Home Country Debt Like Treasuries), 10%, 20% (Interbank), 50% (Mortgages), 100% (Loans) and no rating.
- Banks with an international presence are required to hold capital equal to 8% of their risk-weighted assets (RWA) - At least, 4% in Tier I Capital (Equity Capital + retained earnings) and more than 8% in Tier I and Tier II Capital.

Subsequent Amendments

- Nov. 1991 → Precision on Incorporation of General provisions into CAR calculation
- April 1995 → Treatment of banks' exposures in derivative products (bilateral and multilateral netting) and add-on factors
- Jan. 1996 → Market Risk Amendment: capital requirement for banks' exposures to FX, Commodities, Equities, and Options. For the first time, banks are allowed to use internal VaR models.

Overly simple Basel I rules were subject to “regulatory arbitrage” and poor risk management, which paved the way for Basel II Accord under Chairmen William McDonough (1999) and Jaime Caruana (2004)

Basel II – Motives and Objectives

Addressing key issues in Basel I

- Club-rule (being a member of OECD) is not meaningful in terms of riskiness
- “Broad brush” and lacks risk differentiation: One size fits all
- Divergence between Basel I risk weights and actual economic risks
- Regulatory arbitrage (Solved?)
- Inadequate recognition of advanced credit risk mitigation techniques (Securitization, CDS, etc.)

Main Objectives

- Eliminate regulatory arbitrage
- Get risk weights right
- Align regulation with best practices in risk management
- Provide banks with incentives to enhance risk measurement and management capabilities

“Basel II is not intended simply to ensure compliance with a new set of capital rules. Rather, it is intended to enhance the quality of risk management and supervision.”

Jaime Caruana, Governor of the Banco de España
Former Chairman of Basel Committee

Basel II – Three Key Pillars

--- Pillar I --- Minimum Capital Requirements

- Risk Management Incentives
- New Operational Risk Capital Charge
- More Risk sensitive approach to Risk Weighted Assets Computation
- Market Risk largely unchanged

--- Pillar II --- Supervisory Review Process

- Solvency reports
- Regulatory Review
- Capital Determination
- Regulatory Intervention
- Approaches to accounting for risks that are not captured in Pillar I like concentration, interest rate and liquidity risks.

--- Pillar III --- Market Discipline

- Minimum disclosure requirements
- Capital transparency
- Capital adequacy
- Capital measurement and management
- Risk profiling

→ The **Second Pillar** allows supervisors to ensure that the internal risk management systems and internal capital adequacy assessment process (ICAAP) set up by banks are adequate.

→ The **Third Pillar** defines the disclosure requirements for the types and amounts of risks that banks take. The hope is that public disclosure of risk would reinforce market discipline.

Basel II – Quick overview of CAR calculation

--- Pillar I - 1 --- Credit Risk Weighting

Two Approaches:

- The Standardized Approach that relies on external ratings (i.e. ratings by rating agencies such as Moody's, S&P, and Fitch).
- The Internal Ratings-Based (IRB) Approach, available with two options:
 - (i) foundation IRB and,
 - (ii) advanced IRB

--- Pillar I - 2 --- Market Risk

- Focus is on risk of losses of on-and off-balance sheet positions arising from movements in market price (interest rate, equities, FX and commodities)
- Allows for the measurement of total aggregate risk in a bank's trading book.
- Approaches used include Value at Risk, Stress Testing and Scenario Analysis

--- Pillar I - 3 --- Operational Risk

Operational risk refers to the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. Its computation relies on three Approaches:

- Basic Indicator Approach
- Standardized Approach
- Advanced Measurement Approach

$$\frac{\text{Total capital}}{\text{Credit risk RWA} + \text{Market risk RWA} + \text{Operational risk RWA}} = \text{The bank's capital ratio} \geq 8\%$$

Quick overview of Basel II Credit Risk Weighting Approaches

The Standardized Approach

- Approach very similar to the original Basel I calculation. However, instead of assigning an identical weighting of 100 percent to all loans, the weighting reflects the riskiness of the transaction as identified by ratings of external rating agencies such as Moody's, S&P and Fitch.
- Good progress compared Basel I. But still, for loans to unrated corporations, the weighting is 100 percent, identical to that under Basel I. Since many corporations in a number of countries of the emerging world (Africa, Asia, and Latin America for instance) are unrated, the Standardized Approach is barely helpful in adjusting capital charges to the riskiness of loan portfolios. Hence the Internal Ratings-Based Approach

	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	Below BB-	Unrated
Corporate	20%	50%	100%	100%	150%	100%

The Internal Ratings-Based (IRB) Approach

- Under the IRB approaches, banks have to calculate themselves the probability of default (PD) of a corporate client over a one-year horizon.
- Once the PD has been estimated, a formula devised by the Basel Committee is applied to calculate the capital charge. The terms of the formula are: PD, LGD, Maturity, maturity adjustment – b (PD), correlation (R), cumulative standard normal distribution – N (.) and inverse cumulative normal distribution IN (.).

Quick overview of Basel II Operational Risk Computation Approaches

Basic Indicator Approach

- Operational Risk Capital = α * Gross Revenue
- α is a percentage set by regulator

Standardized Approach

- Operational Risk Capital = β * Gross Revenue per business line averaged over the last three years
- β is a percentage set by regulator

Advanced Measurement Approach

- Operational Risk Capital = risk measure generated by the bank's own operational risk measurement system

Business Lines	Beta Factors
Corporate Finance	18%
Trading and Sales	18%
Retail Banking	12%
Commercial Banking	15%
Payment and Settlements	18%
Agency Services	15%
Asset Management	12%
Retail Brokerage	12%

Under the standardized approach, and in the case of retail banking, the capital is calculated as follows:

$$\text{Capital}_{\text{retail}} = 12\% \times \text{average gross income of last 3 years}$$

$$\text{RWA operational risk} = \text{Capital} \times 12.5.$$

Basel III – Why another set of Basel Rules?

- Compared to Basel I, the Basel II rules profoundly altered banks' aggressive risk taking behavior. However, it contained gaps that banks were able to exploit.
- The 2008 financial crisis exposed the limitations of the Basel II Risk ratings-based approaches. For example, several of the external rating agencies whose ratings the approaches were supposed to rely on failed to be objective, as exposed by the subprime crisis.
- Even before Lehman Brothers collapsed on September 15, 2008, the Basel Committee had acknowledged the deficiencies of the Basel II Framework, and called for further strengthening of certain aspects of the rules, including:
 - Higher capital requirements for certain complex structured credit products: “re-securitizations”, CDOs, ABS, etc. for trading books and off-balance sheet SPVs”
 - The need to improve management of firm-wide risks, banks' stress-testing practices, capital planning processes, risk management tools for securitizations activities, and supervisory assessment of banks' valuation practices.
 - Banks' need for stronger liquidity cushion in order to weather prolonged periods of financial markets stress and liquidity.
 - Better monitoring of concentration risks
 - Enhanced disclosures.

Basel III – What is it?

- Basel 3 is the third set of international standards for bank regulations proposed by the Basel Committee of Banking Supervision.
- The proposed new standards are aimed at strengthening the capital and liquidity regulations for banks. Basel III builds upon and enhances the regulatory framework adopted by Basel II and Basel 2.5
- First draft was published in December 2009, revised draft in August 2010, agreement announced on Sep. 12, 2010.
- Basel Committee on Banking Supervision (BCBS) members agreed to implement Basel III from 1 January 2013, subject to transitional and phase-in arrangements
- Many countries have announced their own regulations based on Basel 3.

Basel III – What does it cover?

Basel 3 includes rules for the following:

- Higher capital adequacy ratios
- Leverage ratio
- Liquidity ratio – short term
- Net stable funding ratio – long term
- Supervision (and extra capital) of Global Systemically Important Banks (G-SIBs)
- Risk Coverage:
 - Securitizations, Trading Book and Counterparty Credit Risk
 - Risk Data Aggregation Capabilities and Disclosures
 - Exposures to Central Counterparties (CCPs)
- Forward Looking Loan Loss Provisioning (including a “directive” to the IASB to sort out IAS39) – included in IFRS9.

Basel III – The Details

In summary, Basel 3 seeks to:

- Raise the quality, consistency, and transparency of the capital base
- Strengthen the risk coverage of the capital framework
- Improve risk weightings, particularly for off-balance sheet instruments and exposures
- Introduce a leverage ratio as a supplementary measure to the Basel II risk-based framework
- Promote the build up of capital buffers in good times
- Require a minimum liquidity standard
- Require additional capital for internationally active banks.

Basel III – Increased Capital Requirements...

Phases - 1 January	2013	2014	2015	2016	2017	2018	2019
Minimum Tier 1	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer	8.0%	8.0%	8.6%	9.3%	9.9%	10.5%	10.5%

- Increased capital ratios (Common Equity Tier 1, Tier 1, Capital Conservation buffer, Countercyclical Capital buffer)
- Common Equity Tier 1 increases to at least 4.5% of RWA
- Total Tier 1 Capital must be at least 6.0% of RWA
- Total Capital (Tier 1 Capital plus Tier 2 Capital) must be at least 8.0% of RWA

Basel III – Increased Capital Requirements...

Total Regulatory Capital

- Total regulatory capital consists of the following elements:
 - Tier I Capital (Going concern Capital) → Common Equity Tier 1 + Additional Tier 1
 - Tier 2 Capital (Gone concern Capital)
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Common Equity Tier 1

- Common Equity Tier 1 consists of:
 - Common shares
 - Stock surplus (share premium)
 - Retained earnings
 - Accumulated other comprehensive income and other disclosed reserves;
 - Common shares issued by consolidated subsidiaries of the bank and held by third parties (minority interest - restricted).
 - Deductions from Common Equity Tier 1 Capital:
 - goodwill and other intangibles
 - deferred tax assets
 - cash flow hedge reserve,
 - gain on sale related to securitization transactions
 - defined benefit pension fund assets and liabilities
 - all unrealized gains and losses due to changes in the bank's own credit risk.
 - Capital loss absorption at the point of non-viability: contractual terms of capital instruments will include a clause that allows – at the discretion of the relevant authority – write-off or conversion to common shares if the bank is judged to be non-viable.
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Capital Buffers

- Capital conservation buffer comprising common equity of 2.5% of RWA, bringing the total common equity standard to 7%.
- Countercyclical buffer imposed within a range of 0-2.5% comprising common equity, when authorities judge credit growth is resulting in an unacceptable build up of systematic risk.

Basel III – Increased Capital Requirements...

Capital Conservation Buffer

- A capital conservation buffer of 2.5%, comprised of Common Equity Tier 1, is established above the regulatory minimum capital requirement
- Capital/profit/dividend distribution constraints will be imposed on a bank when capital levels fall within a specified range, but except for this restriction banks will be able to conduct business as normal when their capital levels fall into the conservation range.

Countercyclical capital buffer

- Ensure that capital requirements take account of the macro-financial environment
- Nationally determined when excess loan growth may result in system-wide risk
- Countercyclical buffer will vary between zero and 2.5% to total risk weighted assets.
- Has to be Common Equity Tier 1.

Common Equity Tier 1 Ratio		Minimum Capital Conservation Ratios (% Earnings)
Lower range	Up to	Profit retention
4.500%	5.13%	100%
5.130%	5.75%	80%
5.750%	6.38%	60%
6.375%	7.00%	40%
Over	7.00%	0%

Calibration of Capital Framework			
	Common Equity Tier 1	Tier 1 Capital	Total Capital
Minimum	4.50%	6%	8%
Conservation Buffer	2.50%		
Minimum + conservation buffer	7%	8.50%	10.50%
Countercyclical buffer range	0%-2.5%		

An additional capital charge is required for Systemically Important Banks

Basel III – Leverage Ratio

- Leverage ratio includes off-balance sheet (OBS) items and will supplement the risk-based capital requirements.
- Banks should calculate OBS items by applying a uniform 100% credit conversion factor (CCF); for any commitments that are unconditionally cancellable at any time by the bank, banks should apply a CCF of 10%.
- Further review to ensure that the 10% CCF is appropriately conservative based on historical experience to be conducted.
- 3% min leverage ratio outlined in BCBS Basel III framework issued in December 2010.
- Supervisory monitoring started in 2011, parallel run from 1 Jan 2013 to 2017, disclosure in 2015, formal implementation in 2018.

$$\text{Leverage ratio} = \frac{\text{Tier 1}}{\text{On + Off B/S items}} \geq 3\%$$

Basel III – Liquidity and Funding

Stock of high-quality liquid assets

Total net cash outflows over the next 30 calendar days

- Liquidity Coverage Ratio (LCR) – short term – 30 days, enough liquid assets to cover cash outflows.
 - Net Stable Funding Ratio (NSFR) – sufficient access to funds, up to one year, to fund assets, loans and investments.
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- Sufficient liquid assets to meet liquidity outflow over next 30 days, in stressed situations. Liquid Assets features:
 - Low credit and market risk
 - Ease and certainty of valuation
 - Low correlation with risky assets
 - Active and sizable market
 - Ideally the assets should be eligible at central banks for intraday and overnight liquidity facilities, as collateral for cash.

Liquidity Coverage Ratio – Numerator

- **Level 1 assets:** cash, central bank reserves, marketable securities representing claims on sovereigns and similar, risk weighted at 0%, traded, and with proven record of liquidity in stressed conditions.
- **Level 2 assets :**
 - marketable securities representing claims on sovereigns and similar, risk weighted at 20%, traded, and with proven record of liquidity – even in stressed conditions.
 - corporate bonds and covered bonds rated at least AA- and not issued by a financial institution.
 - Level 2 assets can only comprise up to 40% of the total.
 - Minimum 15% haircut to the market value of each Level 2 asset is applied. Larger haircut for level 2b assets.

Liquidity Coverage Ratio – Denominator

- **Total net cash outflows over the next 30 calendar days = outflows – Min {inflows; 75% of outflows}**
 - Total expected cash outflows minus total expected cash inflows in the specified stress scenario for the subsequent 30 calendar days.
 - Total expected cash outflows are calculated by multiplying the outstanding balances of various categories of liabilities and off-balance sheet commitments by the rates at which they are expected to be drawn down.
 - Total expected cash inflows are calculated by multiplying the outstanding balances of various categories of contractual receivables by the rates at which they are expected to flow in under the scenario up to an aggregate cap of 75% of total expected cash outflows.

Liquidity Coverage Ratio – Phase-in Arrangement

- Specifically, the LCR was introduced as planned on 1 January 2015, but the minimum requirement will begin at 60%, rising in equal annual steps of 10 percentage points to reach 100% on 1 January 2019.
- This graduated approach is designed to ensure that the LCR can be introduced without disruption to the orderly strengthening of banking systems or the ongoing financing of economic activity. Total expected cash outflows minus total expected cash inflows in the specified stress scenario for the subsequent 30 calendar days.

	2015	2016	2017	2018	2019
Minimum LCR Requirement	60%	70%	80%	90%	100%

Net Stable Funding Ratio

Focus on liabilities – sources of funds to cover assets. Defined to include:

- Capital
- Preferred stock with maturity \geq than one year
- Liabilities with effective maturities of \geq than one year
- “Sticky/Stable” non-maturity deposits and/or term deposits with maturities of less than one year
- “Sticky/Stable” wholesale funding with maturities of less than a year
- “Sticky” means not likely to be withdrawn in an idiosyncratic stress event
- Not yet defined in detail
- Currently in observation period
- Target date for implementation is 1 January 2018.

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$$

Basel Rules Implementation in SSA (excl. UEMOA)

Country	Basel I	Basel II	Basel III
Kenya		✘	<i>Steps to transition to Basel III undertaken</i>
Nigeria		✘	<i>Steps to transition to Basel III undertaken</i>
South Africa		✘	<i>Steps to transition to Basel III undertaken</i>
Rwanda		✘	
Tanzania		✘	
Ghana	✘		
CEMAC	✘		
Mauritius		✘	<i>Steps to transition to Basel III undertaken</i>
Angola		✘	
Zambia		✘	
Malawi		✘	
Zimbabwe		✘	

Basel 2/3 Implementation Framework in the UEMOA Zone

Banking regulation in UEMOA – Towards a third regulatory framework

September
1989

- First regional regulatory framework for the UEMOA banking sector,
- The purpose of this UEMOA wide banking Law was to harmonize banking regulation across member countries following creation of the banking Commission the same year.

July 2008
Current

- The 1989 Law was amended in the context of Basel 2 and of the financial crisis to increase the minimum capital requirements for banks
- The new Law broadened the scope of the Banking Commission's supervisory power to include MFIs. Bank's definition also changed from "*Banque*" to "*Etablissement de Crédit*"

June 2016
Basel 2/3

- New Regulatory package approved by the UEMOA Council of Ministers of Finance on June 25, 2016 in Lome.
- Paves the way for the implementation of Basel 2 and 3 by 2021.
- Does not cover Liquidity aspects of Basel 3



The UEMOA New Banking Law: A combination of the Basel 2 and 3 rules

The New regulatory package represents a big jump from the Basel I framework the region has used for almost three decades.

The newly approved rules are organized along the Basel 2 Three Pillars:

- Pillar I: Minimum Capital Requirements –
 - Total Capital is computed based on Basel 3 guidelines.
 - RWA calculation is as per Basel 2 rules incorporating a risk sensitive approach to assessing credit risk, operational risk and market risk
 - Rules for Credit Risk Mitigation instruments
 - EGER limit revised down to 25% from 75% starting in 2017 (65%)
- Pillar II: Supervisory Review Process – Mainly inspired from Basel 2
- Pillar III: Market Discipline - Basel 2

UEMOA New Banking Law : Close to Full adoption of the Basel 3 Definition of Capital

UEMOA rules

Components of capital

- Common Equity Tier 1 (5% min of RWA)
- Additional Tier 1
- Tier 1 Capital (6% min of RWA)
- Tier 2 Capital (4%) → Tier 1 & 2 of 10%

Common Equity Tier 1

- Common shares
- Stock surplus
- Retained Earnings
- Accumulated OCI and other disclosed reserves
- Special reserves @15% p.a. capped at 20% of share capital

Additional Tier 1 Capital (AT1)

- Instruments issued by the bank that meet specific criteria set out for inclusion in AT1
- Stock Surplus resulting from the issuance of these instruments

Other Considerations

- Criteria for inclusion in CET 1 and AT 1 are same as per Basel 3 guidelines
- Adjustments to CET 1, AT1 and T2 are the same

Basel 3

- Common Equity Tier 1 (3.5% min)
- Additional Tier 1
- Tier 1 Capital (4.5% min)
- Tier 2 Capital
- Tier 1 & Tier 2 Capital of 8% min

- Common shares
- Stock surplus
- Retained Earnings
- Accumulated OCI and other disclosed reserves
- Common shares issued by consolidated subsidiaries

- Instruments issued by the bank that meet specific criteria set out for inclusion in AT1
- Stock Surplus resulting from the issuance of these instruments
- Instruments issued by consolidated subsidiaries and Applicable Regulatory adjustments

- Criteria for inclusion in CET 1 and AT 1 set by BCEAO are same as per the Basel's Adjustments to CET 1, AT1 and T2 are the same

New Banking Law : Capital Buffers

UEMOA rules

Conservation Buffer

- Above the regulatory minimum outside periods of stress. Should be comprised of CET 1 (2.5% of RWA)
- Capital distribution constraints to be imposed on banks if capital falls within this range. Such banks can continue their activity

Capital conservation standards

- CET1: 4.5% - 5.625% → 100% of profit retained
- CET1: >5.625% - 6.25% → 80% of profit
- CET1: >6.25% - 6.875 → 60% of profit retained
- CET1: >6.875 - 7.500% → 40% of profit retained
- CET1: >7.500% → 0% of profit retained

Countercyclical Buffer

- Nationally determined when excess loan growth may result in system-wide risk.
- Countercyclical buffer will vary between zero and 2.5% to total risk weighted assets.
- Has to be Common Equity Tier 1.

Systemic Buffer

- Additional buffer applicable for SIBs as defined by BCEAO

Basel 3

Buffer above the regulatory minimum to be held outside periods of stress

- Capital conservation buffer should be comprised of CET 1 (2.5% of RWA)
- Capital distribution constraints will be imposed on banks' capital fall within this range. Such banks can continue their activity

- CET1: 4.5% - 5.125% → 100% of profit
- CET1: >5.125% - 5.75% → 80% of profit
- CET1: >5.75% - 6.375% → 60% of profit
- CET1: >6.375% - 7.0% → 40% of profit
- CET1: > 7.0% → 0% of profit

- Nationally determined when excess loan growth may result in system-wide risk.
- Countercyclical buffer will vary between zero and 2.5% to total risk weighted assets.
- Has to be Common Equity Tier 1.

- Additional buffer applicable for SIBs as defined by BCEAO

New Banking Law – Credit Risk to be computed using the Basel II Standardized Approach

The Standardized Approach

- Approach very similar to the original Basel I calculation. However, instead of assigning an identical weighting of 100 percent to all loans, the weighting reflects the riskiness of the transaction as identified by ratings of external rating agencies such as Moody's, S&P and Fitch.
- Risk weights proposed in the new regulation are the same for claims on sovereigns (in this case UMOA States, Central banks and non financial international institutions) as were adopted in the original Basel II guidelines.
- Ratings are either issued by Rating Agencies or Export Credit Agencies.

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Sovereigns	0%	20%	50%	100%	150%	100%
Parastatals	20%	50%	100%	100%	150%	100%
Multilateral Dev. Banks	20%	50%	50%	100%	150%	50%
FI > 3 months	20%	50%	50%	100%	150%	50%
FI < 3 months	20%	20%	20%	50%	150%	20%
	AAA to AA-	A+ to A-	BBB+ to BB-		Below BB-	Unrated
Corporates	20%	50%	100%		150%	100%

New Banking Law – Credit Risk to be computed using the Basel II Standardized Approach (Cont'd)

The Standardized Approach

- Claims on the following DFIs will be risk-weighted at 0% : IBRD, IFC, ADB, AFDB, EBRD, IADB, EIB, EIF, NDB, CDB, IDB, MIGA.
- Claims on BOAD will also be risk-weighted at 0% (rated BBB by Moody's)
- Claims included in the regulatory retail portfolios (under certain conditions: orientation criterion, product criterion, granularity and maximum aggregated exposure to one economic group not higher than EUR 1 million) may be risk-weighted at 75%
- Lending fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is rented, will be risk weighted at 35%, provided LTV is 80% max. and minimum DSCR is 2.9x.
- Past due loans
 - The unsecured portion of any loan (other than a qualifying residential mortgage loan) that is past due for more than 90 days, net of specific provisions (including partial write-offs), will be risk-weighted as follows:
 - (i) 150% risk weight when specific provisions are less than 20% of the outstanding amount of the loan;
 - (ii) 100% risk weight when specific provisions are no less than 20% of the outstanding amount of the loan;
 - (iii) 100% risk weight when specific provisions are no less than 50% of the outstanding amount of the loan, but with supervisory discretion to reduce the risk weight to 50%.
- **The new regulation brings NPL recognition to 90 days past due, excluding claims on UMOA governments, UMOA parastatals and SMEs for which classification as NPLs is subject to a 180 days past due.**
- The weight for higher-risk categories has been set at 150% minimum as per the Basel II guidelines.

New Banking Law – Credit Risk to be computed using the Basel II Standardized Approach (Cont'd)

The Standardized Approach (Other Assets and Off-Balance Sheet Items)

- **Other Assets:** Consistently with Basel II, a list of Other Assets has been defined with specific risk-weights based on pre-set criteria. Most relate to investments in equity or regulatory capital instruments issued by banks or securities firms that will be risk weighted at 100%
- **Off-Balance sheet Items:** in line with the standardized approach, OBS items will be converted into credit exposure equivalents through the use of credit conversion factors (CCF) based on counterparty's rating. The new rules present five (5) categories of such counterparty risks, rated 10% (Low risk, such as commitments that are valid only if the counterparty maintains a minimum credit quality), 20% (Minor risk, such as collateralized short term LCs), 50% (Medium risk, > 1 year unsecured LCs, bidding/performance bonds), 75% (High risk, commitment of credit lines), and 100% (Very high risk, sales of assets with recourse, factoring facilities, margin lending, etc.)
- **Credit Risk Mitigation situations (including RSFs):**
 - Weightings are set for a number of credit enhancement situations. In such cases assigned weightings should not be higher than without the enhancement.
 - Eligible CRMs are: collaterals (cash, gold, debt securities, equities, convertible bonds,, etc.), guarantees (sovereign including MDBs such as IBRD, IFC, EBRD, EIB, and non-sovereign), and credit derivatives,
 - Risk weights are based on two approaches: the simple approach (substitution for counterparty risk weighting, subject to a 20% floor) and the comprehensive approach which allows fuller offset of collateral against exposures.

New Banking Law – Operational Risk to be computed using the Basel II Basic Indicator or Standardized Approach

Approaches to Measuring Operational Risk

- Definition: Same as in Basel II rules : “risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.
- Approaches to measuring operational risks: banks in the UEMOA region will have to choose between the Basic Indicator Approach and the Standardized Approach.
 - Basic Indicator Approach: banks in UEMOA must hold capital for operational risk equal to the average over the previous three years of a 15% of positive annual gross income. Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average.
 - In the Standardized Approach, banks’ activities are divided into eight business lines. The capital charge for each business line is calculated by multiplying gross income by a factor (denoted beta) assigned to that business line. Beta serves as a proxy for the industry-wide relationship between the operational risk loss experience for a given business line and the aggregate level of gross income for that business line.
 - The UEMOA betas are the same as per the Basel Committee recommendation: corporate finance (18%), trading & sales (18%), retail banking (12%), commercial banking (15%), payment & settlement (18%), agency services (15%), asset management (12%), and retail brokerage (12%).

New Banking Law – Market Risk to be computed using the Basel II Standardized Approach

Approaches to Measuring Market Risk

- **Definition of Trading book:** positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book. To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants on their tradability or able to be hedged completely. In addition, positions should be frequently and accurately valued, and the portfolio should be actively managed.
- Valuation **Methodologies:** Marking to Market, Marking to Model (if marking to market is not feasible), Independent price verification (in addition to marking to market or to model). Valuation adjustments are allowed.
- Approaches to measuring market risk: specific rules are provided for computing markets risk related capital charges.

EGE and RP

- A section of the new regulation provides for detailed definition of economic group exposure which is in line with the IFC definition and limit (25%), but clearly states that this definition does not apply in the case of entities directly or indirectly controlled by the central government, including parastatals.

New UEMOA Banking Law – Leverage Ratio

Leverage Ratio

- **Rationale and Objective:** one of the underlying features of the crisis was the build-up of excessive on- and off-balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while still showing strong risk based capital ratios. During the most severe part of the crisis, the banking sector was forced by the market to reduce its leverage in a manner that amplified downward pressure on asset prices, further exacerbating the positive feedback loop between losses. The leverage ratio, a non-risk based measure, is intended to act as a credible supplementary measure to the risk-based capital requirement.
- **Definition:** The basis of calculation is the average of the monthly leverage ratio over the quarter based on the definitions of capital under Basel 3. The minimum Tier 1 leverage ratio is set at 3%.
- **Computation:**
$$\text{Leverage ratio} = \frac{\text{Tier 1}}{\text{On + Off B/S items}} \geq 3\%$$

New UEMOA Banking Law – Supervisory Review Process and Market Discipline are fully adopted from Basel II

--- Pillar II --- Supervisory Review Process

- Solvency reports
- Regulatory Review
- Capital Determination
- Regulatory Intervention
- Approaches to accounting for risks that are not captured in Pillar I like concentration, interest rate and liquidity risks.

--- Pillar III --- Market Discipline

- Minimum disclosure requirements
- Capital transparency
- Capital adequacy
- Capital measurement and management
- Risk profiling

→ The **Second Pillar** allows supervisors to ensure that the internal risk management systems and internal capital adequacy assessment process (ICAAP) set up by banks are adequate.

→ The **Third Pillar** defines the disclosure requirements for the types and amounts of risks that banks take. The hope is that public disclosure of risk would reinforce market discipline.

New UEMOA Banking Law – Phase-In Arrangements

Phases - 1 January		2013	2014	2015	2016	2017	2018	2019	2020	2021
Minimum Tier 1	BASEL 3	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
	BCEAO	-	-	-	-	5.0%	5.0%	5.0%	5.0%	5.0%
Minimum Total Capital	BASEL 3	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
	BCEAO	-	-	-	8.0%	8.0%	8.5%	9.0%	9.5%	10.0%
Minimum Total Capital plus conservation buffer	BASEL 3	8.0%	8.0%	8.6%	9.3%	9.9%	10.5%	10.5%	10.5%	10.5%
	BCEAO	-	-	-	-	8.625%	9.75%	10.875%	12.0%	12.5%
Min LCR requirement	BASEL 3			60.0%	70.0%	80.0%	90.0%	100.0%	100.0%	100.0%
	BCEAO	-	-	-	-	-	-	-	-	-

→ While the above timeline has been approved by the Council of Ministers of Finance on June 25th, there is serious doubt about the implementation timeline of the new rules.

→ The rules on Liquidity are still to be finalized and may have a different phase-in arrangement.

Question: How could IFC influence this implementation process?

Thank you