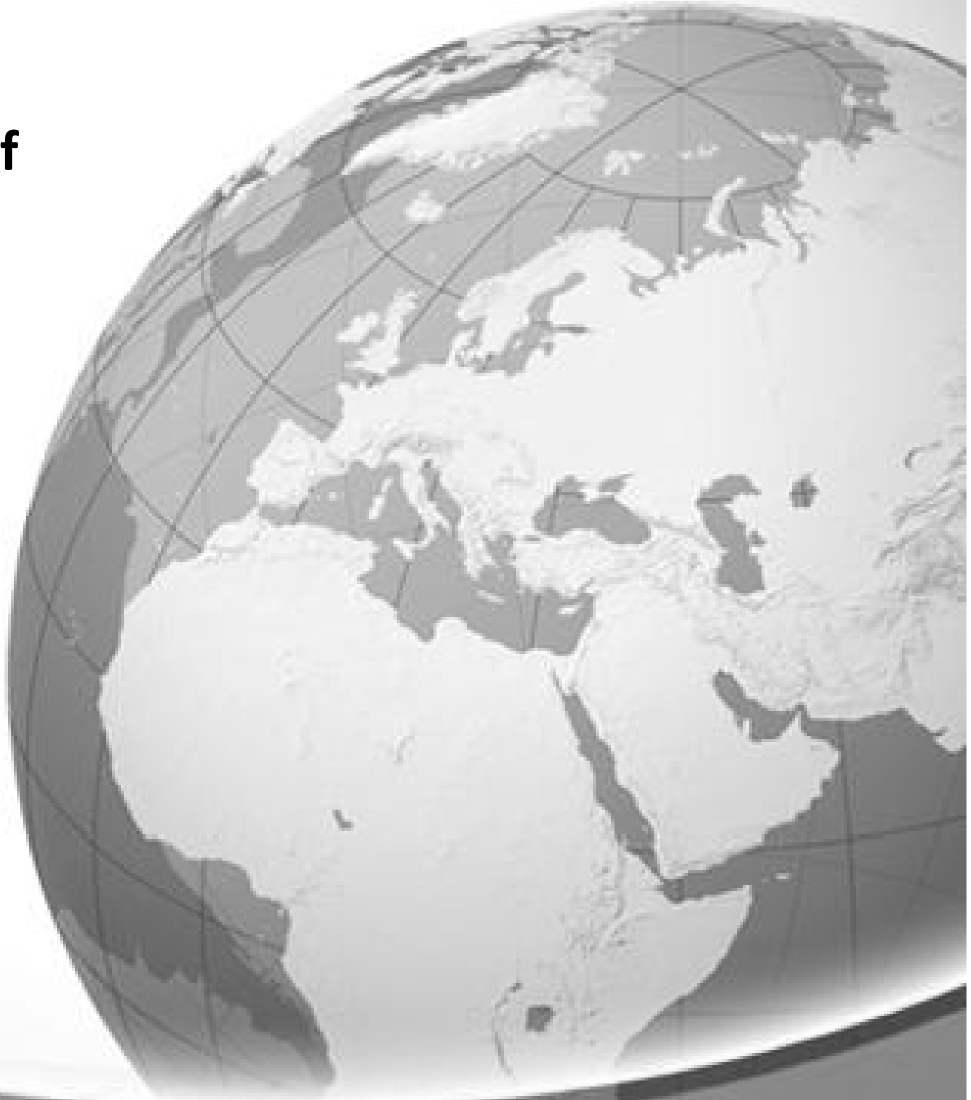
VAKIFBANK GLOBAL ECONOMY WEEKLY

A brief introduction and critique of BASEL III Criteria



T. Vakıflar Bankası T.A.O

New Basel regulations require significant increase in capital standards

- As part of the efforts of G20 countries to establish global financial stability and provide its sustainability after the 2007 financial crisis, Basel committee finalized and announced the new Basel standards of bank capital requirements on 12th September 2010 .
- A more comprehensive report on the new Basel rules with the rest of the details will be presented in G20 meetings in 11-12 November 2010.
- The timing of application is supportive for global economic recovery.
- With the new regulations banks will be forced to raise capital.
- Weaker banks are relieved by the length of the adjustment period, which is longer than it should be.
- Although there is a significant increase in capital requirement ratios, Basel III does not bring solution to most of the problems of the global financial system.
- New Basel rules are just a part of the work to be done for global financial stability and further effort by global and local authorities is essential.

Specific differences stand out between Basel II and Basel III arrangements

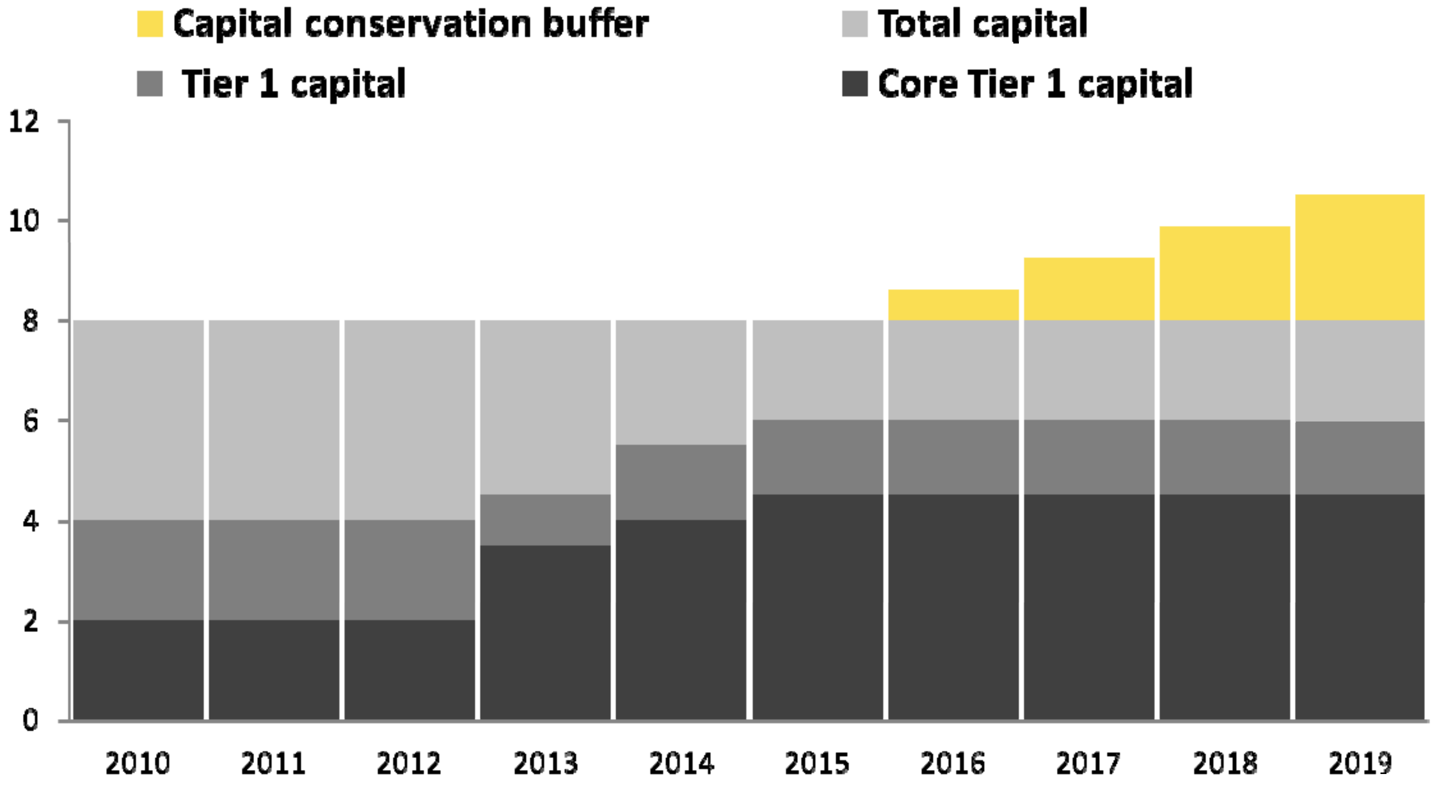
	BASEL II	BASEL III
Minimum Common Equity Ratio	2.00%	4.50%
Minimum Tier 1 Ratio	4.00%	6.00%
Minimum Core Tier 1 Ratio	2.00%	4.50%
Capital Conservation Buffer	--	2.50%
Countercyclical Buffer Range	--	%0-%2.5
Capital for Systemically Important Banks	--	Work continues on this issue

Source: BIS

Basel III requires special capital buffers in addition to increased capital ratios of Basel II

- Basel III starts with an increase in minimum common equity ratio from 2% to 4.5%.
- Tier 1 ratio increases to 6% from 4% and minimum core Tier 1 is supposed to rise to 4.5%.
- Basic novelty brought by Basel III is the capital conservation and countercyclical buffers.
- Basel III introduces a capital conservation buffer of 2.5% as an addition to Tier 1 capital. It will be phased in from January 2016 and will be fully effective in January 2019.
- Banks for which capital ratio falls below conservation buffer, will face restrictions by regulatory authorities on payouts such as dividends, share buybacks and bonuses.
- Capital conservation buffer is set at 0-2.5% of common equity. During times of excessive credit growth that threatens to spark further loan losses, banks will be forced to start building up this extra buffer and avoid a need for fresh capital.

Total Capital Requirement of Basel III will be 10.5% by 1st January 2019



Source: BIS

Total Regulatory Capital Ratio = Tier 1 Capital Ratio + Capital Conservation Buffer + Countercyclical Capital Buffer

Basel III Transition Periods

<table>
<tr><th></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>1 Jan 2019</th></tr>
<tr><td>Minimum Common Equity Capital Ratio</td><td></td><td></td><td>3.5</td><td>4</td><td>4.5</td><td>4.5</td><td>4.5</td><td>4.5</td><td>4.5</td></tr>
<tr><td>Capital Conservation Buffer</td><td></td><td></td><td></td><td></td><td></td><td>0.625</td><td>1.25</td><td>1.875</td><td>2.5</td></tr>
<tr><td>Minimum Common Equity + Conservation Buffer</td><td></td><td></td><td>3.5</td><td>4</td><td>4.5</td><td>5.125</td><td>5.75</td><td>6.375</td><td>7</td></tr>
<tr><td>Phase-in of deductions from common equity (including amounts exceeding the limit for DTAs, MSRs and financials)</td><td></td><td></td><td></td><td>20</td><td>40</td><td>60</td><td>80</td><td>100</td><td>100</td></tr>
<tr><td>Minimum Tier 1 Capital</td><td></td><td></td><td>4.5</td><td>5.5</td><td>6</td><td>6</td><td>6</td><td>6</td><td>6</td></tr>
<tr><td>Minimum Total Capital</td><td></td><td></td><td>8</td><td>8</td><td>8</td><td>8</td><td>8</td><td>8</td><td>8</td></tr>
<tr><td>Minimum Total Capital + Conservation Buffer</td><td></td><td></td><td>8</td><td>8</td><td>8</td><td>8.625</td><td>9.25</td><td>9.875</td><td>10.5</td></tr>
<tr><td rowspan="2">Capital Instruments that no longer qualify as non-core Tier 1 or Tier 2 capital</td><td rowspan="2"></td><td rowspan="2"></td><td colspan="7">Phased out over 10 year horizon beginning 2013</td></tr>
<tr><td>90</td><td>80</td><td>70</td><td>60</td><td>50</td><td>40</td><td>30</td></tr>
<tr><td>Tier-1 Leverage Ratio</td><td colspan="2">Supervisory monitoring</td><td colspan="4">Parellel run 1 Jan 2013 – 1 Jan 2017
Disclosure starts 1 Jan 2015</td><td>Final adjustments</td><td colspan="2">Migration to pillar 1</td></tr>
<tr><td>Liquidity Coverage Ratio</td><td colspan="3">Observation period begins</td><td colspan="6">Introduce minimum standard</td></tr>
<tr><td>Net Stable Funding Rato</td><td></td><td colspan="5">Observation period begins</td><td colspan="3">Introduce minimum standard</td></tr>
</table>

Source: BIS

BASEL III standards are planned to become effective by 1st January 2013 and transition phases will be completed in 9 years

- As of 1 January 2013, banks will be required to meet the new minimum requirements in relation to risk-weighted assets (RWAs):
  - 3.5% common equity/RWAs;
  - 4.5% Tier 1 capital/RWAs, and
  - 8.0% total capital/RWAs
- The minimum common equity and Tier 1 requirements will be phased in between 1 January 2013 and 1 January 2015.
- The regulatory adjustments will begin at 20% of the required deductions from common equity on 1 January 2014 and after a gradual increase, reach 100% by 1 January 2018.
- The capital conservation buffer will be phased in between 1 January 2016 and year end 2018 becoming fully effective on 1 January 2019.
- Countries that experience excessive credit growth is recommended to accelerate the build up of the capital conservation buffer and the countercyclical buffer. National authorities have the discretion to impose shorter transition periods.
- Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital will be phased out over a 10 year horizon beginning 1 January 2013.
- For the leverage ratio the supervisory monitoring period will commence on 1 January 2011.
- The parallel run period will commence 1 January 2013 and run until 1 January 2017; and disclosure of the leverage ratio and its components will start on 1 January 2015.
- Based on the results of the parallel run period, any final adjustments will be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration.

Pros and Cons of Basel III

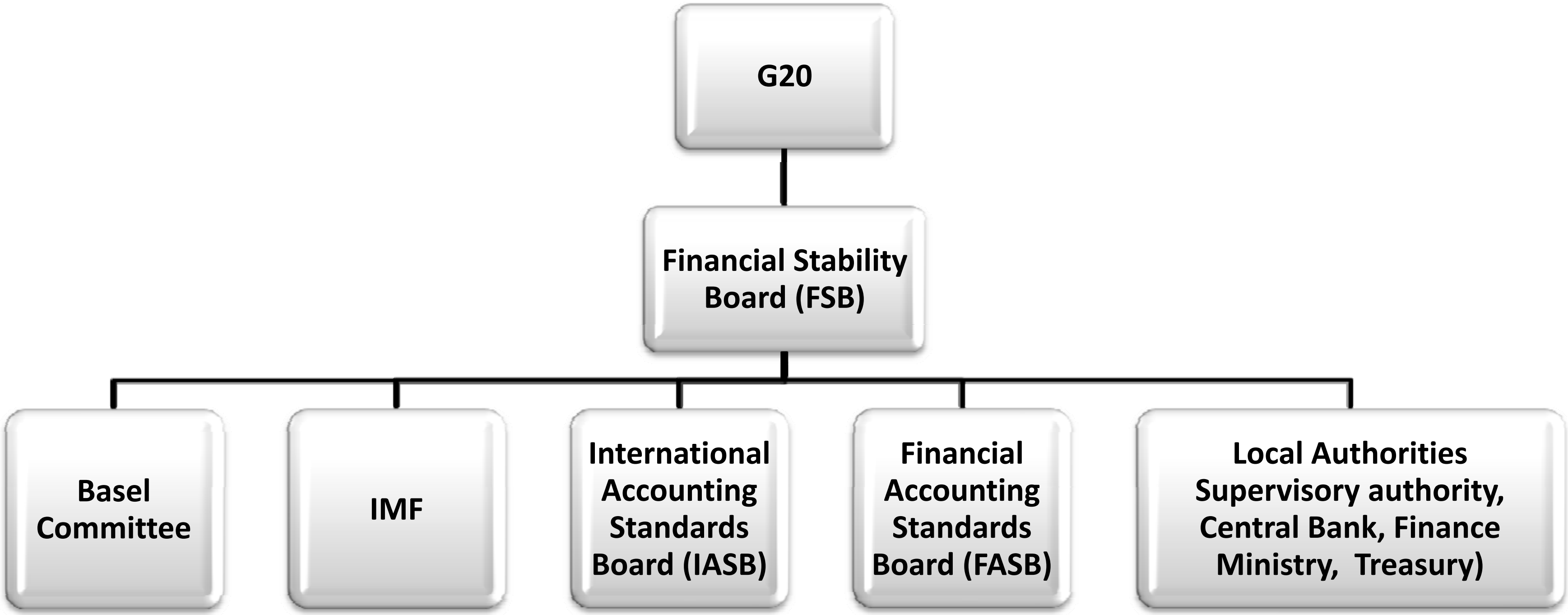
Pros

- Additional capital allocation will reduce systemic risks of banking sector.
- Length of transition period will enable banks to support economic recovery.
- The first comprehensive attempt to stabilize global financial system after the crisis.
- Negative impact of capital requirements on banks willingness to extend credit to corporate sector, might enduce use of equity and capital markets by firms.

Cons

- Long transition period makes the system less resistant to new risks.
- The instabilities of the global financial system still exist.
- No concrete steps are taken against the systemic risk of **"too big to fail"** banks.
- Additional capital allocation might reduce bank profits.
- Capital injection via issuing equities might decrease ROE of banks
- Banks may avoid complying Basel III rules by transferring activities and exposures to less developed markets where capital requirements are lower.
- Less credit allocation in the long run might have negative impact on economic activity.

Basel III rules is just one part of the solutions for global financial stability



Basel committee is one of the regulatory authorities working for global financial stability, under the supervision of FSB and G20 in cooperation with other regulatory bodies. So, Basel III does not paint the final picture of the global regulations after the 2007 crises.

Serkan Özcan
Chief Economist
+ 90 312 455 7087
serkan.ozcan@vakifbank.com.tr

Nazan Kılıç
Economist
+ 90 312 455 8489
nazan.kilic@vakifbank.com.tr

Fatma Özlem Kanbur
Researcher
+ 90 312 455 8482
fatmaozlem.kanbur@vakifbank.com.tr

T. Vakiflar Bankasi T.A.O
Ataturk Bulvari No: 207
Kavaklidere 06683 Ankara, Turkey
www.vakifbank.com.tr

ekonomik.arastirmalar@vakifbank.com.tr