Basel III: A new capital adequacy and liquidity framework for banks

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1. Introduction

On 17 December 2010 the Basel Committee on Banking Supervision (the Basel Committee) published its requirements to strengthen the resilience of the banking sector (Basel III). These proposals followed a period of intense reflection by financial regulators and governments on the causes and lessons of the financial crisis. The December proposals complement earlier changes to the Basel II framework announced in July 2009 which related to trading risks and securitisation. A revised version of Basel III was published on 1 June 2011 which made modifications to the proposals on counterparty credit risk.

In summary:

- banks will be required to hold significantly more common equity, with the minimum common equity ratio rising from 2% to an effective 7% of risk-weighted assets;

- the quality of bank capital will be improved as a result of stricter definitions for core and non-core Tier 1 capital;

- Innovative Tier 1 capital and Tier 3 capital will be abolished;

- non-core Tier 1 and Tier 2 capital will require enhanced loss absorbency and such instruments will, at supervisory discretion, either be written off or convert to common equity at the point of non-viability of the issuer;

- a stricter regime for deductions from capital is being introduced with most deductions being made from common equity;

- higher capital charges will apply to counterparty risk on derivatives, repos and securities financing transactions;

- a leverage ratio will be introduced as a backstop to the risk-based framework;

- banks will be required in good times to build up capital buffers that can be drawn down in periods of stress; and

- two new liquidity standards are being introduced to reflect the central role of liquidity for banks: a liquidity coverage ratio (LCR) requiring banks to hold a stock of highly liquid assets sufficient to survive a short-term stress event as well as a net stable funding ratio (NSFR) requiring banks to maintain sufficient sources of stable funding over a longer period.

This package of new standards will start to come into force from 1 January 2013, and must be fully implemented by 1 January 2019. Existing capital instruments that do not meet the new requirements will be phased out by 31 December 2021.

Basel III will be implemented in the EU and EEA by legislation amending existing EU Directives. This proposal, known as CRD IV, is expected to be published in summer 2011. It is currently uncertain to what extent national supervisors in the EU will be able to apply requirements that are more stringent than those required under CRD IV.
IMPORTANT NOTE:
This memorandum is intended only as a guide to the Basel proposals. It should not be relied upon as a substitute for legal advice which should be sought as required. The Basel documents are long and contain many technical provisions, not all of which are addressed by this memorandum, and their application to specific situations or particular transactions will require careful consideration.

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2. The Basel Committee and the Financial Crisis

Basel II was finalised in 2004 and made fundamental changes to the capital requirements for internationally active banks. The main changes included the adoption of external credit ratings to determine counterparty risk weights, the ability for banks to use their own internal models to calculate capital charges for credit risk, greater recognition of credit risk mitigation techniques, new rules on securitisation and a new capital charge for operational risk. Adjustments to the treatment of banks’ trading book exposures followed in 2005.

Basel II was transposed into EU law through two Directives, known together as the Capital Requirements Directive, or CRD (Directive 2006/48/EC and Directive 2006/49/EC), which continued the harmonisation of the prudential regulation of banks and investment firms within the EU. The CRD was implemented in the UK from 1 January 2007. However, under transitional provisions, many banks and investment firms were able to continue to use Basel I risk weights until 1 January 2008.

2.1 THE LIMITATIONS OF BASEL II

Given its delayed implementation, Basel II clearly cannot have caused the financial crisis, although it may be fair to say that, had the Basel II requirements been fully implemented earlier, or had those more recent measures adopted or proposed by the Basel Committee (such as those relating to securitisations) been in force at the relevant time, the crisis might not have played out in quite so severe a manner. Hindsight, of course, facilitates such analyses.

However, even if Basel II had been fully implemented there is no reason to doubt that the market’s appetite to accept risk in the pursuit of yield, balance sheet arbitrage, and the rapid innovation and increasing complexity of financial product design, would nevertheless have occurred, possibly in much the same way.

Extensive ex post analysis of the financial crisis led to a broad consensus among governments, regulators and market participants that there was a fundamental failure in market discipline as much as in the regulation of markets, and that the causes of this failure went far beyond mere inadequacies in bank capital requirements.

Nevertheless, a consensus also rapidly developed that there were a number of deficiencies in the Basel II regulatory framework that needed to be addressed.

A fundamental failing demonstrated by the financial crisis is that the financial sector did not hold enough capital. More highly capitalised institutions would have been better placed to absorb losses without requiring government support or enforced mergers with stronger institutions. The quality of much financial sector capital also proved to be inadequate and did not absorb losses in the crisis. In the run up to the crisis banks continued paying dividends and coupons on preference shares and hybrid securities for fear otherwise of signalling financial weakness. Holders of subordinated debt did not suffer significant losses when insolvent institutions were rescued by taxpayers. The holders of all of these forms of capital benefited from public sector equity injections which rank behind other Tier 1 and Tier 2 capital instruments.
The lack of emphasis on liquidity in the Basel II framework was striking. Capital requirements are concerned with solvency and aim to enable an institution to continue trading in times of financial adversity. However, a bank can equally fail as a result of insufficient liquidity. In its initial stages the financial crisis manifested itself through a lack of liquidity at such institutions as Northern Rock in the UK and Bear Stearns in the United States.

Another feature of the Basel II regime that has received criticism is that it did not impose restrictions on leverage. This gave rise to incentives for banks to engage in riskier trading activities in the relatively benign economic conditions that prevailed prior to the onset of the financial crisis, which boosted revenues and profits in that period, but at the same time increased systemic risk and the possibility of individual bank failure. By way of example, if a bank is leveraged 30:1 then a fall in the value of its assets of 3.4% will generate losses greater than the amount of its common equity resulting in the bank becoming balance sheet insolvent.

The focus of Basel II on capital also resulted in regulators overlooking the growth of systemic risk as they concentrated on the position of individual institutions. Ultimately, the interconnectedness of large and small institutions created through complex webs of OTC derivatives and by the rapid growth of an unregulated ‘shadow banking sector’ resulted in a situation where the failure of a moderately-sized investment bank, Lehman Brothers, risked bringing down the global financial system.

In addition, the capital requirements for banks’ trading book and securitisations failed to reflect the real level of risk in these areas. Financial institutions were, therefore, incentivised to book transactions in the trading book, many of which were illiquid assets such as the now-infamous collateralised debt obligations (CDOs). In the absence of a ready market, institutions marked these assets to model, but little actual trading took place. Once the crisis broke, firms experienced increasingly large losses in their trading portfolios. Rating downgrades to assets became a significant cause of mark-to-market losses but, unlike credit defaults, the Basel II framework did not take this problem into account.

The financial crisis also demonstrated structural flaws in the value at risk (VaR) models used by financial institutions: short observation periods combined with historically low volatility in market prices (with limited data sets that did not include data from a severe economic downturn), models systematically underestimating the significance of low frequency high impact events, overlooking the importance of systemic risk and the presence of uncertainties that are not capable of being modelled. According to VaR measures, risk was low in spring 2007; in fact, the system was fraught with huge systemic risk.

Perhaps most damning of all was that many of the senior managers of the institutions most at risk did not understand, and in many cases were not in a position to understand, these matters. This resulted in an overreliance in many firms on technical staff who effectively determined matters of critical importance to the stability of the institutions concerned. In many cases banks’ trading book portfolios, or parts of them, proved to be extremely difficult to value once liquidity evaporated, the models previously employed by the banks having broken down and senior management of many banks having lost confidence in those models and their seemingly indecipherable mathematical complexity.

The role of incentives to individuals in the form of their remuneration has, of course, also come under very close scrutiny in all of the countries that were adversely affected by the financial crisis.
2.2 JULY 2009 BASEL REFORM PACKAGE

The first package of changes to Basel II following the financial crisis was adopted by the Basel Committee in July 2009 and included:

- increasing the capital charges for securitisation exposures, including introducing a higher capital charge for re-securitisations (e.g. CDOs and certain conduits) as well as increasing the capital charge for certain liquidity facilities. Banks that invest in securitisations are required to carry out due diligence on the underlying asset pool. If they fail to do so they may be required to deduct such positions from capital;

- eliminating the regulatory arbitrage under which banks that choose to hold securitisation exposures in their trading book can avoid higher capital charges. Instead capital requirements for such exposures will be aligned across the banking and trading books;

- improvements to banks’ models used to calculate capital charges for non-securitisation positions held in the trading book through the introduction of a new ‘stressed’ value at risk calculation taking into account a defined observation period relating to significant losses. The intention is to capture the risks of low frequency high impact ‘tail’ events, as well as significant market movements over a sustained period; and

- introduction of an incremental risk charge (IRC) to cover the effect of credit risk migration (i.e. ratings downgrades) on a bank’s holdings of debt instruments in the trading book. This reflects the fact that losses in the crisis did not principally arise from defaults but from credit migrations combined with widening of credit spreads and the loss of liquidity.

This package has been implemented in the EU through two Directives: Directive 2009/111/EC (known as ‘CRD II’) and Directive 2010/76/EU (known as ‘CRD III’). CRD II was required to be implemented by 31 December 2010. The remuneration and certain other provisions of CRD III were required to be implemented by 1 January 2011, with the remaining provisions following by 31 December 2011.

2.3 STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR

The July 2009 package addressed the treatment of trading book exposures and securitisation. However, the Basel Committee recognised the need for a comprehensive package of measures to strengthen the regulation, supervision and risk management of the banking sector. The first step came with the Basel Committee’s December 2009 consultation on Strengthening the Resilience of the Banking Sector. This document covered the following topics:

- improving the quality of capital;

- improving the treatment of counterparty credit risk;

- the introduction of a leverage ratio; and

- measures to counteract pro-cyclicality in the Basel II Framework.

At the same time, the Basel Committee published a draft framework for liquidity risk measurement, standards and monitoring. The document proposed two standards for liquidity risk:
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- a liquidity coverage ratio (LCR) to ensure that institutions have sufficient high-quality liquidity resources to survive an acute stress scenario; and
- a net stable funding ratio (NSFR) to promote resilience over a longer time horizon – one year – creating additional incentives for banks to fund their activities from more stable sources of funding.

2.4 NEGOTIATING BASEL III

Several of the proposals in the December 2009 consultation proved controversial, leading to a number of changes. On 26 July 2010 the Basel Committee announced broad agreement on the capital and liquidity reform package, including a number of modifications to the December 2009 proposals.

Deductions from Capital
The Basel Committee announced the following changes to its proposals on deductions from capital.

Material holdings. The consultation document proposed requiring the deduction of all investments in unconsolidated financial institutions that exceed specified thresholds. This remains the case. However, the document also stated that gross long positions may be deducted net of short positions only if the short positions involve no counterparty risk. The Basel Committee agreed to eliminate this restriction on hedging.

Deferred tax assets (DTAs). The proposal to deduct DTAs from common equity generated considerable controversy. The Basel Committee confirmed in July 2010 that DTAs that arise from net loss carry-forwards will be deducted from common equity. However, DTAs that arise from temporary differences may enjoy limited recognition as a reserve within core Tier 1 capital.

Mortgage servicing rights (MSRs). MSRs (basically, fees that banks receive for handling mortgages) will be excluded from the definition of intangibles that are required to be deducted from capital. Instead, MSRs will be recognised up to 10% of common equity.

Additional limit for significant investments, DTAs and MSRs. A further cumulative limit will apply to these three asset classes in addition to the individual 10% cap. Where the total of (i) significant investments in common shares held in unconsolidated financial institutions, (ii) mortgage servicing rights and (iii) DTAs arising out of timing differences exceeds 15% of a bank’s common equity, the excess above 15% will be required to be deducted from common equity.

Intangibles. Intangibles will be deducted from common equity. However, firms will be permitted to use IFRS, instead of national GAAP, when identifying intangible assets. This addresses a concern that the definition of intangibles under GAAP may be broader than under IFRS.

Liquidity. The Basel Committee revised the LCR with a view to ensuring that the calibration of the ratio “penalises imprudent liquidity profiles, while minimising system level distortions”. The Basel Committee recognised that the proposal for the NSFR “needs to be modified”, in particular with regard to the calibration of the proposal and the relative incentives across different business models.

Counterparty Credit Risk
The December consultation document made the following proposals in respect of counterparty credit risk:
- banks will be required to determine their capital requirement for counterparty credit risk using stressed inputs to address periods of limited market volatility;
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- banks will be subject to a capital charge for mark-to-market losses associated with a deterioration in the creditworthiness of a counterparty;
- standards for collateral management and initial margining will be strengthened;
- risk weights on exposures to financial institutions will be increased relative to those on exposures to the non-financial corporate sector; and
- credit risk management standards will be improved in a number of areas.

These proposals have been retained, although some changes will be made to the calibration.

**Additional capital charge for mark-to-market losses.** The capital charge to address the risk of loss associated with a decline in creditworthiness short of default will be based on the notional capital charge on a bond used as a proxy for measuring the effect of a decline in credit quality. The Basel Committee has stated that more advanced alternatives could be considered as part of its fundamental review of the trading book (see page 9).

**Large and highly leveraged institutions.** The credit quality of financial institutions proved to be more highly correlated in the financial crisis than with non-financial firms. The consultation document therefore proposed applying a multiplier of 1.25 to reflect this correlation. The Basel Committee decided to retain this multiplier, but to raise the threshold before exposures to banks, broker-dealers and insurance companies are subject to it from $25 billion to $100 billion. Exposures to highly leveraged entities (e.g. unregulated intermediaries, hedge funds and financial guarantors) will be subject to the multiplier regardless of size.

**Central counterparties (CCPs).** In December 2009 the Basel Committee proposed applying a 0% risk weight for exposures to central counterparties to reinforce incentives for banks to use central counterparties to reduce systemic risk. This proposal has been withdrawn and mark-to-market and collateral exposures to central counterparties will instead be subject to a ‘modest’ risk weight to reflect the fact that such exposures are not risk free. On 20 December 2010 the Basel Committee published a consultation document on bank exposures to central counterparties. Under the proposal trade exposures to a qualifying CCP will generally receive a 2% risk weight. In addition, default fund exposures to a CCP will, in accordance with a risk sensitive waterfall approach (based on a CCP’s actual financial resources and hypothetical capital requirements), be capitalised according to a method that estimates risk arising from such exposures.

**Leverage Ratio**

The December 2009 consultation document proposed that in calculating the leverage ratio exposures would be determined in accordance with applicable accounting standards. Collateral and netting would not be permitted to reduce exposures. Subsequently, the Basel Committee announced the following modifications:

- off-balance sheet items will be subject to uniform credit conversion factors, with a 10% credit conversion factor for unconditionally cancellable commitments (subject to further review); and
- all derivatives (including credit derivatives) will be subject to Basel II netting. Potential future exposure on derivative contracts will be captured by add-ons based on the standardised add-ons that apply under the current exposure method in Basel II.

The 2009 consultation document did not include a calibration of the leverage ratio. It is now proposed that the leverage ratio will be calculated as a bank’s average leverage over each quarter. The calibration will be set at 3% of Tier 1 capital initially.
Counter-Cyclical Capital Buffers
The Basel Committee published a consultation document on 16 July 2010 on a proposed counter-cyclical capital buffer. This buffer is intended to ensure that capital requirements take account of the macro-prudential environment in which banks operate. It will be applied when excess credit growth is associated with a build up of system-wide risk. As the proposal has now been finalised, it is discussed in section 7.2 below.

Loss Absorbency at the Point of Non-Viability
On 19 August 2010 the Basel Committee released for consultation a proposal to require all capital instruments issued by banks (other than common equity) to absorb losses at the point of non-viability of the issuing bank. These proposals were finalised on 13 January 2011 and are summarised in section 3.3.

2.5 OTHER BASEL COMMITTEE WORK

The Basel Committee is currently engaging in work in the following areas:

Systemically Important Financial Institutions (SIFIs)
The Basel Committee, together with the Financial Stability Board (FSB), are finalising an integrated approach to systemically important banks “which could include combinations of capital surcharges, contingent capital and bail-in debt”. Work is expected to continue in 2011.

On 2 November 2010 the FSB published recommendations for enhanced supervision of SIFIs. The FSB considers that the level of supervision applied by national authorities to SIFIs must be commensurate with the potential destabilisation risk that such firms pose to their domestic financial system, as well as the broader international financial system. The report identifies a series of recommendations covering the mandates of supervisors, independence, adequate resources, supervisory powers, supervision techniques and macro-prudential surveillance.

On 12 November the FSB followed up with a report on reducing the moral hazard posed by SIFIs. The recommendations include:

- All FSB member jurisdictions should put in place a policy framework to reduce the risks and externalities associated with domestic and global SIFIs in their jurisdictions.

- Global SIFIs should have loss absorption capacity beyond the Basel III standards. They should have a higher share of their balance sheets funded by capital and/or by other instruments which increase the resilience of the institution as a going concern. Depending on national circumstances, this could be drawn from a menu of alternatives and be achieved by a combination of a capital surcharge, a quantitative requirement for contingent capital instruments, and a share of debt instruments or other liabilities represented by ‘bail-inable’ claims. In some circumstances, further measures, including liquidity surcharges, tighter large exposure restrictions, levies, and structural measures could reduce the risks that a global SIFI presents.

- All jurisdictions should undertake necessary legal reforms to ensure that they have in place a resolution regime which makes feasible the resolution of any financial institution without taxpayer exposure to loss. National authorities should consider restructuring mechanisms to allow recapitalisation as a going concern by way of contractual and/or statutory debt-equity conversion and write-down tools.
Recovery and resolution plans that assess global SIFIs’ resolvability should be mandatory. Authorities must have powers to require a financial institution to make changes to its legal and operational structure to facilitate resolution.

The FSB will by mid-2011 set out criteria for assessing the resolvability of SIFIs, which should be taken into account in determining the systemic risk of a global SIFI, and the attributes of effective resolution regimes. The FSB, in consultation with the Basel Committee, will also undertake a thematic peer review on the implementation of the attributes of effective resolution regimes in 2012.

The FSB and national authorities, drawing on relevant qualitative and quantitative indicators, will determine by mid-2011 those institutions to which the FSB global SIFI recommendations will initially apply. A Peer Review Council will be established with a mandate to assess and report to the FSB on national policies adopted with regard to global SIFIs.

**Trading Book Review**

The Basel Committee is committed to undertaking a fundamental review of the rules applicable to banks’ trading books as called for by the UK Turner Review (March 2009). The UK Financial Services Authority published a discussion paper in August 2010 which is intended to inform work on the future of the trading book undertaken by the Basel Committee. This review is targeted for completion by the end of 2011.

**Securitisation**

The Basel Committee has announced a review of the securitisation framework, including its reliance on external ratings of securitisation positions.

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2.6 **Calibration and Endorsement by the G20**

On 12 September 2010 the Basel Committee announced agreement on the new minimum capital requirements for banks as well as the transitional provisions. The detailed requirements were published on 16 December 2010 and are described in the remaining sections of this memorandum.

The G20 Leaders meeting in Seoul on 11-12 November 2010 endorsed Basel III and reaffirmed that no firm should be too big or too complicated to fail, nor should taxpayers bear the costs of resolution. Progress in implementation will be reviewed at the G20 Summit in Cannes in November 2011.
3. Improving the Quality and Quantity of Capital

The types of regulatory capital, as well as the 8% minimum ratio of capital to risk-weighted assets, were set by the Basel Committee in 1988. Both were left unchanged by Basel II. The current rules place no restriction on the amount of Tier 1 capital that a bank can hold. However, limits exist in respect of the recognition of all other tiers of capital, which are set by reference to the amount of Tier 1 capital held by a bank. In this way Tier 1 capital forms a basis for limiting recognition of other types of capital.

Under Basel II, Tier 2 capital is limited to 100% of a bank’s Tier 1 capital after deductions. The result is that a bank may satisfy the Basel minimum requirements by holding Tier 1 capital equal to 4% of its risk-weighted assets with the other 4% being supported by Tier 2 capital. At least 50% of Tier 1 capital must comprise ordinary shares and reserves, known as core Tier 1 capital. Under the existing framework a bank could therefore hold core Tier 1 capital representing only 2% of its risk-weighted assets with the balance made up of hybrid capital and subordinated debt. In practice, banks have tended to hold higher amounts of common equity and less Tier 2 capital than permitted by the rules, but as the financial crisis demonstrated, the levels of capital were still inadequate.

In September 2010 the Basel Committee announced that the common equity component of capital (which includes reserves) would be increased to 4.5% and the total Tier 1 ratio to 6%. This increase will be phased in as follows:

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<tr>
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<th>Common Equity</th>
<th>Total Tier 1</th>
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<tbody>
<tr>
<td><strong>Current Basel II requirement</strong></td>
<td>2%</td>
<td>4%</td>
</tr>
<tr>
<td>From 1 January 2013</td>
<td>3.5%</td>
<td>4.5%</td>
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<tr>
<td>From 1 January 2014</td>
<td>4%</td>
<td>5.5%</td>
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<tr>
<td>From 1 January 2015</td>
<td>4.5%</td>
<td>6%</td>
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3.1 CORE TIER 1 CAPITAL

Basel III seeks to reinforce the position of core Tier 1 capital as the predominant form of capital. To ensure its quality and consistency across jurisdictions Basel III sets out a list of criteria that common equity will be required to satisfy. These include:

- it is the most subordinated claim in a liquidation;
- it has an unlimited and variable claim in a liquidation after all senior claims have been repaid;
- it is perpetual and is never repaid outside of liquidation (other than discretionary repurchases and other reductions of capital allowed under national company law);
- the bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled;
- distributions are paid out of distributable items and are not in any way linked to the amount paid at issuance or capped;
- distributions are paid only after legal and contractual obligations have been met and payments on more senior capital instruments have been made;
- the paid up amount is classified as equity under relevant accounting standards;
- the shares are directly issued; and
- the shares are paid up.

It follows that the following are not eligible as common shares under Basel III:

- shares with a fixed claim in a winding up;
- shares with a fixed (but fully discretionary) coupon;
- shares that are accounted for as a liability; and
- indirect issues of shares (e.g. through an SPV). Minority interests in consolidated subsidiaries can count towards the consolidated common equity requirement as described below in section 3.6.

These requirements will also apply to mutuals and co-operatives (such as building societies) taking into account their specific constitution and legal structure. An example of instruments that meet the Basel III requirements for core Tier 1 capital are the profit participating deferred shares (PPDS) issued by certain UK building societies.

Shares need not carry voting rights in order to meet the Basel criteria although non-voting shares must be identical to the voting shares of the bank in all other respects. The exclusion from core Tier 1 capital of shares with a discretionary fixed coupon is likely to prevent fixed income investors from investing in such capital instruments.

Other elements eligible for inclusion as core Tier 1 capital include:

- share premium resulting from the issue of instruments included as core Tier 1 capital. Share premium arising on Tier 1 hybrid capital or Tier 2 instruments must be treated as falling within that tier of capital;
- retained earnings; and
- accumulated other comprehensive income and other disclosed reserves. No adjustment is made to remove unrealised gains or losses recognised on the balance sheet from the common equity component.
3.2 COMPARISON WITH EU REQUIREMENTS IN CRD II

CRD II amended the definition of core Tier 1 capital in EU legislation with effect from 31 December 2010. The CRD II definition consists of equity share capital, plus related share premium accounts, insofar as it fully absorbs losses on a going concern basis, and in the event of bankruptcy or liquidation ranks after all other claims.

As required by CRD II the European Banking Authority (EBA) has published guidelines on the requirements for instruments to be included within core Tier 1 capital. Retained earnings are also included within core Tier 1 capital. The EBA criteria are essentially consistent with the Basel requirements, although they are more detailed. For example, the EBA states that common equity should not have an alternative coupon satisfaction mechanism (under which dividends not paid in cash are paid in ordinary shares) or a dividend stopper. Neither feature would be acceptable under Basel III.

Recital 4 of CRD II permits within core Tier 1 capital instruments that have preferential rights to a dividend payment on a non-cumulative basis. According to the EBA, this is the only form of a preference that is permitted, and the instrument must not include a dividend stopper. Such a preference is not permitted under Basel III.

The EBA guidelines permit the inclusion as share capital of instruments that do not own a bank’s reserves, but require instead that the instrument has a principal write-down feature “that absorbs losses pari passu with ordinary shareholders”. It is unclear what is meant by ‘owning’ reserves, as shareholders of a company cannot compel the directors to distribute reserves other than through a winding up. There also seems to be some confusion as to how ordinary shares absorb losses as once reserves are exhausted by losses the bank’s share capital is not written down. Instead, losses will result in the bank holding negative reserves, which will need to be made good out of future profits before the bank will be able to make a distribution to ordinary shareholders. Basel III does not permit the inclusion of capital instruments as common equity for non-mutuals as “the criteria must be met solely with common shares”.

3.3 OTHER (NON-CORE) TIER 1 CAPITAL

The Basel Committee states that certain other instruments will be eligible for inclusion as ‘non-predominant’ (i.e. non-core) Tier 1 capital.

Definition of Non-Core Tier 1 Capital

The detailed criteria include the following requirements:

- it is issued and paid up;
- the instrument is subordinated to depositors, general creditors and subordinated debt holders;
- the instrument is perpetual;
- there are no step-ups or incentives on the issuer to redeem;
- an issuer call may only be made after five years and is subject to prior supervisory consent;
- a bank must not do anything which creates an expectation that a call will be exercised;
- a bank must not exercise a call unless either the instrument is replaced with capital of the same or better quality or the bank demonstrates that its capital position is well above the minimum capital requirements (which may at national discretion be higher than the Basel III minima) after exercise of the call;
the instrument cannot have any feature that hinders recapitalisation, such as provisions requiring the issuer to compensate investors if a new instrument is issued at a lower price within a specified time frame; and

any repurchase of the instrument is subject to supervisory consent and the bank must not create a market expectation that approval will be given.

These requirements are consistent with current FSA requirements. In addition, all distributions must be fully discretionary, and a decision to cancel payment of a coupon must not impose any restrictions on the bank except in relation to distributions to ordinary shareholders (i.e. a dividend stopper is acceptable provided that it does not operate in a way that hinders recapitalisation).

Dividends that are reset periodically based on the credit rating of the issuer (i.e. a margin ratchet) will not be permitted. Any payment of dividends or coupons must be made out of distributable items. Under English company law the payment of interest on debt is not made out of such profits. Presumably, the requirement that payment is made out of distributable items will be satisfied if payment is conditional on the issuer having sufficient profits available for distribution to its members. A footnote clarifies that dividend pushers and alternative coupon satisfaction mechanisms (which are common in existing innovative Tier 1 issues) are not permitted.

Principal Loss Absorbency
Under the Basel proposals, if an instrument is classified as a liability for accounting purposes it must have principal loss absorbency either through conversion to common shares at an objective, pre-specified trigger or a write down mechanism which allocates losses to the principal amount of the instrument at a pre-specified trigger. As mentioned above the instrument must also not have any feature that hinders recapitalisation.

Basel III states that write-down will have the following effects. It will:

• reduce the claim of the instrument in the liquidation of the issuer;

• reduce the amount repaid when a call is exercised; and

• partially or fully reduce coupon/dividend payments on the instrument.

It is implicit in the above requirements that the write-down is permanent, and that it will not be possible for the issuer to write back up the instrument out of future profits. This contrasts with the position in the EU under CRD II where a temporary write down is permitted. CRD II is summarised briefly in the next section.

The requirement to include write down provisions applies to instruments that are classified as a liability for accounting purposes. It follows that it is not necessary for equity-accounted capital. Non-redeemable preference shares with a discretionary coupon are equity accounted under IAS 32 with the result that they would not need to include a write-down feature under Basel III (preference shares with a mandatory coupon are not eligible as Tier 1 capital).

However, it is uncertain whether the distinction based on the accounting treatment will be reflected in CRD IV, which is the legislation under which it is expected that Basel III will be implemented in the EU. In its pre-consultation on CRD IV the European Commission stated in February 2010 that “The Commission services consider it to be vital that all forms of going concern capital absorb losses effectively on a going concern basis. Therefore, the Commission services will consider further the potential need for all non-Core Tier 1 instruments to have a mandatory principal write-down or conversion feature.”
Principal ‘loss absorbency’ is required to be achieved through conversion or write down. The concept is that when an instrument is written down the reduction of the principal amount will give rise to a non-distributable reserve that will be capable of absorbing losses. Under English company law there are restrictions on the write down of the nominal amount of preference shares in a public limited company (as a reduction in share capital by such a company may only be done if sanctioned by the court). However, it may be possible to achieve a similar outcome e.g. by conversion and re-denomination.

It should be noted that this write-down requirement is distinct from the separate requirement for write-down or conversion at the point of non-viability that will apply to all capital instruments. This is discussed below.

Write-Down at the Point of Non-Viability
Basel III requires all capital instruments (Tier 1 and Tier 2) to provide for their write-down or conversion at the point of non-viability. This reflects the fact that in the crisis such instruments did not bear losses as expected. Where financial institutions were rescued by governments through capital injections, insolvency was averted. However, as Tier 1 and Tier 2 capital instruments are senior to equity they benefited directly from the new equity provided by taxpayers.

Moreover, as such instruments invariably contained a dividend stopper on ordinary shares if coupons were not paid, holders often continued to receive distributions as well. The existence of such stoppers is a hindrance to recapitalisation as private sector capital providers would be unlikely to invest in share capital if there was no reasonable prospect of receiving a dividend because of the continuing obligation to make distributions on higher ranking capital instruments.

As a result, the Basel Committee announced on 13 January 2011 that:

“The terms and conditions of all non-common Tier 1 and Tier 2 instruments issued by an internationally active bank must have a provision that requires such instruments, at the option of the relevant authority, to either be written off or converted into common equity”.

These new requirements apply to all capital instruments issued on or after 1 January 2013. Instruments issued prior to 1 January 2013 that do not meet the criteria set out above, but that meet all of the criteria for Additional Tier 1 or Tier 2 capital set out in Basel III, will be eligible for limited grandfathering (as to which see section 3.13 below).

The only exception to the new requirements for write down or conversion is if:

(a) the governing jurisdiction of the bank has in place laws that (i) require such Tier 1 and Tier 2 instruments to be written off upon such event, or (ii) otherwise require such instruments to fully absorb losses before taxpayers are exposed to loss;

(b) a peer group review confirms that the jurisdiction conforms with clause (a); and

(c) it is disclosed by the relevant regulator and by the issuing bank, in issuance documents going forward, that such instruments are subject to loss under clause (a) above.

The UK has passed legislation to facilitate the orderly resolution of banks incorporated in the UK in the Banking Act 2009. This introduced three pre-insolvency stabilisation options as well as two new insolvency procedures for banks in financial difficulties. The intention is to provide the Treasury, the FSA and the Bank of England (the authorities) with a range of tools to deal with failing banks.
The stabilisation options are:

- the transfer of all or part of a bank to a private sector purchaser (PSP);
- the transfer of all or part of a bank to a ‘bridge bank’ owned by the Bank of England (Bridge Bank); and
- the transfer of a bank or a bank holding company into temporary public ownership (TPO).

Although the Act confers wide-ranging powers on the authorities to resolve a failed institution, there is currently no power to write off existing debt or to convert debt into equity. This was confirmed by the UK Government in a letter from the Financial Services Secretary at HM Treasury to the Association of British Insurers. Further primary or secondary legislation would therefore be needed to create such a statutory framework in the UK.

Pending adoption of a statutory regime for imposing losses on capital providers it will be necessary to satisfy the Basel requirements through a contractual mechanism. The trigger for write-down/conversion is the earlier of: (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and (2) a decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority.

The following points may be noted. Firstly, the operation of the trigger is discretionary. It follows that if there are alternative means of resolving the bank (such as a merger with a stronger institution) these may be exercised. Secondly, it is the relevant supervisor and not the bank that decides whether or not to exercise the trigger. Thirdly, there is some uncertainty as to what ‘non-viable’ means in this context. However, it seems likely that non-viability is intended to cover a point short of insolvency where the bank can still be saved. It may therefore cover situations where an institution is losing the confidence of its depositors and counterparties but where insolvency is not unavoidable. It is likely that the FSA (or its successor on these matters, the Prudential Regulatory Authority) will also regard a bank as non-viable if it fails to meet the threshold conditions for authorisation under the Financial Services and Markets Act 2000 or replacement legislation.

Further, it seems from the Basel statement that the choice whether to require capital instruments to be written off or converted to equity is a matter of regulatory discretion which is to be exercised at the time when the supervisor determines that an institution is no longer viable. In other words, investors will not know in advance whether they will receive new common equity or have their investment written off.

Finally, Basel III does not seek to regulate the conversion ratio with the result that countries may decide to limit the number of ordinary shares issued when conversion takes place. The FSA has imposed limits on ‘principal stock settlement’ in the context of the repayment of innovative Tier 1 capital instruments, and has also imposed a cap on the conversion ratio in the context of the rules on principal loss absorbency under CRD II. For capital instruments within the 35% bucket under CRD II (as to which see section 3.4) the FSA requires that the maximum number of shares must: (i) be determined at the date of issue on the basis of the market value of those instruments at that date; (ii) have an aggregate value no more than 150% of par value; and (iii) not increase if the share price falls. We consider that a similar approach may be taken in the case of Basel III compliant Tier 1 and Tier 2 instruments.

Potential investors may wish to ensure that an issue of new shares is a possibility by requiring that the issuer has sufficient authorised share capital (if relevant),
that the directors have authority to allot new shares and that existing shareholders’ pre-emption rights have been disapplied (if required). Issuers will need to consider which other terms are appropriate, although as conversion will only occur if the issuer becomes non-viable the full suite of covenants and undertakings customarily found in convertible bond issues may not be appropriate.

A further significant uncertainty is whether these changes to capital instruments, introducing ‘equity-like’ features to debt instruments, will materially impact the pricing of Tier 1 and Tier 2 capital, as well as the mix of investors willing (or permitted) to hold such instruments.

For banking groups, capital instruments issued by a banking subsidiary will only be eligible for inclusion in consolidated capital if the trigger references both the bank issuer and the group as a whole. Basel III states:

“where an issuing bank is part of a wider banking group and if the issuing bank wishes the instrument to be included in the consolidated group’s capital in addition to its solo capital, the terms and conditions must specify an additional trigger event. This trigger event is the earlier of: (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority in the home jurisdiction; and (2) the decision to make a public sector injection of capital, or equivalent support, in the jurisdiction of the consolidated supervisor, without which the firm receiving the support would have become non-viable, as determined by the relevant authority in that jurisdiction”.

If this additional trigger is not included the capital will only be recognised at a solo level.

Where capital instruments are issued by a banking subsidiary new ordinary shares may be issued by the parent company instead of the bank. This is necessary to avoid the creation of minority interests at the level of the bank as well as potential adverse tax consequences. If the parent company is listed then shares in that company would also be more readily marketable.

The UK Government is committed to ensuring an appropriate tax treatment for Basel III compliant capital. The 2011 UK Budget states:

“A number of required features of these instruments make the tax treatment under the present tax rules uncertain in a number of respects so the Government will set up an industry working group to explore any emerging tax issues associated with the development of new loss absorbing bank capital instruments in light of the Basel III proposals, and if necessary will legislate in Finance Bill 2012. [HM Revenue & Customs (HMRC)] will shortly be inviting industry members, representative bodies and advisers to participate in workshops to be held over the summer”.

Minority Interests and Indirect Issues of Non-Core Tier 1 Capital

The requirements for non-core Tier 1 instruments also apply to indirect issues that appear as a minority interest in consolidated capital. It follows that if the issuer is an authorised bank then minority interests will need to meet the requirements for other Tier 1 capital. This is no change from current FSA requirements. However, if the issuer is not an operating entity (e.g. the issuer is an SPV) then the capital raised by the SPV will need to be on-lent to the holding company, or to an operating entity, in the form of Tier 1 instruments. An ‘operating entity’ is "an entity set up to conduct business with clients with the intention of earning a profit in its own right". It follows that a regulated subsidiary (e.g. a bank, broker-dealer or an asset management company) will be treated as an operating entity for this purpose. It is unclear if non-regulated entities that have customers (e.g. non-regulated captive lenders, leasing companies and factoring entities) will also be treated as operating entities.
A bank that has issued non-core Tier 1 or Tier 2 capital through an SPV may treat the capital issued by the SPV as having been issued directly by the bank if (in addition to meeting the relevant requirements) the SPV is fully consolidated with the bank and the only asset of the SPV is its investment in capital instruments constituting the same or a higher tier of capital. In other words, a bank issuing Tier 1 or Tier 2 capital via an SPV will be able to recognise that capital at a consolidated level provided that the SPV invests in Tier 1 or Tier 2 capital in the bank.

The requirements for SPVs mean that it is unlikely to be possible to obtain tax deductibility in the UK on indirect issues of Tier 1 capital as both the instrument issued to investors and the intra-group investment will need to have a fully discretionary coupon. Consequently, unless HMRC are prepared to recommend an appropriate change in tax law, indirectly issued capital is less likely to be an attractive option for UK banks in the future.

### Calibration

Under Basel II, non-core Tier 1 capital is capped at 4% of risk-weighted assets, although few banks approach this limit. Under Basel III this will be reduced to 1.5% of risk-weighted assets. The requirements will be transitioned as follows. It is unclear why the Basel Committee opted for a 1% cap on non-core Tier 1 capital in 2013.

<table>
<thead>
<tr>
<th>Date</th>
<th>Other Tier 1 Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basel II maximum</td>
<td>2%</td>
</tr>
<tr>
<td>From 1 January 2013</td>
<td>1%</td>
</tr>
<tr>
<td>From 1 January 2014</td>
<td>1.5%</td>
</tr>
<tr>
<td>From January 1 2015</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

### 3.4 NON-CORE TIER 1 CAPITAL UNDER CRD II

CRD II introduced significant changes to the way in which non-core Tier 1 capital is defined, and the extent to which it may be used by banks. The FSA implemented this Directive in the UK on 31 December 2010. Although there are similarities with Basel III, there are also a number of significant differences and consequently CRD II has in one sense led to an 'interim regime' in the EU/EEA pending full implementation of Basel III. In practice, we expect banks are unlikely to find it attractive to issue capital instruments that qualify as non-core Tier 1 capital under CRD II but are ineligible under Basel III. Any such instruments issued on or after 12 September 2010 will be ineligible for grandfathering and so will automatically cease to count as capital from 1 January 2013.

A major reason for this parallel approach is that the EU review of non-core Tier 1 capital, also called hybrid capital, predated the financial crisis. Prior to implementation of CRD II the only type of hybrid capital that the FSA recognised was preference shares (for banks) and permanent interest-bearing shares (PIBS) (for building societies). Neither type of instrument was tax deductible.

CRD II introduced three sub-tiers of hybrid capital. The CRD II requirements, which are supplemented by advice published by the EBA, are complex, but may be summarised briefly as follows:

- hybrid capital is limited to 50% of total Tier 1 capital less deductions; and
- there are sub-limits, or buckets, of 15%, 35% and 50% of total Tier 1 capital after deductions for different categories of hybrid capital which are to be determined by reference to the characteristics of such instruments.
The 15% and 35% Buckets
The 15% bucket applies to dated instruments with a minimum original maturity of 30 years as well as instruments that contain an incentive to redeem (i.e. a step-up or principal stock settlement). It therefore corresponds to the innovative instruments included in Tier 1 under the 1998 Basel press release. The 35% bucket applies to instruments that do not have an incentive to redeem (e.g. no step-up).

The FSA, as part of its implementation of CRD II, has also included indirect issues of Tier 1 capital (i.e. SPV structures) within the 15% bucket, although this is not required by CRD II, or, for that matter, under Basel III. Dated instruments are subject to a ‘lock in’ preventing repayment if repayment at maturity would lead to a breach of the issuer’s regulatory capital requirements. Instruments within the 15% and 35% buckets also need to satisfy a requirement for going concern ‘loss absorbency’ in addition to a requirement that the payment of coupons/dividends be wholly flexible.

Under the Directive, this means that the instrument must either convert into ordinary shares, or be written down, at a pre-defined trigger point. Once the instrument is written down no coupons or dividends may be paid, and any dividend stopper will be turned off (enabling the issuer to pay dividends on ordinary shares). If the bank returns to profitability then the instrument may be written up again (through cancellation of a corresponding amount of reserves).

In implementing the CRD II requirements the FSA requires the trigger to be:

(a) before a breach of the firm’s capital resources requirement and both: (i) when the firm’s losses lead to a significant reduction of the firm’s retained earnings or other reserves which causes a significant deterioration of the firm’s financial and solvency conditions; and (ii) when it is reasonably foreseeable that the events described in (i) will occur; and

(b) when the firm is in breach of its capital resources requirement.

It remains to be seen whether a similar trigger will be applied to the write-down or conversion of non-core Tier 1 capital instruments under Basel III.

The FSA rules implementing CRD II do not permit the instrument to be written up in priority to the payment of dividends on ordinary shares (as is the case, for example, with deeply subordinated notes that were issued by French banks during the financial crisis). Instead, any write up must occur pari passu with the making of distributions on ordinary shares.

Finally, there must be no provision that prevents new capital from being raised (e.g. a prohibition on issuing further capital instruments at a lower price in the future). Instruments within the 15% and 35% buckets may be redeemed provided that the FSA consents. Repurchases are likewise subject to prior regulatory consent.

The 50% bucket
The 50% bucket is intended to cover ‘quasi-equity’ and is limited to instruments that convert into ordinary shares in emergency situations or at the initiative of the relevant supervisor at any time. The issuer must also have the right to convert such instruments at any time into ordinary shares and no call is permitted.
Noteworthy Differences between CRD II and Basel III

There are many similarities between CRD II and Basel III. However, one may note the following significant differences:

- CRD II allows dated instruments within the 15% bucket. Under Basel III, all Tier 1 instruments must be perpetual.

- CRD II recognises instruments with an incentive to redeem (such as a step-up). Under the Basel proposals this is not permitted for any Tier 1 or Tier 2 instrument.

- Both the Basel III requirements and CRD II require coupon flexibility and loss absorbency through conversion or a write down of principal. However, Basel III only requires this for instruments that are accounted for as a liability under national law. Equity-accounted preference shares are therefore not caught by Basel III. Preference shares are, however, subject to the loss absorbency requirements of CRD II regardless of their accounting treatment.

- There is no parallel under Basel III to the 50% bucket under CRD II. Nor do the Basel requirements prevent an issuer call from being made after five years (although supervisory consent is required).

- CRD II permits the use of an alternative coupon satisfaction mechanism (ACSM) for instruments within the 15% and 35% buckets. It follows that an issuer may be required, if it decides not to pay a coupon in cash, to pay the coupon by issuing new shares to investors (although the issuer must not be obliged to find purchasers for the shares). Basel does not permit ACSM for Tier 1 instruments.

- CRD II restricts the operation of dividend stoppers, and prevents payment of coupons/dividends on hybrids while they are written down. Basel III does not prohibit dividend stoppers applying to common equity (although such stoppers must not hinder recapitalisation). However, dividend pushers are prohibited. Moreover, there is no prohibition on the payment of distributions while an instrument is written down. This follows from the fact that the write down is permanent, thereby permitting payment on the reduced amount of the instrument. If the instrument is written down to zero then no coupon will be payable. Given the lack of detail in Basel III as to the details of the write down procedure, scope remains for inconsistent national interpretation of these requirements.

- Basel and CRD II both require that an instrument does not hinder recapitalisation. However, in view of the above differences, it is not clear whether this has the same meaning under both sets of requirements. Given that a dividend stopper may hinder recapitalisation of a failing bank, it seems likely that stoppers will need to be turned off at this point, although Basel III does not expressly state this.

The European Commission launched a consultation on the December 2009 Basel consultation paper on 26 February 2010 (CRD IV). The EU is not obliged to align its rules with the Basel proposals. However, as many EU Member States are also members of the Basel Committee, and as Basel III represents an international consensus, there seems little doubt that the EU will implement Basel III. There is more uncertainty as to whether the EU requirements will differ in certain respects from the Basel framework. This may be necessary given that the EU rules will have a much broader scope applying to all banks (and not just internationally active banks) as well as investment firms. Given that not all EU Member States are members of the Basel Committee, and that the EU legislative process is a political procedure, it would not be surprising if some divergences were to emerge, although what they will be is still too early to say.
3.5 INNOVATIVE TIER 1 CAPITAL

Under the terms of the Basel Committee’s 1998 Sydney press release banks were able to include within Tier 1 capital certain instruments with innovative features, such as an incentive to redeem. This was subject to a limit of 15% of Tier 1 capital. The Basel Committee has decided that these features, which lowered the cost of issuance for banks, diluted the quality of Tier 1 capital and should be phased out. Existing innovative instruments will be grandfathered for a limited period. This is discussed in section 3.13 below.

As mentioned above, the FSA treats all indirect issues of capital as innovative. Such issues are not innovative under Basel III and so will continue to be possible. However, unless HMRC are prepared to recommend an appropriate change in taxation law, it seems unlikely that future issues will benefit from tax deductibility of coupons in the UK.

3.6 MINORITY INTERESTS

In December 2009 the Basel Committee proposed that minority interests would not be eligible for inclusion as common equity within Tier 1 and would therefore need to be deducted from consolidated capital resources. The reason given was that an equity investment made by a third party in a subsidiary supports the risks in that subsidiary, and therefore that capital could not be expected to be available to support risks in the group as a whole. As a result of representations made during consultation, a more refined treatment of minority interests has been formulated.

Common Equity

Basel III states that a minority interest arising from the issue of common shares by a fully consolidated subsidiary of the bank may receive recognition in common equity Tier 1 only if:

- the instrument giving rise to the minority interest would, if issued by the bank, meet all of the criteria for inclusion as common shares for regulatory capital purposes; and

- the subsidiary that issued the instrument is itself a bank.

Unsurprisingly, the minority interest must “solely represent genuine third party common equity contributions to the subsidiary”. A footnote states that the reference to minority interests being issued by a bank includes “any institution that is subject to the same minimum prudential standards and level of supervision as a bank”. Given that investment firms are subject to the same prudential requirements as credit institutions within the EEA it is possible that this will catch investment firm subsidiaries as well. Non-bank subsidiaries (including special purpose entities) are excluded, and minority interests in such entities must be excluded (i.e. deducted) from consolidated common equity.

Basel III specifies the amount of the minority interest that is eligible for inclusion in common equity based on the surplus common equity Tier 1 that is attributable to the minority shareholders. This is, basically, the amount of surplus common equity (over the 7% minimum requirement that will eventually apply) in the subsidiary multiplied by the percentage of common equity held by the third party investors.

Non-Core Tier 1 Capital

Tier 1 capital instruments issued by a fully consolidated subsidiary of the bank to third party investors may receive recognition in Tier 1 capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 capital. This includes minority investments in the common equity of a consolidated subsidiary other than a bank.

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56
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58
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60
61
The calculation of the amount that is eligible is similar to that for common equity. It is based on the amount of Tier 1 capital that is in excess of 8.5%.

Other Capital
A similar approach applies to Tier 2 instruments issued by fully consolidated subsidiaries of the bank. Such instruments may receive recognition in consolidated capital only if the relevant instruments meet all the requirements for recognition under Basel III.

SPV Issues
As seen above, capital issued through a special purpose entity cannot be included within consolidated common equity, but may be eligible as additional Tier 1 capital or Tier 2 capital. Basel III imposes an additional requirement that the only asset of the SPV is an investment in the capital of the bank that satisfies the relevant Basel requirements, i.e. if recognition as Tier 1 is sought then the SPV must invest in Basel-compliant Tier 1 capital of the bank. The same applies for Tier 2 capital.

3.7 OTHER CHANGES TO TIER 1 CAPITAL

Basel III makes a number of changes which will impact on Tier 1 capital. Deductions from capital are considered in section 4 of this memorandum.

Share Premium
Share premium will be included in common equity only if it arises on shares that are included within common equity. Premium arising on other shares and capital instruments must be included in the same element of capital as the shares or instruments to which the premium relates. Under existing FSA rules share premium must generally be allocated to the same tier of capital on which it arises. However, the FSA permits share premium on preference shares to be treated as core Tier 1 capital if the terms of issue of the preference shares provide that any premium is not repayable on redemption; this will cease to be possible in the future.

Unrealised Gains and Losses
No adjustment will be made to remove from common equity unrealised gains or losses. This is intended to address concerns that the filtering out of certain unrealised losses has undermined confidence in Tier 1 capital.

Cash Flow Hedge Reserve
Basel III will eliminate positive and negative cash flows relating to the fair value of derivatives used for hedging purposes. This reserve gives rise to artificial volatility in common equity and, in the view of the Basel Committee, is not prudentially appropriate where the hedged future cash flow is not subject to fair value adjustments.

3.8 TIER 2 CAPITAL

Currently Tier 2 capital is divided into upper and lower tiers of capital. Upper Tier 2 consists of permanent cumulative preference shares and other undated instruments with a cumulative feature (e.g. perpetual subordinated debt). Under Basel II it is necessary that upper Tier 2 capital absorbs losses on a going concern basis through the ability to defer (on a cumulative basis) payment of coupons or dividends.

Dated subordinated debt is lower Tier 2 capital. To be eligible the debt must have an original maturity of at least five years, and be amortised to zero, for capital purposes, on a straight-line basis in the five years prior to its contractual maturity date.

Under Basel II upper and lower Tier 2 capital may include an incentive to redeem (e.g. a step-up).

As noted above, Tier 2 capital cannot exceed 100% of total Tier 1 capital after deductions and lower Tier 2 capital is currently restricted to 50% of Tier 1 capital.
Basel III will abolish upper Tier 2 capital as a separate tier of capital, with the result that the Tier 2 requirement can be met entirely with lower Tier 2 capital. This does not prevent issuers from continuing to issue upper Tier 2 capital. However, given that upper Tier 2 instruments include a solvency condition enabling the issuer to defer (on a cumulative basis) payment of interest, this is unlikely to be commercially attractive as there is no regulatory requirement for such a solvency condition under Basel III.

*Prima facie* it appears that all existing issues of upper and lower Tier 2 are not Basel III compliant as they do not include provision for write-down or conversion to common equity at the point of non-viability. If this is the case, it follows that existing Tier 2 capital will only be eligible under the grandfathering provisions described in section 3.13 below. This is unlikely to be a problem with lower Tier 2 capital as such issues typically have an original maturity of, or a call after, five years enabling issuers to refinance such instruments (subject to the availability of replacement finance). As upper Tier 2 is perpetual there may be less opportunity to refinance, although where such instruments contain an issuer call it will be possible to replace such issues at the call date with Basel III compliant Tier 2 capital.

**Calibration**

Tier 2 capital is currently eligible to cover 4% of risk-weighted assets provided that the bank meets its minimum Tier 1 requirement. Under Basel III the eligibility of Tier 2 capital will be reduced to 2% of risk-weighted assets. As this is the same as the current cap on lower Tier 2 capital, upper Tier 2 is in effect being replaced by a requirement to hold common equity. This will be phased in as follows:

<table>
<thead>
<tr>
<th></th>
<th>Upper Tier 2</th>
<th>Lower Tier 2</th>
<th>Total Tier 2%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Basel II requirement</td>
<td>4% (but total of upper and lower Tier 2 cannot exceed 4%)</td>
<td>2%</td>
<td>4%</td>
</tr>
<tr>
<td>From 1 January 2013</td>
<td>-</td>
<td>3.5%</td>
<td>3.5%</td>
</tr>
<tr>
<td>From 1 January 2014</td>
<td>-</td>
<td>2.5%</td>
<td>2.5%</td>
</tr>
<tr>
<td>From 1 January 2015</td>
<td>-</td>
<td>2%</td>
<td>2%</td>
</tr>
</tbody>
</table>
Detailed Requirements for Tier 2 Capital

The Basel Committee has decided upon a substantial simplification of the requirements for Tier 2 capital. CRD II, by contrast, did not make any changes to Tier 2 capital. Under Basel III:

- Tier 2 capital must absorb losses on a gone concern basis only (i.e. in an insolvency or if the issuer is no longer viable). It will not be necessary for Tier 2 capital to absorb losses on a going concern basis through coupon deferral;
- the two sub-tiers of Tier 2 capital are abolished with the result that the whole of a bank’s Tier 2 capital may be comprised of dated subordinated debt; and
- no step-up or incentive to redeem is permitted.

The detailed Basel III criteria for Tier 2 capital include:

- the instruments must be subordinated to depositors and general creditors;
- the instruments cannot be either secured or guaranteed by the issuer or a related company that legally or economically enhances the seniority of the instruments;
- the minimum original maturity must be five years with amortisation on a straight line basis in the five years prior to maturity;
- the instruments may be called after at least five years with prior supervisory consent;
- the issuer must not do anything which creates an expectation that a call will be exercised;
- a bank must not exercise a call unless either the instrument is replaced with capital of the same or better quality or the bank demonstrates that its capital position is well above the minimum capital requirements (which may at national discretion be higher than the Basel III minima) after exercising the call;
- an investor must have no rights to accelerate the repayment of coupons or principal except in bankruptcy or liquidation; and
- the coupon must not reset periodically based in whole (or in part) on the bank’s credit rating (i.e. a credit rating ratchet).

The main change brought in by Basel III to what is currently lower Tier 2 is the introduction of a prohibition on incentives to redeem. Existing issues of lower Tier 2 capital have often been structured with a 10 year maturity but with an issuer call after five years. If the issuer fails to exercise the call the coupon is subject to a step-up. The assumption of issuers and investors was that the debt would be refinanced at year five with the result that the bank would not need to amortise the capital before refinancing. Such arrangements will no longer be permissible under Basel III.

3.9 TIER 3 CAPITAL

Tier 3 capital instruments consist of short-term subordinated debt (i.e. debt with a minimum maturity of two years). Repayment of such debt is subject to a ‘lock in’ insofar as repayment at maturity is conditional on the bank being able to meet its regulatory requirements after repayment. Tier 3 capital is only available to cover trading book exposures. The Basel Committee has decided to abolish Tier 3 capital. The same quality of capital (Tier 1 and Tier 2) will therefore be required to cover market risk as is needed in respect of credit and other risks.
3.10 DISCLOSURE REQUIREMENTS

Banks will be required to make the following disclosures under Basel III:

- full reconciliation of regulatory capital elements back to the balance sheet in the audited financial statements;
- separate disclosure of all regulatory adjustments (i.e. deductions from capital);
- description of all limits and minima, identifying the positive and negative elements of capital to which the limits and minima apply;
- a description of the main features of capital instruments issued; and
- banks which disclose ratios involving components of regulatory capital (e.g. ‘equity Tier 1’, ‘core Tier 1’ or ‘tangible common equity’ ratios) to accompany these with a comprehensive explanation of how these ratios are calculated.\(^{73}\)

Banks will also need to make available the full terms and conditions of instruments included in regulatory capital on their website.\(^ {24}\)

3.11 SUMMARY: CAPITAL UNDER BASEL III

The limits on capital, together with the relevant transitional provisions, have been set out above. The table below summarises the new minimum capital requirements, together with the capital conservation buffer discussed in section 7.1 below.

<table>
<thead>
<tr>
<th></th>
<th>Common equity</th>
<th>Common equity (including capital conservation buffer)</th>
<th>Non-core Tier 1</th>
<th>Total Tier 1 capital</th>
<th>Tier 2 capital</th>
<th>Total capital including capital conservation buffer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Basel II requirement</td>
<td>2%</td>
<td>2%</td>
<td>2% maximum</td>
<td>4%</td>
<td>4%</td>
<td>8% maximum</td>
</tr>
<tr>
<td>From 1 January 2013</td>
<td>3.5%</td>
<td>3.5%</td>
<td>1%</td>
<td>4.5%</td>
<td>3.5%</td>
<td>8%</td>
</tr>
<tr>
<td>From 1 January 2014</td>
<td>4%</td>
<td>4%</td>
<td>1.5%</td>
<td>5.5%</td>
<td>2.5%</td>
<td>8%</td>
</tr>
<tr>
<td>From 1 January 2015</td>
<td>4.5%</td>
<td>4.5%</td>
<td>1.5%</td>
<td>6%</td>
<td>2%</td>
<td>8%</td>
</tr>
<tr>
<td>From 1 January 2016</td>
<td>4.5%</td>
<td>5.125%</td>
<td>1.5%</td>
<td>6.625%</td>
<td>2%</td>
<td>8.625%</td>
</tr>
<tr>
<td>From 1 January 2017</td>
<td>4.5%</td>
<td>5.75%</td>
<td>1.5%</td>
<td>7.25%</td>
<td>2%</td>
<td>9.25%</td>
</tr>
<tr>
<td>From 1 January 2018</td>
<td>4.5%</td>
<td>6.375%</td>
<td>1.5%</td>
<td>7.875%</td>
<td>2%</td>
<td>9.875%</td>
</tr>
<tr>
<td>From 1 January 2019</td>
<td>4.5%</td>
<td>7%</td>
<td>1.5%</td>
<td>8.5%</td>
<td>2%</td>
<td>10.5%</td>
</tr>
</tbody>
</table>
Although the overall capital requirement of 8% only increases by the amount of the capital conservation buffer (and, potentially, a counter-cyclical buffer) this does not mean that there will not be a significant increase in the amount and quality of capital required. This is because:

- the requirements for core Tier 1, non-core Tier 1 and total capital will need to be made up of Basel III compliant instruments;
- innovative Tier 1 and Tier 3 capital are being abolished;
- it currently appears that all existing non-core Tier 1 and Tier 2 capital will need to be replaced by instruments that may be written down or which convert to common equity at the point of non-viability; and
- a much more stringent approach to deductions from capital will apply, with most deductions being made from common equity.

### 3.12 CONVERTIBLE CAPITAL (COCos)

The December 2009 consultation document did not include proposals in respect of contingent and convertible capital (such as the enhanced capital notes issued by Lloyds Banking Group). However, it stated that:

“[t]he Committee intends to discuss specific proposals at its July 2010 meeting on the role of convertibility, including as a possible entry criterion for Tier 1 and/or Tier 2 to ensure loss absorbency, and on the role of contingent and convertible capital more generally both within the regulatory capital minimum and as buffers”\(^\text{75}\).

Basel III has set out requirements for loss absorbency at the point of non-viability which are considered above. However, no developed proposals have emerged as to the role of contingent capital in other circumstances, although this is understood to be under consideration as a possible element in the toolkit to address systemically important financial institutions and, in particular, the problem of ‘too big to fail’.

In Switzerland the Commission of Experts appointed by the Federal Council recommended in September 2010 that UBS and Credit Suisse be required to maintain 9% in the form of ‘contingent capital’ and other securities with a capacity to absorb losses at times of stress on top of a minimum 10% common equity requirement\(^\text{76}\). These bonds would automatically convert into common equity when a bank’s common equity ratio dropped below a predefined level.

In February 2011 Credit Suisse successfully placed CHF 6 billion of Tier 1 buffer capital notes with a further issue of CHF 2 billion in Tier 2 buffer capital notes. In the case of the Tier 1 buffer capital notes they will convert into Credit Suisse Group ordinary shares if the Group’s reported Basel III common equity Tier 1 ratio falls below 7%. The notes will also be converted if FINMA, the relevant Swiss regulator, determines that Credit Suisse requires public sector support to prevent it from becoming insolvent. The Tier 2 buffer capital notes will convert into Credit Suisse Group ordinary shares if the Group’s reported consolidated risk-based capital ratio falls below 7% or if FINMA determines that Credit Suisse requires public support. Rabobank has also issued convertible capital.

It is unclear whether such proposals will gain further international support and be adopted more widely, and doubts have been expressed as to the willingness of investors to hold significant amounts of contingent capital.
3.13 GRANDFATHERING OF CAPITAL INSTRUMENTS

The December 2009 consultation paper did not include any proposals for grandfathering and implied that capital instruments issued after 17 December 2009 would need to satisfy the Basel III requirements. The Basel Committee has now formulated detailed rules in respect of grandfathering of existing capital instruments.

The rules set out below only apply to capital instruments issued before 12 September 2010. Instruments issued after that date that do not comply with the new Basel III definitions will cease to be eligible as regulatory capital from 1 January 2013. An exception applies to the requirement for write down or conversion at the point of non-viability for instruments issued before 1 January 2013, which will be grandfathered provided that they otherwise meet the Basel III capital definitions.

Common Equity
Capital instruments that no longer count as common equity under the Basel III definition will be excluded from common equity from 1 January 2013. A limited transitional provision exists for instruments issued by mutuals and other banks without share capital.

Non-Common Equity Tier 1
These instruments will be phased out starting on 1 January 2013. Basel III requires banks to fix the base at the nominal amount of such instruments outstanding on 1 January 2013 and sets a cap for recognition of 90%. It follows that 90% of such non-compliant instruments will be recognised as regulatory capital. This figure will then decrease by 10 percentage points per year as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Percentage Recognised as Regulatory Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 January 2013</td>
<td>90%</td>
</tr>
<tr>
<td>1 January 2014</td>
<td>80%</td>
</tr>
<tr>
<td>1 January 2015</td>
<td>70%</td>
</tr>
<tr>
<td>1 January 2016</td>
<td>60%</td>
</tr>
<tr>
<td>1 January 2017</td>
<td>50%</td>
</tr>
<tr>
<td>1 January 2018</td>
<td>40%</td>
</tr>
<tr>
<td>1 January 2019</td>
<td>30%</td>
</tr>
<tr>
<td>1 January 2020</td>
<td>20%</td>
</tr>
<tr>
<td>1 January 2021</td>
<td>10%</td>
</tr>
<tr>
<td>1 January 2022</td>
<td>0%</td>
</tr>
</tbody>
</table>

As mentioned above, the base amount will be fixed on 1 January 2013. Basel III states that the redemption of such instruments after 2013 has no effect on the base amount, with the result that banks may be able to recognise non-compliant capital instruments up to the relevant percentage set out in the table regardless of whether or not the particular instrument was recognised as capital on 1 January 2013 because of the application of the above limits.

Tier 2 Instruments
The requirements for amortisation of non-compliant Tier 2 instruments will be the same as those for Tier 1. However, the base amount for Tier 2 instruments will be set independently on 1 January 2013.

Public Sector Injections of Capital
These will be grandfathered until 1 January 2018.
Step-up and Call Before 13 September 2010
If the instrument is not called before 13 September 2010, and does not satisfy the Basel III requirements for Tier 1 or Tier 2 capital then it will be amortised from 1 January 2013 as set out above.

Step-up and Call Between 13 September 2010 and 1 January 2013
If the instrument is not called, and satisfies the requirements in Basel III for Tier 1 or Tier 2 capital then it will be recognised in the appropriate tier of capital.
If the instrument is not called and does not satisfy the new eligibility criteria it will be fully derecognised in that tier of capital on 1 January 2013. The intention seems to be to require banks that have issued capital instruments with a call feature to exercise that call and, if necessary, replace the instruments with Basel III compliant capital. As mentioned above, we are not aware of any existing Tier 1 or Tier 2 instruments issued by banks in the UK that incorporate conversion/write-down features that are Basel III compliant. Such existing capital instruments with a call may therefore face disqualification from capital in 2013 if the call is not exercised. Clarification on whether conversion/write down at the point of non-viability is required for the instrument to be treated as Basel III compliant would be welcome.

Step-up and Call on or after 1 January 2013
Prior to the call date such instruments will be treated as non-compliant and therefore subject to amortisation as set out in the table above. If the instrument is not called and it satisfies the requirements in Basel III for Tier 1 or Tier 2 capital then it will be recognised in the appropriate tier of capital.
If the instrument is not called and does not satisfy the new eligibility criteria it will be fully derecognised. Again, the intention is that the call be exercised and, if necessary, the capital be replaced with Basel III compliant instruments.

Tier 3 Capital
Tier 3 capital is abolished. There are no specific transitional provisions. However, as Tier 3 capital consists of short-term subordinated debt (generally, two years) such capital will be able to be refinanced (subject to the availability of finance) before the implementation of Basel III.
4. Deductions from Capital

Basel III will bring about major changes to the way in which deductions are made from capital.

4.1 Existing FSA Approach to Deductions from Capital

Under existing FSA rules the following deductions are made:

Deductions from Total Tier 1 Capital

- investment in own shares;
- intangible assets (including goodwill);
- net losses on equities in the available-for-sale asset category; and
- 50% of deductions in respect of material holdings (i.e. investment in affiliated undertakings and participations), expected losses and certain securitisation positions (see further below).

Deductions from Total Tier 1 and Tier 2 Capital

- qualifying holdings (i.e. direct or indirect holdings in a non-financial undertaking which represent 10% or more of the capital or of the voting rights, or which make it possible to exercise a significant influence over management);
- reciprocal cross-holdings (essentially, cross-investments made to artificially boost banks’ capital ratios);
- connected lending of a capital nature (typically, long-term or subordinated lending to other group companies, together with guarantees with similar effect);
- material holdings not deducted from Tier 1;
- expected losses not deducted from Tier 1; and
- certain securitisation positions not deducted from Tier 1.

4.2 Deductions under CRD II

CRD II introduced on 31 December 2010 a new limit on hybrid (i.e. non-core) capital of 100% of Tier 1 capital after deductions. Previously, the FSA required banks to hold core Tier 1 capital (common shares and reserves) of at least 50% of total Tier 1 less reserves. The effect of this change was that deductions from Tier 1 capital now need to be made from core Tier 1 capital in calculating the overall limits on hybrid capital.

4.3 Deductions under Basel III

Basel III will result in a radical overhaul to deductions from capital. In December 2009 the Basel Committee proposed that deductions from capital should be applied to the component of capital that is affected by the recognition of the relevant element on the balance sheet. Generally, this is retained earnings. It follows that most deductions should be made from core Tier 1 capital. This treatment has been confirmed in the final rules.
The practical effect of making deductions from core Tier 1 capital is to increase the amount of common equity and reserves that a bank must hold. Furthermore, as Basel III will require banks to publish capital ratios after deductions this may affect the published core Tier 1 ratios of some banking groups. The purpose of this change is to prevent banks from showing strong Tier 1 capital ratios while having lower levels of tangible common equity.

Goodwill and other Intangibles
The FSA currently requires goodwill to be deducted from total Tier 1 capital. Under Basel III this deduction will be made from common equity (core Tier 1 capital). The deduction is net of any associated deferred tax liability which would be extinguished if the goodwill was impaired or derecognised under accounting standards. One effect of this change is that banking groups that grow by acquisitions will not have a capital advantage over groups that grow organically. With prior supervisory approval, banks using local GAAP may use the IFRS definition of ‘intangible assets’ to determine which assets are covered by this deduction. The intention is to prevent differences between local GAAP and IFRS affecting the deductions that banks are required to make.

DTAs and Liabilities
The treatment of DTAs and related liabilities is complex with three different approaches.

DTAs that rely on future profitability to be realised (e.g. operating losses carried forward, unused tax losses and unused tax credits) will be deducted from common equity. Such DTAs can only be realised through a reduction in future tax payments if the bank makes a profit in the future. Because of the uncertainty of future profits the Basel Committee considers that reliance on such assets as a reserve is not appropriate. Moreover, such DTAs provide no protection to depositors or government insurance funds if a bank becomes insolvent.

Deferred tax liabilities may be netted provided that they relate to taxes levied by the same tax authority and offsetting is permitted by that authority. Deferred tax liabilities to be netted against DTAs are required to exclude amounts netted against the deduction for goodwill, other intangibles and defined benefit pension assets. Deferred tax liabilities must be allocated pro rata between DTAs subject to deduction from common equity and those DTAs subject to threshold deductions (see below).

A separate treatment applies to DTAs arising from ‘temporary differences’ which are subject to the threshold deductions approach referred to below. Basel III gives the example of allowances for credit losses.

DTAs that are a claim on a tax authority (i.e. prepayments of tax or tax receivables) will be risk-weighted as a claim on the relevant government on the basis that such claims represent sovereign risk. This includes over-instalments of tax and, where so provided under local law, current year tax losses that are a receivable from the government or tax authority. Such DTAs are not deducted as they are a debt owed to the bank as opposed to a contingent right to offset losses against future profits.

Cash Flow Hedge Reserve
A cash flow hedge reserve that relates to the hedging of items not fair valued on the balance sheet is excluded from regulatory capital. Positive items are therefore deducted while negative amounts are added back. The reason is that the reserve reflects the fair value of the derivative entered into but not changes in the fair value of the hedged future cash flow.

Shortfall in Provisions
Unsurprisingly, shortfalls in provisions for expected losses must be deducted. This is a treatment allowed under the internal ratings-based (IRB) approach followed by some banks with the relevant FSA approval. Currently, this deduction is made from total Tier 1 and Tier 2 capital.
Gain on Sale of Certain Securitisation Transactions
Any increase in equity capital resulting from securitisations (e.g. from expected future margin income) must be deducted. The FSA currently achieves this by excluding such gains from the profit and loss account and reserves.

Gains and Losses Due to Changes in Own Credit Risk
All unrealised gains and losses that result from changes in the fair value of liabilities that are attributable to changes in the bank’s own credit risk must be excluded from regulatory capital.

Pension Fund Assets and Liabilities
Basel III requires that defined benefit pension fund liabilities should be fully deducted from the calculation of common equity. The effect is that any pension deficits must be deducted from common equity. Defined benefit pension fund assets will also be deducted from common equity net of any associated deferred tax liability which would be extinguished if the asset became impaired or derecognised under accounting standards. The reason is that such assets may not be capable of being withdrawn and used to pay depositors and creditors. However, if the bank can satisfy its supervisor that it has unrestricted and unfettered access to assets in the fund then the bank may offset the deduction with such assets. Such offsetting assets will be risk-weighted as if they were directly owned by the bank.

Investment in Own Shares
All investments in own shares will be deducted from common equity. The purpose of this deduction is to avoid the double counting of a bank’s capital. Currently, the FSA requires this deduction to be made from total Tier 1. Similarly, any stock which a bank could be contractually obliged to purchase (e.g. due to an investor call) must be deducted. This applies regardless of whether the investment is held in the banking book or the trading book of the bank. Indirect holdings held through a position in an index must also be deducted. Long and short positions may only be netted if there is no counterparty risk on the short positions (as would be the case if the share were partly paid).

Banks’ investment in their own non-core Tier 1 and Tier 2 capital must also be deducted. In accordance with the ‘corresponding deduction’ approach (see page 31), non-core Tier 1 instruments must be deducted from that tier of capital and own holdings of Tier 2 capital from total Tier 2 capital.

Reciprocal Cross-holdings
Reciprocal cross-holdings artificially boost the capital of the banks investing in each other’s capital instruments. A corresponding deduction approach applies, with equity holdings being deducted from common equity. Currently, the deduction is made from total Tier 1 capital.

Material Holdings and Investments in Affiliates
As mentioned above, the FSA requires the deduction of material holdings (including investments in affiliates). A material holding is, basically, an investment of 10% or more in the shares and capital of a bank or financial institution. An investment that exceeds 10% of the bank’s own capital is also required to be deducted as a material holding if it is less than 10% of the share capital of the relevant entity. Holdings of 20% or more in insurance companies must also be deducted under current FSA rules.

Basel III requires the deduction of holdings that collectively exceed 10% of a bank’s common equity after applying all other regulatory adjustments (deductions) prior to this one if:

- a bank owns less than 10% of the issued common shares of the banking, financial and insurance entities; and
- such investments are outside the scope of regulatory consolidation.
The amount of the deduction is the excess over 10% of the bank's common equity (i.e. if the bank holds capital instruments issued by banking, financial and insurance entities equal to 13% of its common equity then only 3% will be deducted under this heading)\(^{98}\). Holdings below the 10% threshold that are not deducted will be risk-weighted in the normal way\(^{99}\).

In calculating the 10% limit, direct, indirect and synthetic\(^{100}\) holdings of shares and capital instruments (e.g. subordinated debt) must be aggregated, whether held in the trading book or the banking book. Holdings through an index must also be included. The bank will then determine its net long position through adding up all long positions in shares and other capital instruments and deducting all short positions in the same underlying exposure (provided that the short positions match the long position or have a residual maturity of at least one year)\(^{101}\).

Any capital instrument that does not meet the criteria for common equity, non-core Tier 1 or Tier 2 capital of the bank is considered to be common shares. This seems to require banks to treat as common equity for the application of the relevant limits any capital instruments (in the sense that they form part of the capital of the issuer) that are non-compliant with the new Basel III requirements. This seems a surprising outcome and it is to be hoped that this will be clarified through the implementation process. If the capital has been issued out of a regulated financial entity, and is not included in regulatory capital, a footnote states that it is not required to be deducted\(^{102}\).

At national discretion banks may exclude temporarily investments where these have been made in the context of resolving or providing financial assistance to reorganise a distressed institution\(^{103}\).

The Basel Committee has adopted a ‘corresponding deduction’ approach to investments in the capital of banks, financial institutions and insurers that are not consolidated with the bank. This means that deductions must be applied to the same component of capital that the capital would qualify as if it were issued by the bank. Thus:

\[\text{"the amount to be deducted from common equity should be calculated as the total of all holdings which in aggregate exceed 10% of the bank’s common equity (as per above) multiplied by the common equity holdings as a percentage of the total capital holdings. This would result in a common equity deduction which corresponds to the proportion of total capital holdings held in common equity. Similarly, the amount to be deducted from Additional Tier 1 capital should be calculated as the total of all holdings which in aggregate exceed 10% of the bank’s common equity (as per above) multiplied by the Additional Tier 1 capital holdings as a percentage of the total capital holdings."}^{104}\]

The same approach applies to Tier 2 capital. If a bank does not have sufficient capital of the relevant tier, the deduction is made against the next higher tier of capital (i.e. non-core Tier 1 against common equity)\(^{105}\).

In addition, individual holdings in excess of 10% of the issued common share capital of banking, financial and insurance entities that are not consolidated with the bank must be deducted from capital. Holdings in affiliates that are not consolidated with the bank must likewise be deducted\(^{106}\). An ‘affiliate’ for these purposes is “a company that controls, or is controlled by, or is under common control with the bank”. Control “is defined as (1) ownership, control, or holding with power to vote 20% or more of a class of voting securities of the company; or (2) consolidation of the company for financial reporting purposes”\(^{107}\).

The treatment of such deductions differs depending on whether the bank has invested in common equity or other capital instruments. Investments in common equity are eligible for the threshold deduction
treatment, which is discussed below. However, any other investments:

“must be fully deducted following a corresponding deduction approach. This means the deduction should be applied to the same tier of capital for which the capital would qualify if it was issued by the bank itself. If the bank is required to make a deduction from a particular tier of capital and it does not have enough of that tier of capital to satisfy that deduction, the shortfall will be deducted from the next higher tier of capital.”

Curiously, the effect is to impose a less onerous treatment on individual holdings of more than 10% in common equity than positions in preference shares or Tier 2 debt that are less risky (because they enjoy a higher ranking on an insolvency). This was one of the compromises reached as part of the negotiations on the Basel III framework.

The above threshold for identification of a material holding is similar to that set out in the current FSA rules (which are themselves derived from EU Directives). However, the deduction for aggregate investments that exceed 10% is applied at the level of common equity rather than the sum of Tier 1 and Tier 2 capital. This may significantly reduce the level at which investments that do not individually exceed 10% of the share capital of the target are required to be deducted.

The above rules apply on a consolidated basis, reflecting the group-based approach in Basel II. However, individual supervisors may decide to apply the requirements on a solo or unconsolidated basis. This approach has been followed by the FSA in the UK. In this case, any investment in subsidiaries and participations (i.e. 20% equity interests) will need to be deducted from common equity. This will make it less efficient from a capital perspective for regulated banks within a group to perform a holding company role through owning operating subsidiaries.

Threshold Deductions
Reference has been made above to ‘threshold deductions’. Under Basel III the following may each receive limited recognition when calculating a bank’s common equity:

- significant investments in the common shares of unconsolidated financial institutions (i.e. individual investments of over 10%);
- MSRs; and
- DTAs that arise from temporary differences.

From 1 January 2013 banks will be required to deduct the amount by which the sum of the above three amounts exceeds 15% of their common equity. The 15% figure is calculated before deduction of those amounts but after deduction of all the previous regulatory adjustments. Furthermore, the amounts included in the 15% bucket will need to be disclosed.

From 1 January 2018 this treatment will change as the 15% limit will be calculated after deduction of all regulatory adjustments (including the three items included in the 15% bucket). It follows that those items will be used to reduce the (notional) amount of common equity against which the 15% limit is calculated.

In practice a bank may recognise a lower amount than 15%, for example, if the sum of the three items is below 15% or if any individual category exceeds the 10% individual limit.

Items not deducted from capital under the threshold deduction treatment are risk-weighted at 250%.
4.4 OTHER DEDUCTIONS FROM CAPITAL

Basel II, and existing FSA rules, require other deductions to be made at 50% from Tier 1 and 50% from Tier 2 capital. These include:

- certain securitisation exposures;
- certain equity exposures for banks applying the IRB approach;
- non-payment and non-delivery on transactions that do not settle on a delivery versus payment or a payment versus payment basis; and
- significant investments in commercial entities (referred to in the EU CRD and FSA rules as ‘qualifying holdings’).

These positions will now be risk-weighted at 1250%. Given the minimum risk-asset ratio is 8%, a risk weight of 1250% is equivalent to a deduction from capital as the bank is required to hold capital equal to 100% of the nominal amount of the exposures. The reason given for this change is to simplify the definition of capital and the calculation of the relevant limits.

4.5 PHASING IN THE NEW DEDUCTIONS

The new approach to deductions will be phased in starting on 1 January 2014, being one year after the Basel III requirements on capital are introduced. Moreover, the changes will be phased in with banks applying both the new and existing national treatments to deductions during the transition period. This will necessarily have systems implications for banks.

The transitional arrangements are summarised below.\textsuperscript{114}
5. Counterparty Credit Risk

In July 2009 the Basel Committee published reforms to the Basel II framework which, when implemented, will increase capital requirements substantially for trading book exposures as well as for complex securitisations. The changes will:

- introduce much higher capital charges for re-securitisation exposures (such as CDOs of ABS);
- require banks to improve their models to measure capital requirements for trading activity through the introduction of a stressed risk measurement; and
- require capital to be held against credit risk migration (e.g. ratings downgrades) in respect of debt instruments.

These changes are being implemented in the EU mainly by the CRD III Directive on 31 December 2011.

Basel III addresses the following further deficiencies that the financial crisis revealed, principally in respect of repurchase agreements, securities financing transactions and OTC derivatives:

- defaults and credit downgrades occurred at a time when market volatility, and therefore counterparty exposures, were higher than usual;
- mark-to-market losses due to credit adjustments were not subject to capital requirements. Two-thirds of counterparty credit losses were in fact due to credit downgrades and only one-third were due to defaults;
- large financial institutions are significantly more interconnected than was assumed by Basel II;
- the close-out period for replacing trades with a counterparty consisting of complex trades or backed by illiquid collateral exceeded that presupposed by the Basel II calculations;
- initial margining was low at the start of the financial crisis and increased rapidly thereafter, destabilising market expectations and sometimes causing defaults where financial institutions were required to find large amounts of collateral at short notice when they were already under strain; and
- inadequate use of central counterparties to clear derivatives trades exposed institutions to a much greater degree of counterparty credit risk than necessary. This compounded the difficulties caused by a lack of transparency as to level of exposures of individual institutions.

Basel III seeks to address these problems, principally by raising capital requirements in respect of trading book transactions:

- banks will be required to determine their capital requirement for counterparty credit risk on repurchase agreements, securities financing transactions and OTC derivatives using stressed inputs. The intention is to address concerns that existing capital charges became too low during periods of low market volatility;
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- banks will be subject to a capital charge for mark-to-market losses associated with a deterioration in the creditworthiness of a counterparty;
- standards for collateral management and initial margining will be strengthened. Banks with large and illiquid derivative exposures will have to apply longer margining periods as a basis for determining their regulatory capital requirements;
- risk weights on exposures to financial institutions will increase relative to those on the non-financial corporate sector;
- banks’ collateral and mark-to-market exposures to central counterparties will be harmonised; and
- improving credit risk management standards in a number of areas, including the treatment of wrong-way risk (i.e. where an exposure to a counterparty is adversely correlated with the credit quality of that counterparty).

These proposals are examined in more detail below.

5.1 USE OF STRESSED INPUTS WHEN CALCULATING CAPITAL REQUIREMENTS

Capital requirements for counterparty credit risk are currently based on the effective ‘expected positive exposure’ (Effective EPE). This is because a bank will only suffer a credit-related loss on repo and OTC derivative transactions if the contract has positive net value (i.e. it is in the money). Effective EPE is calculated under Basel II as the weighted average of the exposure over a one year period or, if shorter, the time period of the longest maturity contract in the netting set. Under the proposals, banks must use the maximum of the capital charge based on Effective EPE using current market data and a capital charge based on Effective EPE using a three year period that includes a period of stress (such as the 2007/8 financial crisis) calculated on a portfolio basis. The stress period must coincide with a period of increased CDS or other credit spreads. This is intended to ensure that periods of low market volatility (such as were experienced in the run up to 2007) do not lead to an undue reduction in capital requirements, thereby failing to reflect the real level of risk in the financial system.

5.2 ADDITIONAL CAPITAL CHARGE FOR MARK-TO-MARKET LOSSES

As mentioned above, a significant driver of mark-to-market losses was a decline in credit ratings (internal or external) short of actual default (credit valuation adjustments). Basel III addresses this risk by introducing a new incremental capital charge to capture the risk of loss associated with a decline short of default in the creditworthiness of a counterparty for OTC derivatives and repo-style transactions. This involves a capital add-on based on the notional capital requirement for a bond used as a proxy for a ratings downgrade. The method used for calculating the additional charge depends on the bank’s existing approach to determining counterparty credit risk (e.g. the internal models method). The formulae were corrected in the June 2011 revision of Basel III.

The capital requirement for the ‘bond’ will be calculated using the market risk framework, with a nominal value equal to the exposure at default (EAD) of the counterparty. Banks will be able to hedge this notional exposure (thereby reducing the capital charge) by a single-name credit default swap referencing the counterparty and similar hedging arrangements. This will provide an incentive for banks to hedge their exposure to credit downgrades.

5.3 DEALING WITH ‘WRONG-WAY’ RISK

Wrong-way risk arises if an exposure to a counterparty is adversely correlated with the credit quality of that
counterparty (i.e. the probability of default (PD) and the EAD are positively correlated). Specific wrong-way risk arises if the correlation relates to a single counterparty and generally arises from poorly designed transactions (e.g. taking a counterparty’s own shares as collateral). General wrong-way risk arises if the PD of counterparties in general is positively correlated with market risk factors. (Wrong-way risk would, perhaps, be better described as ‘same-way risk’ or ‘correlation risk’.)

Banks were exposed to significant general wrong-way risk in the financial crisis through the purchase of credit protection from monoline insurers. This is because the circumstances in which a counterparty defaulted and the circumstances in which the monoline was required to perform under its CDS contracts were precisely the circumstances in which, due to its obligations under other CDS contracts, the monoline was more likely to default.

The Basel Committee has decided that it is not possible to address general wrong-way risk through capital charges. Banks will be required to deal with this risk through stress testing and scenario analysis to identify factors that are positively correlated with counterparty credit risk. Such testing should address the possibility of severe risks occurring.

However, specific wrong-way risk will be recognised and measured. A capital charge is therefore introduced for each counterparty where there exists a legal connection that gives rise to measurable wrong-way risk. For single-name credit default swaps where there exists a legal connection between the counterparty and the underlying issuer, the Basel Committee states that such transactions will be excluded from the same netting set as other transactions with that counterparty. For credit default swaps the EAD in respect of such swap counterparty will equal the full expected loss in the fair value of the underlying instrument assuming the issuer is in liquidation. The loss given default (LGD) will be set at 100% for both foundation and advanced IRB banks. Banks on the standardised approach will treat the transaction as being unsecured. In addition, for equity derivatives, bond options, securities financing transactions, etc. referencing a single company where there exists a legal connection between the counterparty and the underlying company, the EAD is the value of the transaction on the assumption of a jump-to-default of the underlying entity. LGD must therefore be 100%.

5.4 COLLATERALISED TRANSACTIONS

The crisis demonstrated that effecting a close-out can take longer than the supervisory assumption of 10 business days for OTC derivatives and five business days for securities financing transactions in Basel II.

The liquidity of trades, the cost of hedging open positions, the size of netting sets and the occurrence of disputes were observed as key causes for longer close-out periods. Many close-outs were completed rapidly but often at the cost of accepting price discounts. While the Basel Committee considers that the Basel II supervisory floors should not be changed, there are circumstances in which the five or 10 day floors should be increased to capture the illiquidity of collateral, the length of margin call disputes, and the costs of trade replacement.

The following changes have been agreed:

- increasing the margin period of risk for OTC derivatives and securities financing transactions. Banks with a history of margin call disputes will be required to use a margin period of risk at least double the supervisory floor for such counterparties for the subsequent two quarters;
- amending the ‘shortcut method’ so that more realistic assumptions are taken into account to estimate Effective EPE when a bank cannot model margin requirements along with its exposures.
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5.5 SECURITISATION EXPOSURES AS COLLATERAL

Banks that use supervisory estimates for haircuts to collateral under the comprehensive approach to collateral or the foundation IRB approach will be required to apply greater haircuts for collateral in the form of securitisation exposures. These will be double the haircuts applied to other issuers. Re-securitisation exposures (e.g. CDOs) will not be eligible as collateral\(^{125}\).

5.6 CENTRAL COUNTERPARTIES

In December 2010 the Basel Committee published a consultation document on the capitalisation of bank exposures to central counterparties. The intention is that the new regime will be in place by 1 January 2013 as part of Basel III. Currently Basel II allows exposures to central counterparties to be risk-weighted at 0%. The Basel Committee considers that this is not appropriate as central counterparty exposures involve some credit risk. Given the G20 commitment to increase the use of central counterparties, banks and other financial market participants will be increasingly reliant on such counterparties in the future.

Under the Basel Committee proposal a 2% risk weight would apply to exposures to qualifying central counterparties in respect of:

- posted collateral;
- mark-to-market exposures; and
- potential future exposure.

A central counterparty will only qualify for this capital treatment if it satisfies the applicable CPSS-IOSCO standards and is able to assist clearing members to capitalise central counterparty exposures either by undertaking the calculation of the relevant capital charge itself or through providing sufficient information to enable clearing members to calculate their capital requirement.

No capital charge will apply where a bank posts collateral in connection with trades on a qualifying central counterparty if the collateral is segregated and held by a bankruptcy remote custodian (although the bank will need to risk weight its holding of the actual assets posted as collateral).

Exposures to the central counterparty’s default fund would be capitalised based on the hypothetical capital requirement of the central counterparty. Essentially, this involves estimating the central counterparty’s exposure to its members on a bilateral basis and then reducing this by the initial margin held by the central counterparty. The capital charge for a bank’s default fund contribution will depend on whether the pre-funded capital resources of the central counterparty exceed this notional capital requirement, as well as the adequacy of the initial margining and financial resources of the central counterparty. It should be stressed that this is a notional capital requirement.
and the Basel Committee is not establishing actual minimum capital requirements for central counterparties (although there are other initiatives, such as the EU EMIR regulation, that will set minimum prudential requirements for central counterparties).

Equity investments in a central counterparty must be treated as an equivalent equity investment in a corresponding financial entity.

Exposures to non-qualifying central counterparties would be capitalised as a bilateral exposure. The intention is to encourage banks to deal with central counterparties that comply with CPSS-IOSCO standards.

The Basel Committee requested comments on the proposed framework by 4 February 2011. It intends to finalise its rules by September 2011.

5.7 EXPOSURES TO LARGE OR HIGHLY LEVERAGED FINANCIAL INSTITUTIONS

During the crisis, financial institutions’ credit quality deteriorated in a highly correlated manner and was more sensitive to systemic risk than that of non-financial firms. The Basel Committee has determined that asset value correlations for financial firms are 25% or more higher than is the case for exposures to non-financial firms. This higher level of correlation is being recognised through applying a multiplier as part of the IRB framework under Basel II for all such transactions.\(^\text{126}\)

The multiplier (which is expected to increase capital requirements for exposures to relevant counterparties by approximately 35%) will apply to:

- Regulated financial institutions whose assets are greater than or equal to US$100 billion. If the institution is part of a group the test will be applied at the level of the parent with its consolidated subsidiaries.\(^\text{127}\). For this purpose ‘regulated institutions’ include insurance companies, broker/dealers, banks, thrifts and futures commission merchants.\(^\text{128}\).

- Unregulated financial institutions regardless of size, i.e., firms whose main business includes the management of financial assets, lending, factoring, leasing, providing credit enhancements, securitisation, custody, central counterparties, proprietary trading and other activities identified by supervisors.

This would include hedge funds. A consequence of this change is a possible reduction in the liquidity of financial institution securities.

5.8 IMPROVING RELIANCE ON EXTERNAL CREDIT RATINGS

The Basel Committee identified a number of negative effects from the reliance on external ratings under Basel II: firstly, neglect of banks’ own independent assessment of risk; secondly, an incentive for rating agencies to produce good ratings, if necessary through issuers ‘shopping around’; and thirdly, so-called ‘cliff’ effects arising from the limited number of risk buckets. On 27 October 2010 the Financial Stability Board published principles for reducing reliance on credit rating agency ratings. The recommendations include the following:

- standard setters and authorities should assess references to credit rating agency ratings in standards, laws and regulations and, wherever possible, remove them or replace them by suitable alternative standards of creditworthiness;

- banks, market participants and institutional investors should make their own credit assessments, and not rely solely or mechanistically on ratings;
central banks should reach their own credit judgements on the financial instruments that they will accept in open market operations, both as collateral and as outright purchases. Central bank policies should avoid mechanistic approaches that could lead to unnecessarily abrupt and large changes in the eligibility of financial instruments; and

banks must not rely mechanistically on ratings for assessing the creditworthiness of assets. Larger, more sophisticated banks should be expected to assess the credit risk of everything they hold (either outright or as collateral).

Pending more substantial reform the Basel Committee has made a number of changes to the treatment of external ratings under Basel III. These include:

- Restricting the use of issue-specific credit assessments where a bank invests in an unrated debt to situations where the unrated claim ranks pari passu or senior in all respect to the rated issue.

- Banks will be required to assess the credit risk in exposures to borrowers regardless of whether they are rated or unrated. If a bank assesses that the inherent risk in an exposure is significantly higher than that implied by the relevant risk weight (whether rated or unrated) the bank should consider its higher estimate of the credit risk in the evaluation of its overall capital adequacy.

- National supervisors should refer to the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies in assessing the eligibility of rating agency credit ratings. Basel III makes minor amendments to the eligibility criteria.

- The abolition of the Basel II requirement that insurers and corporates that provide unfunded credit protection (guarantees and credit derivatives) must be externally or internally rated A- or better to be an eligible protection provider. The reason for this change is to mitigate cliff effects where the rating of a guarantor or CDS counterparty falls below A-. However, credit providers to a securitisation exposure would need to have an external rating of A- or better at the time that the credit protection was provided, and still be rated BBB- or better in order to be recognised.

- Banks will be precluded from changing their use of ratings arbitrarily from different rating agencies to ‘cherry pick’ assessments. Basel II is also being amended to specify that unsolicited ratings may only be used if national supervisors are satisfied that their quality is not inferior to the general quality of solicited ratings.
6. Leverage Ratio

The years leading up to the financial crisis were marked by an excessive increase in leverage without, in most cases, this adversely affecting banks’ disclosed capital ratios. Once the crisis erupted, the pressure to reduce leverage amplified downward pressure on asset prices, magnifying mark-to-market losses and write downs against capital, thereby leading to a significant contraction in the availability of credit to the real economy.

The Basel Committee has therefore decided to supplement the risk-based measurements in Basel II with a leverage ratio to curtail the build up of leverage and risk in the financial sector. This ratio will introduce an additional safeguard against model risk and measurement error. The leverage ratio is therefore a supplement and not a substitute for the risk asset ratio. It will principally affect banks whose business model involves investing in or lending to high credit quality counterparties where the risk-adjusted value of such exposures is low. Other business models likely to be affected include banks that have traditionally securitised a large percentage of their loan book as it will be extremely difficult in practice to exclude securitisations from the leverage ratio and trade finance.

The leverage ratio will be calculated based on the monthly leverage ratio over each quarter\textsuperscript{136}. The numerator will be the measure of capital (currently expected to be Tier 1 capital) and the denominator the measure of exposures which, as mentioned below, will be determined using applicable accounting standards. During a test phase from 1 January 2013 to 1 January 2017 the ratio will be set at 3%. This is considered further in section 6.4 below.

6.1 THE MEASURE OF CAPITAL

The capital measure used for the leverage ratio is proposed to be Tier 1 capital. However, the Basel Committee intends to collect data during the transition period tracking the impact of using core Tier 1 and total regulatory capital\textsuperscript{137}.

Exposures that are deducted from capital do not contribute to leverage, and should be excluded from the measure of exposures. Deductions from regulatory capital will therefore also be made to total exposures\textsuperscript{138}.

The treatment of significant investments (i.e. material holdings and subsidiaries not included in the regulatory consolidation) will follow the approach used under the capital framework. Where a bank has a subsidiary that is included in its accounting consolidation, but not in the regulatory consolidation (e.g. because it is an insurance company or a non-financial operating company), then that holding will be deducted when calculating the leverage ratio\textsuperscript{139}.

6.2 MEASURING EXPOSURES

Exposures will generally be determined in accordance with applicable accounting standards. It follows that non-derivative on-balance sheet exposures should be measured net of provisions and value adjustments. Collateral, guarantees and other credit risk mitigation techniques will not be permitted to reduce exposures\textsuperscript{140}.
Netting. Netting of loans and deposits is not permitted.

On-balance sheet items. All assets (including high-quality assets) on their accounting balance sheet must be included within the leverage ratio. The treatment of securitisation exposures will follow the accounting treatment. For funded securitisation structures, this will depend on whether the securitisation meets the criteria for derecognition. If so, the bank will be exposed to any retained positions as well as in respect of any credit enhancements provided. If the securitisation is not de-recognised, or is unfunded, then the bank will be treated as being exposed to the underlying portfolio. This is likely to impact on those banks and groups that have relied extensively on securitisation to fund loans originated by them.

Securities funding transactions (repurchase agreements and securities lending) are included based on their accounting treatment. Netting will, however, be permitted as set out in the Basel II framework.

Derivatives. Derivatives give rise to an on-balance sheet value based on the fair value of the contract. At the outset this will usually be nil, but will subsequently reflect the performance of the contract. A derivative will also reflect a notional exposure to the underlying economic interest of the derivative. Derivatives will be included in the leverage ratio using the accounting measure of exposure plus an add-on for potential future exposure calculated using the current exposure method under Basel II. Regulatory netting will be permitted in accordance with Basel II.

6.3 OFF-BALANCE SHEET ITEMS

Off-balance sheet items are a source of potentially significant leverage. Their exclusion from the leverage ratio would create incentives for firms to shift items off their balance sheet. Commitments, liquidity facilities, direct credit substitutes, acceptances, standby letters of credit, trade letters of credit, failed transactions and unsettled transactions will all therefore be included. A uniform 100% credit conversion factor will apply to all off-balance sheet items. This means that the full nominal amount of such exposures will be included. By way of exception, a 10% credit conversion factor will be applied to commitments that are unconditionally cancellable at any time by the bank without prior notice. The Basel Committee will carry out a further review to ensure that this is appropriate. Concerns have been expressed that this 100% credit conversion factor (together with the new liquidity requirements) could affect the pricing and availability of trade finance.

6.4 IMPLEMENTATION

Supervisory monitoring of the leverage ratio will commence on 1 January 2011. During this period supervisors will focus on developing templates to track the leverage ratio in a consistent manner.

From 1 January 2013 banks will be required to report their leverage ratio to supervisors based on the standards set out in Basel III. Public disclosure of the leverage ratio will commence on 1 January 2015 based on an agreed disclosure template. The intention is to enable the Basel Committee to assess if the 3% ratio is appropriate over a full credit cycle for different types of business model. The Basel Committee will also consider whether a wider definition of exposures would better achieve the objectives of the ratio.

Any final adjustments to the definition and calibration of the leverage ratio will be made in the first half of 2017 with the leverage ratio becoming a binding Pillar 1 requirement on 1 January 2018.
7. Capital Conservation and Counter-Cyclical Buffers

Basel III will require banks to hold capital buffers above the regulatory minimum outside periods of stress. This is not a new concept in the UK, where the FSA has required banks to maintain capital resources well in excess of the Pillar 1 minimum and has a framework in place to give banks individual capital guidance on the level of capital that they are expected to maintain, including such a buffer.

Capital buffers should be capable of being drawn down in times of stress (thereby distinguishing the buffers from the Pillar 1 minimum which should never be breached). However, once drawn down, banks will be subject to restrictions on dividend payments, buy-backs of shares or capital instruments and payment of bonuses to staff. Alternatively, banks would be permitted to raise new capital to rebuild the buffer.

7.1 CAPITAL CONSERVATION BUFFER

Basel III explains the rationale for requiring banks to maintain capital in excess of the minimum capital requirement as follows:

“It is not acceptable for banks which have depleted their capital buffers to use future predictions of recovery as justification for maintaining generous distributions to shareholders, other capital providers and employees. These stakeholders, rather than depositors, must bear the risk that recovery will not be forthcoming.”

Further:

“It is also not acceptable for banks which have depleted their capital buffers to try and use the distribution of capital as a way to signal their financial strength. Not only is this irresponsible from the perspective of an individual bank, putting shareholders’ interests above depositors’, it may also encourage other banks to follow suit. As a consequence, banks in aggregate can end up increasing distributions at the exact point in time when they should be conserving earnings.”

The Basel Committee has made these comments because during the financial crisis some banks continued to pay dividends and make distributions on capital instruments despite the fact that their financial condition and the outlook for the banking sector were deteriorating.

Under Basel III, a buffer range will be established above the regulatory minimum. Banks whose capital levels fall within the buffer range will be subject to quantitative restrictions on distributions, buy-backs and staff bonus payments, but will not be constrained in respect of their other activities (e.g., lending).

Under the framework, the restrictions will be limited at the top of the range. This reflects the fact that banks will from time to time fall into the buffer as capital ratios are depleted by losses in a downturn. However, as the bank’s ratios approach its Pillar 1 minimum capital requirement the constraints will increase. The restrictions are set out below in the following table.
Capital measure. The capital buffer has been set at 2.5% and must be made up of core Tier 1 capital.

Payments subject to restrictions. Dividends, share buy-backs, discretionary payments on other Tier 1 capital instruments and discretionary bonus payments to staff will all be subject to restrictions. Distributions that do not deplete capital, such as scrip dividends, will not be subject to these restrictions154. The treatment of discretionary distributions on other capital instruments (e.g. existing upper Tier 2 capital) is unclear.

Earnings. The definition of earnings is distributable profits prior to the deduction of items subject to the restriction on distributions (e.g. bonus payments)155.

Scope of application. The capital conservation regime applies on a consolidated basis. National supervisors have the option of applying it at a solo level as well156.

Supervisory intervention. Banks will be able to draw down the capital buffer. However, the Basel Committee considers that banks should not choose in normal times to operate in the buffer to compete with other banks and gain market share. Nor should banks deplete their capital buffer to fund acquisitions. Supervisors will therefore have the ability to impose time limits on banks operating within the buffer range157. In practice, this is likely to mean that the bank will be required either to reduce the scale of its operations or to raise additional capital.

The proposal raises the question of whether the proposed new capital conservation buffer amounts to a new minimum capital requirement. It is clear that the Basel Committee does not intend the buffer to be viewed as such. However, the fact that a bank that falls within the buffer zone will be subject to restrictions on distributions and staff bonuses, and may be required by its regulator to restore the situation within a specified period of time, is likely to act as a significant disincentive to banks falling into the buffer zone. For this reason the market is likely to view the buffer as an effective floor.

Relationship with FSA Capital Planning Buffer
The FSA requires banks to hold capital planning buffers under a policy promulgated in September 2010. This forms part of the FSA’s approach to Pillar 2 of Basel II. Under the FSA’s approach to Pillar 2:

### Individual bank minimum capital conservation standards

<table>
<thead>
<tr>
<th>Common equity Tier 1 ratio</th>
<th>Minimum Capital Conservation Ratios (expressed as a percentage of earnings)</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.5% – 5.125%</td>
<td>100%</td>
</tr>
<tr>
<td>5.125% – 5.75%</td>
<td>80%</td>
</tr>
<tr>
<td>5.75% – 6.375%</td>
<td>60%</td>
</tr>
<tr>
<td>6.375% – 7%</td>
<td>40%</td>
</tr>
<tr>
<td>7%</td>
<td>0%</td>
</tr>
</tbody>
</table>
• capital is required to be held to supplement the Pillar 1 capital charge against risks that are not fully captured under Pillar 1 (e.g. interest rate risk outside the trading book and certain concentration risks). This is referred to by the FSA as ‘Pillar 2A’; and

• firms must also maintain a capital planning buffer that absorbs losses and/or covers increasing capital requirements in adverse circumstances outside of a firm’s direct control (‘Pillar 2B’).

Pillar 2A is a minimum capital requirement and must be met at all times. Pillar 2B, by contrast, is a buffer that firms can use in adverse circumstances. Pillar 2A is therefore included within the individual capital guidance (ICG) that the FSA provides to firms. According to the FSA:

“Although the [capital planning buffer] is not a minimum regulatory capital requirement, it serves to help firms to meet their minimum capital requirements at all times and therefore, actions may be necessary to ensure that the firm does not breach its minimum capital requirements in future. The nature and intensity of any actions will depend on the individual circumstances”.

Firms are expected to discuss with the FSA in advance any proposed use of the buffer. If the FSA is not satisfied with the explanation (for example, because the need to resort to the buffer results from poor planning) then the firm may be required to rebuild the buffer. The capital planning buffer may not be used to cover matters within the bank’s control (e.g. making an acquisition).

The FSA may also provide individual capital guidance or set the capital planning buffer in terms of particular tiers of capital (e.g. core Tier 1). This is to ensure that firms can meet all relevant capital ratios at all points in the economic cycle and have sufficient capital to absorb losses and meet any increases in capital requirements.

The future relationship between this FSA requirement and Basel III is currently unclear. The FSA has noted the following differences between the capital planning buffer and the Basel III capital conservation buffer:

• the FSA buffer is firm-specific whereas the Basel buffer is a uniform 2.5% of risk-weighted assets;

• the FSA buffer is designed to ensure that a firm can meet its minimum regulatory requirements at all times; and

• the FSA buffer is updated periodically as part of the FSA’s review of firms’ capital adequacy.

According to the FSA:

“Our view is that any [capital planning buffer] set for an individual firm should not be additive to any capital buffers agreed internationally. We will continue to review our Pillar 2 framework in the context of international developments and will consult in due course on the UK’s implementation of the European Directive giving effect to the final Basel 3 package”.

Transitional Arrangements
The Basel capital conservation buffer will be phased in over a four year period. The table below sets out the relevant requirements:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount of capital conservation buffer</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 January 2016</td>
<td>0.625%</td>
</tr>
<tr>
<td>1 January 2017</td>
<td>1.25%</td>
</tr>
<tr>
<td>1 January 2018</td>
<td>1.875%</td>
</tr>
<tr>
<td>1 January 2019</td>
<td>2.5%</td>
</tr>
</tbody>
</table>
According to Basel III:

"Banks that already meet the minimum ratio requirement during the transition period but remain below the 7% Common Equity Tier 1 target (minimum plus capital conservation buffer) should maintain prudent earnings retention policies with a view to meeting the conservation buffer as soon as reasonably possible."

During the transitional period the buffer will be split up into four quartiles, with the capital conservation percentage varying from 100% at the bottom of the scale to 40% at the top. The size of these quartiles will expand as the buffer expands over the transitional period.

### 7.2 COUNTER-CYCLICAL CAPITAL BUFFER

A feature of the 2007/2009 financial crisis was excessive pre-crisis growth in credit that exacerbated the scope of the downturn after the crisis took hold. As a result, the Basel Committee has adopted a regime that will adjust the range of the capital buffer when there are signs that credit growth is excessive. According to the Basel Committee:

"Losses incurred in the banking sector can be extremely large when a downturn 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. These interactions highlight the particular importance of the banking sector building up additional capital defences in periods where the risks of system-wide stress are growing markedly."

The counter-cyclical buffer "aims to ensure that banking sector capital requirements take account of the macro-financial environment in which banks operate. It will be deployed by national jurisdictions 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."

Under the proposals national authorities will monitor credit growth and any other factors that may signal a build up of system-wide risk to assess whether credit growth is excessive. If the authorities judge this to be the case, they will announce the imposition of a counter-cyclical buffer. Internationally active banks will calculate their counter-cyclical capital buffer based on the geographic location of their exposures. In other words, if a counter-cyclical buffer is imposed in respect of one country, the bank would be required to hold an additional capital buffer in respect of all of its exposures to borrowers in that jurisdiction, but not elsewhere.

Each member of the Basel Committee will be required to identify an authority with responsibility to decide on the size of the counter-cyclical capital buffer. If that authority considers that excessive credit growth is leading to the build up of systemic risk it will decide whether to put in place a buffer of up to 2.5% of risk-weighted assets depending on their judgment as to the extent of the build up of system-wide risk. This buffer will be added to the capital conservation buffer, increasing the overall buffer from 2.5% to a maximum of 5% of risk-weighted assets. The buffer must be met with common equity or "other fully loss absorbing capital."

The proposal has the following elements:

- Each jurisdiction will decide, based on credit conditions in that country, when to activate the buffer. Once activated, the buffer will take the form of an add-on to minimum capital requirements, and will be capped at 2.5%. At all other times the buffer will be zero.
Jurisdictions will be required to pre-announce by up to 12 months a decision to impose a counter-cyclical buffer to give banks time to adjust (if necessary, by increasing capital or reducing lending). However, this will not prevent supervisors from imposing a buffer more rapidly if economic conditions require it. It is to be hoped that supervisors will normally allow banks the full 12 months to build up the buffer to avoid causing unnecessary stresses in the credit markets. Reductions to the buffer will take effect immediately when announced.

- Banks with purely domestic exposure will be subject to the full amount of the buffer.
- Banks that are internationally active will apply an add-on depending on the geographical location of their credit exposures.

If a bank’s home state regulator determines that the buffer required by a local regulator is inadequate it may increase the buffer for that jurisdiction (but may not reduce it). Home state regulators are also free to set buffers reflecting credit conditions in countries that do not operate their own counter-cyclical buffer.

The Basel Committee considered that setting a buffer is likely to be appropriate where the ratio of credit to GDP exceeds its long-term trend. However, as this measure is not always a clear indicator of excessive credit growth, judgment will need to be applied.

A bank that fails to satisfy the counter-cyclical buffer will be subject to the same restrictions on distributions and discretionary payments to staff as apply to banks that do not meet the capital conservation buffer. The application of the restrictions is set out in the table below. As the buffer may vary from 0% to 2.5% of risk-weighted assets the restrictions are based on the extent to which the bank is failing to hold the requisite percentage of the buffer. For example, if the buffer is 2% then the restrictions will apply at 0.5%, 1%, 1.5% and 2% of risk-weighted assets. As the buffer is additive to the capital conservation buffer, a bank operating within the latter buffer by definition will not satisfy the counter-cyclical buffer if imposed and will therefore be subject to a 100% capital retention percentage.

<table>
<thead>
<tr>
<th>Individual bank minimum capital conservation standards</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Common equity Tier 1 ratio</strong></td>
</tr>
<tr>
<td>Within first quartile of buffer</td>
</tr>
<tr>
<td>Within second quartile of buffer</td>
</tr>
<tr>
<td>Within third quartile of buffer</td>
</tr>
<tr>
<td>Within fourth quartile of buffer</td>
</tr>
<tr>
<td>Above top of buffer</td>
</tr>
</tbody>
</table>

*Source: Basel III A global regulatory framework for more resilient banks and banking systems, p. 59.*
Banks will be required to calculate and publicly disclose any counter-cyclical buffer with the same frequency as their minimum capital requirements.\textsuperscript{171}

**Transitional Arrangements**

The counter-cyclical buffer regime will be introduced in parallel with the capital conservation buffer starting on 1 January 2016 and will become fully effective on 1 January 2019. The effect is that the maximum possible counter-cyclical buffer will be 0.625\% of risk-weighted assets in 2016 rising by an additional 0.625\% each year until reaching 2.5\% in 2019.

Basel III states that countries experiencing excessive credit growth during the transition "will consider accelerating the build up of the capital conservation buffer and the countercyclical buffer. In addition, jurisdictions may choose to implement larger countercyclical buffer requirements."\textsuperscript{172} This clearly contemplates implementation of both buffers more rapidly than set out in the Basel III accord. It is not clear why this applies to the capital conservation buffer given that this buffer is not intended to address excessive credit expansion.
8. Liquidity

The financial crisis demonstrated the critical importance of liquidity. The failures of Northern Rock, Bear Stearns and Lehman Brothers were, to a significant degree, caused by a lack of liquidity when market confidence in those institutions evaporated. Yet the Basel Committee had previously not agreed any international standards for bank liquidity. This is addressed by Basel III, which will introduce two new liquidity standards. However, it has not yet proved possible to agree all the details of the new requirements, with the result that the proposals are likely to undergo further refinement, and potentially adjustment, over the coming years.

Inadequate management of liquidity characterised the first phase of the financial crisis as banks had come to rely on the continuing availability of liquidity at low cost to fund longer-term lending. Much of that liquidity was provided by the shadow banking sector (including conduits, money market funds, structured investment vehicles). Once the crisis hit, liquidity evaporated and only massive intervention by central banks prevented even more financial institutions from collapsing.

In response, the Basel Committee has formulated two new liquidity standards:

- a LCR to promote short-term resilience by ensuring that banks have sufficient high-quality liquid assets to survive a one month significant stress; and
- a NSFR requiring banks to fund their activities from more stable long-term sources, providing an appropriate matching of assets and liabilities.

8.1 Liquidity Coverage Ratio

As mentioned above, the purpose of the LCR is to ensure that banks have a sufficient stock of high-quality liquid assets that can be converted into cash to enable the bank to survive to day 30 of a hypothetical stress scenario. The intention is that this will enable either corrective action to be taken by management or supervisors, or the bank to be resolved in an orderly way.\(^\text{173}\)

Under the standard:

\[
\frac{\text{Stock of high-quality liquid assets}}{\text{Total net cash outflows over 30 day period}} \geq 100\%
\]

In setting the parameters of the LCR the Basel Committee has postulated the following events:

- a run-off of a proportion of retail deposits;
- partial loss of unsecured wholesale funding;
- partial loss of secured short-term financing;
- additional contractual outflows arising from a downgrade in the bank’s credit rating of three notches;
- an increase in market volatility that impacts on the quality of collateral or future exposures under derivative contracts requiring additional collateral haircuts or additional collateral to be provided;
- unscheduled drawings on committed but unused credit and liquidity facilities; and
a potential need for the bank to buy-back debt or honour non-committed obligations to mitigate reputational risk.\textsuperscript{174}

The LCR is therefore based on two elements: a definition of high-quality liquid assets and a metric for calculating net cash outflows. Both will be determined using supervisory inputs. It follows that banks will not be permitted to use their own internal models, or their experience in the financial crisis, to measure the LCR.

The LCR will be implemented by 1 January 2015. The Basel Committee will use data submitted by banks to make any necessary revisions by mid-2013.\textsuperscript{175} It is proposed that banks will report the LCR at least monthly, although supervisors may require banks to report more regularly, particularly in stressed situations.\textsuperscript{176} Banks must, of course, meet the LCR on a continuous basis.\textsuperscript{177}

8.2 LIQUID ASSETS

To be eligible as high-quality liquid assets the assets should be liquid in a time of stress and, ideally, be central bank eligible (although central bank eligibility does not mean that an asset is necessarily eligible as a high-quality liquid asset).\textsuperscript{178} Basel III requires that these assets should have low credit and market risk, be easily capable of being valued, have a low correlation with risky assets and be listed on a developed exchange.\textsuperscript{180} This excludes structured or exotic products.

To be eligible, assets must also be unencumbered (i.e. not pledged explicitly or implicitly to secure, collateralise or provide credit enhancements for any transaction). Assets may be treated as ‘unencumbered’ if they are received under a reverse repurchase transaction or are pledged to a central bank, but are not currently being used.\textsuperscript{181}

The LCR will be reported in a single currency (i.e. the currency used for regulatory reporting). However, banks will be expected to meet their liquidity needs in each currency and maintain highly liquid assets in each relevant currency.\textsuperscript{182} Although Basel III does not state this, presumably supervisors will apply a de minimis threshold when it comes to currency risk. The obligation to hold a sufficient stock of high-quality liquid assets in each currency could potentially impose a significant burden on banks operating in smaller or developing markets where such assets may not be readily available.

If an asset ceases to be eligible (e.g. because of a rating downgrade), banks will be allowed to continue to recognise it for 30 calendar days. The purpose is to give the bank time to replace the asset.\textsuperscript{183} However, the obligation for banks globally to replace assets that cease to be eligible within 30 days could potentially trigger market disruption and significant losses as banks replace those assets.

There are two classes of assets that are eligible to meet the LCR: Level 1 assets and Level 2 assets.\textsuperscript{184}

Level 1 Assets

Level 1 assets are the best quality assets and may be used without limit to meet a bank’s LCR. Level 1 assets are limited to:

\begin{itemize}
  \item cash;
  \item central bank reserves (to the extent these can be drawn down in time of stress);
  \item securities issued or guaranteed by sovereigns, central banks, public sector entities and certain international organisations that: (i) have a 0% risk weight under the Basel II standardised approach; (ii) trade in large, deep and active repo or cash markets; (iii) have a proven record as a reliable source of liquidity during stressed situations; and (iv) are not issued by a financial institution or its affiliates;
\end{itemize}
• sovereign and central bank securities not eligible for a 0% risk weight issued in the domestic currency provided that this is the currency in which liquidity risk is being taken; and

• domestic sovereign and central bank debt not eligible for a 0% risk weight issued in foreign currencies to the extent that holding such debt matches the currency needs of the bank’s operations in that jurisdiction.

Level 1 assets are held at market value and are not subject to any haircut. Supervisors may, however, require banks to apply a haircut. The Basel Committee intends that banks’ LCR will predominantly be made up of government securities. However, the sovereign debt crisis that has affected many Eurozone countries, coupled with the build up of sovereign debt as a result of, and often in response to, the financial crisis raises the question whether sovereign debt is quite so risk free, and therefore a safe source of liquidity, in times of serious financial stress.

Level 2 Assets
Level 2 assets are capped at 40% of the stock of liquid assets after all relevant haircuts have been applied. The calculation of this cap must take into account the impact on holdings of Level 1 or Level 2 assets (i.e. cash and government securities) caused by secured funding transactions or collateral swaps maturing over the specified 30 day stress period.

Level 2 assets are limited to:

• securities issued or guaranteed by sovereigns, central banks, public sector entities or multi-lateral development banks that: (i) have a 20% risk weight under the Basel II standardised approach; (ii) trade in large, deep and active repo or cash markets; (iii) have a proven record as a reliable source of liquidity during stressed situations; and (iv) are not issued by a financial institution or its affiliates; and

• corporate bonds and covered bonds: (i) not issued by a financial institution or its affiliates (for corporate bonds); (ii) not issued by the bank itself or any of its affiliates (for covered bonds); (iii) rated AA- or better (or, for banks using their own internal ratings, with an internal rating at least equal to AA-); (iv) trade in large, deep and active repo or cash markets; and (v) have a proven record as a reliable source of liquidity during stressed situations.

Level 2 assets are subject to a minimum 15% haircut to their current market value. In terms of criteria other than credit ratings for Level 2 assets, Basel III states:

“The Committee will test a number of qualitative and quantitative criteria during the observation period to determine the appropriate set and calibration of the criteria to use. These tested criteria will include volume, bid-ask spread, turn-over, and other possible criteria to be further developed by the Committee.”

The Basel Committee recognises that in some currencies there may be insufficient Level 1 assets, and that the availability of Level 2 assets may also be limited. For these jurisdictions and currencies the Basel Committee has stated its intention to develop an alternative treatment. Basel III sets out three potential options to be finalised during the ‘observation period’.

Option 1 would allow banks to meet their liquidity requirement through contractually committed liquidity facilities with the relevant central bank.

Option 2 would enable supervisors to permit banks to meet their liquidity requirement with liquid assets in a currency that does not match the currency of the associated liquidity risk.

Option 3 would allow additional use of Level 2 assets (subject to a higher haircut) if there are sufficient Level 2 assets but insufficient Level 1 assets.
Globally active banks with a large proportion of their liabilities denominated in foreign currencies should meet the LCR requirement in those currencies and only use the alternative treatment if there is a shortfall in the domestic currency to meet domestic currency outflows\(^{398}\).

### 8.3 TOTAL NET CASH OUTFLOWS

Total net cash outflows will be measured as the total expected cash outflows less total expected cash inflows for the specified stress scenario. Cash outflows will be calculated by multiplying outstanding balances of specified types by a percentage representing the rate at which they are assumed to run-off or be drawn down. Cash inflows will be calculated by multiplying categories of receivables by a percentage representing the rate at which they are expected to flow in, subject to a cap of 75\%\(^{199}\).

#### Cash Outflows

Basel III assumes the following cash outflows. As mentioned above, this is a supervisory framework and the percentages required to be applied are not dependent on a bank’s experience during the financial crisis or more generally.

- **Retail deposits.** Retail deposits are divided into stable and less stable deposits. Retail deposits are stable if protected by an effective deposit guarantee scheme or public guarantee and either the depositor has an established relationship with the bank making withdrawal highly unlikely or the deposit is in a transactional account (e.g. a current account into which salaries are paid). The run-off rate for stable deposits is at least 5\%\(^{200}\).

  The run-off rate for less stable deposits is at least 10\%. Supervisors are expected to develop additional buckets for potentially less stable retail deposits. Examples could include deposits not covered by a deposit guarantee scheme or public guarantee, high-value deposits and deposits from sophisticated or high net worth individuals\(^{201}\). Supervisors are also tasked with determining the run-off percentage for foreign currency deposits\(^{202}\).

- Fixed-term deposits with a maturity or notice period of at least 30 days will be excluded from the LCR (i.e. no liquid assets will be required to be held in respect of such deposits). However, supervisors will be able to apply a higher run-off rate “if they consider it likely that depositors would withdraw term deposits in a similar fashion as retail demand deposits during either normal or stress times, or that banks may repay such deposits early in stressed times for reputational reasons”\(^{203}\).

- Unsecured wholesale funding. Unsecured wholesale funding constitutes liabilities and general obligations raised from legal entities, partnerships or sole traders which are not collateralised\(^{204}\). All funding that is callable within 30 days or has its earliest possible contractual maturity within that period is included within the LCR, including all funding with options exercisable at the investor’s discretion within 30 days. If the funding contains options exercisable at the bank’s discretion reputational factors must be taken into account that may limit the bank’s ability to exercise those options. Liabilities that the market expects to be redeemed before their legal final maturity date must also be included as outflows\(^{205}\).

  Wholesale funding that is callable on more than 30 days’ notice is excluded from the LCR\(^{206}\).

- Unsecured funding provided by small business customers that are managed as retail exposures will be treated in the same way as retail deposits. Stable unsecured funding will be subject to a minimum 5\% run-off and less stable funding subject to a run-off of at least 10\%\(^{207}\). Term loans from small businesses will be treated in the same way as retail term deposits\(^{208}\).

- Unsecured wholesale funding provided by non-financial corporate customers, sovereigns, central banks and public sector entities that are covered by deposit insurance will be assumed to suffer a 5\% run-off\(^{209}\).
Deposits and other funds provided by wholesale counterparties “with specific operational relationships” may qualify for a 25% assumed run-off factor. This treatment will be restricted to funds specifically needed for operational purposes and the customer must have an established operational relationship with the bank upon which it has a substantive dependency. An operational relationship “refers to clearing, custody or cash management relationships in which the customer is reliant on the bank to perform these services as an independent third party intermediary in order to fulfil its normal banking activities over the next 30 days”\(^\text{210}\). Deposits eligible for the 25% run-off must be priced below market and represent the by-product of the underlying services provided by the bank. Moreover, only the part of that balance that is required for such operational needs will qualify as stable\(^\text{211}\). Deposits arising out of correspondent banking services and prime brokerage agreements will be expressly excluded from this treatment\(^\text{212}\).

Deposits in institutional networks of co-operative banks. This category applies to groups of autonomous banks with a statutory framework of co-operation with a common strategic focus and brand where specific functions are performed by a central institution and/or service providers. A 25% run-off will apply to deposits made by members with the central institution and/or central service provider(s) that are placed (i) due to statutory minimum deposit requirements or (ii) in the context of common task sharing and legal, statutory or contractual arrangements so long as both the paying and the receiving bank participate in the same institutional network’s mutual protection scheme\(^\text{213}\). Supervisory approval will be required for banks to rely on this treatment\(^\text{214}\).

Unsecured wholesale funding provided by non-financial corporates, etc. All deposits and unsecured funding from non-financial corporate customers (i.e. not small businesses) and domestic and foreign sovereigns, central banks and public sector entities will have an assumed run-off rate of 75%\(^\text{215}\). Deposits held for operational purposes satisfying the requirement for the 25% run-off rate will be excluded.

Unsecured wholesale funding provided by others. Deposits and wholesale funding provided by other entities (including banks, securities firms, insurance companies, fiduciaries, beneficiaries, conduits and special purpose vehicles), as well as affiliated entities of the bank, will be assumed to have a 100% run-off\(^\text{216}\). The assumption is that the totality of such deposits will be withdrawn in a liquidity stress. This category includes all notes, bonds and other debt securities issued by the bank regardless of the holder unless the bond is exclusively sold to retail investors (in which case it can be treated as a retail deposit)\(^\text{217}\).

Secured Funding Transactions. A bank will be constrained in its ability to raise liquidity through secured funding transactions during a stress scenario. The bank’s ability to continue to enter into repurchase, reverse repurchase and similar transactions (e.g. securities lending) is therefore assumed to be limited to transactions backed by high-quality liquid assets, or with the bank’s central bank or sovereign. Banks will be required to assume the following outflows on outstanding secured funding transactions with maturities falling within the 30 day stress period\(^\text{218}\) set out in the table below\(^\text{219}\). The amount of the outflow is based on the amount borrowed and not the value of the collateral provided.
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**Derivatives.** Known amounts that are payable and receivable will be taken into account on a net basis. Any net payable will be accorded a 100% run-off\(^{220}\).

According to Basel III most counterparties to derivative transactions secure the mark-to-market value of derivative positions with assets eligible for a 0% risk weight under the standardised approach (e.g. cash or highly rated government securities). If Level 1 liquid assets are used as collateral in this way no additional stock of liquid assets will need to be maintained to cover potential valuation changes. However, if a bank uses other forms of collateral (e.g. Level 2 assets) then 20% of the value of all such posted collateral will need to be added to the stock of required liquid assets to cover the risk of a loss of market value on such assets triggering the need for the bank to provide additional collateral\(^{221}\).

**Credit rating downgrade triggers.** The full amount (i.e. 100%) of any collateral that will need to be posted in the event of a three notch ratings downgrade by the bank will have to be treated as an outflow. Examples are triggers in derivative contacts requiring provision of additional collateral in the event of a ratings downgrade, or requirements for early repayment in the event that a bank’s rating is downgraded\(^{222}\).

**Loss of funding on asset-backed securities, etc.** Asset-backed securities, covered bonds and structured financing instruments issued by a bank will be subject to a 100% run-off. This reflects the assumption that the refinancing market will have closed in a liquidity stress\(^{223}\). The same applies to funding from asset-backed commercial paper, conduits, securities investment vehicles and other financing facilities, as no funding will be available from such sources\(^{224}\). If the structured financing activities of a bank are conducted through a special purpose entity (e.g. a SIV), the bank should look through the entity to the debt instruments issued, irrespective of whether the special purpose entity is consolidated. Embedded options in financing arrangements that allow for the return of assets or liquidity support will also have to be taken into account\(^{225}\).

**Drawings on committed facilities.** The LCR applies to contractually committed or conditionally revocable facilities. Unconditionally revocable facilities that are unconditionally cancellable by the bank are treated as other contingent funding liabilities and not as commitments under the LCR (see below). As it may be difficult for borrowers to repay drawings quickly in a stressed environment, all facilities that are assumed to be drawn will be treated as outstanding.

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### Categories for outstanding maturing secured funding transactions

<table>
<thead>
<tr>
<th>Categories</th>
<th>Amount to add to cash outflows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Backed by Level 1 assets</td>
<td>0%</td>
</tr>
<tr>
<td>Backed by Level 2 assets</td>
<td>15%</td>
</tr>
<tr>
<td>Secured funding transactions with domestic sovereign, central banks or PSEs that are not backed by Level 1 or 2 assets. PSEs that receive this treatment should be limited to those that are 20% or lower risk-weighted</td>
<td>25%</td>
</tr>
<tr>
<td>All others</td>
<td>100%</td>
</tr>
</tbody>
</table>

*Source: Basel III International framework for liquidity risk measurement, standards and monitoring, p.18.*
throughout the duration of the stress regardless of their contractual maturity (i.e. drawings repayable within the 30 day stress period will be assumed not to be repaid).\textsuperscript{226}

The currently undrawn portion of facilities may be netted against high-quality liquid assets provided to secure that facility if the bank is legally entitled to re-use such collateral once the facility is drawn.\textsuperscript{227} Under English law a secured creditor generally has no right to use collateral prior to the borrower’s default, although the facility agreement may give the bank the right to re-use (or ‘re-hypothecate’) such collateral. Such right of use has become less common since the collapse of Lehman Brothers.

A ‘liquidity facility’ is any committed, undrawn back-up facility put in place expressly for the purpose of refinancing the debt of a customer in situations where the customer is unable to obtain its ordinary course of business funding requirements (e.g. under a commercial paper programme). General working capital facilities are not liquidity facilities but credit facilities.\textsuperscript{228}

Basel III stipulates the following drawdown rates that will apply for committed facilities:

- committed credit and liquidity facilities to retail and small business customers: 5%;
- committed credit facilities to non-financial corporates, sovereigns and public sector entities: 10%;
- committed liquidity facilities to non-financial corporates, sovereigns and public sector entities: 100%;
- committed credit and liquidity facilities to other legal entities (including banks, securities firms and insurance companies): 100%;\textsuperscript{229} and
- any other contractual lending commitments to financial institutions: 100%.\textsuperscript{230}

The assumption that liquidity facilities to the corporate sector will be fully drawn down for the purposes of the LCR has the potential to significantly increase the cost for banks of offering such facilities. Banks may therefore attempt to document such facilities as credit facilities in the future owing to the significantly lower liquidity requirement for credit facilities. Borrowers are likely to resist this where the purpose of the facility is to provide liquidity support, although it may be possible to identify liquidity backstop agreements (e.g. swingline facilities) separately within a wider arrangement.

Other contingent funding obligations. Basel III leaves it to national supervisors to determine the appropriate liquidity impact of other contingent funding obligations. It follows that supervisors will need to specify the appropriate run-off rate, as well as the stock of high-quality liquid assets that will need to be held to cover such exposures.\textsuperscript{231} Obligations may be committed or uncommitted (e.g. where the bank is at risk of reputational damage if it were to fail to allow the commitment to be drawn down).\textsuperscript{232} Examples include:

- unconditionally revocable ‘uncommitted’ credit and liquidity facilities;
- guarantees;
- letters of credit;
- other trade finance instruments;
- non-contractual obligations such as structured products where investors expect ready marketability, and managed funds marketed with the objective of maintaining a stable value (e.g. money market funds); and
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8.4 CASH INFLOWS

As the metric is based on net outflows, it will be necessary to take account of a bank’s contractual inflows over the specified 30 day horizon. Banks must only include inflows from fully performing exposures that the bank has no reason to expect will default within that period.

Basel III imposes a cap on total inflows of 75% of total expected cash outflows. The effect will be to require banks to hold a minimum stock of highly liquid assets equal to at least 25% of outflows.

Reverse repos and securities borrowing. Maturing reverse repurchase agreements and securities borrowing transactions secured with Level 1 assets will be deemed to be rolled over (i.e. there will be no net inflow of cash). Transactions secured by Level 2 assets will be assumed to lead to an inflow of cash of 15% as the funds extended against the collateral are reduced. Banks will be assumed not to roll over repos and securities borrowing secured by other assets which will therefore generate a 100% inflow. If, however, collateral obtained through a reverse repurchase transaction is re-hypothecated for 30 days or more to cover short positions the bank must not recognise any cash inflows given its need to continue to cover the short position or re-purchase the securities.

Credit lines. No credit lines, liquidity facilities or other contingent funding facilities that the bank has with other institutions will be recognised under the LCR.

Liquidity needs related to market value of derivatives. Banks are expected by the market to collateralise all mark-to-market exposures on derivatives. National supervisors will therefore determine a requirement to reflect this risk, which must be greater than zero.

Other contractual outflows. All other contractual cash outflows over the 30 day stress period (e.g. declared dividends) will be subject to a 100% requirement.

Other cash inflows. The assumed inflow rates will depend on the identity of the counterparty. The requirements may be summarised as follows:

- deposits held at other financial institutions for operational purposes, such as clearing, custody and cash management: 0%;
- deposits held at the centralised institution in a co-operative banking network: 0%;
- retail and small business customers: 50%;
- non-financial wholesale counterparties: 50%;
- financial institution counterparties: 100%; and
- derivatives receivables: 100%.

The difference in treatment between deposits held with other financial institutions for operational purposes and all other deposits with financial institutions is striking.

Other contractual inflows. It will be up to national supervisors to specify inflow percentages for other contractual cash inflows.
8.5 NET STABLE FUNDING RATIO

The second liquidity standard is the NSFR. It will establish a minimum acceptable amount of stable funding based on the liquidity characteristics of a bank’s assets and liabilities over a one year period. Banking is based on maturity transformation under which short-term deposits and funding are used to make long-term loans to companies and individuals. The premise of the NSFR is that a sufficient proportion of long-term commitments should be funded by long-term funding sources, thereby limiting banks’ reliance on short-term wholesale funding. As such, the NSFR draws on the experience in the financial crisis that financial institutions that relied on short-term funding sources were unable to continue trading without unprecedented public sector support once private sector liquidity evaporated.

Given the difficulties thrown up by the original Basel Committee proposals and the need for further validation of the proposals, the requirements in Basel III for the NSFR are less fully developed than in other areas. The Basel Committee has stated that it will use information provided by financial institutions to make necessary revisions to the NSFR by mid-2016. The NSFR will become a minimum standard by 1 January 2018. The NSFR will be calculated and reported at least quarterly.

The NSFR is defined as follows:

\[
\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} > 100\%
\]

Stable funding under the metric is funding that is expected to be reliable over a one year time horizon under conditions of extended stress. The amount of such funding that a bank will need to hold will depend on the liquidity characteristics of its balance sheet and off-balance sheet liabilities.

Stable Funding

Stable funding is defined as the following:

- capital;
- undated or dated preference shares with a maturity of one year or more;
- liabilities with an effective maturity of one year or more;
- that portion of deposits and/or term deposits with a maturity of less than one year that is expected to remain with a bank over an extended period of stress; and
- that portion of wholesale funding with a maturity of less than one year that is expected to stay with the bank over an extended period of stress.

The last two categories are based upon supervisory parameters and not the bank’s expectations of what is likely to happen.

In setting the requirements for the NSFR the Basel Committee has assumed the following:

- a significant decline in profitability or solvency arising from an increase in credit, market or operational risk;
- a potential downgrade in debt, counterparty credit or deposit rating; and/or
- a material event that calls into question the reputation or creditworthiness of the bank.

The NSFR also disregards extended funding from central banks outside regular open market operations so as “not to create a reliance on the central bank as a source of funding.”
The five categories of stable funding set out above are multiplied by a percentage to give the available amount of stable funding. This is referred to in Basel III as an available stable funding (ASF) factor. Each category of eligible stable funding is multiplied by the relevant ASF factor. The bank’s available stable funding is the sum across all five categories.

<table>
<thead>
<tr>
<th>Category</th>
<th>ASF Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital (including Tier 1 and Tier 2 capital)</td>
<td>100%</td>
</tr>
<tr>
<td>Preference shares not included in Tier 2 that have an effective maturity of one year or more</td>
<td>100%</td>
</tr>
<tr>
<td>Secured and unsecured borrowing with an effective maturity of one year or more</td>
<td>100%</td>
</tr>
<tr>
<td>Stable deposits (as defined in LCR) and/or term deposits with a residual maturity of less than one year from retail and small business customers</td>
<td>90%</td>
</tr>
<tr>
<td>Less stable deposits (as defined in LCR) and/or term deposits with residual maturity of less than one year provided by retail and small business customers</td>
<td>80%</td>
</tr>
<tr>
<td>Unsecured wholesale funding, demand deposits and/or term deposits provided by non-financial corporates, sovereigns, central banks and public sector entities</td>
<td>50%</td>
</tr>
<tr>
<td>All other funding (including inter-bank)</td>
<td>0%</td>
</tr>
</tbody>
</table>

Source: adapted from Basel III International framework for liquidity risk measurement, standards and monitoring, p. 27.

As with the LCR, no credit will be given to funding provided by other financial institutions, regardless of maturity.

Required Stable Funding

The amount of stable funding that a bank is required to have will be based on the broad characteristics and liquidity profile of the bank’s assets, off-balance sheet liabilities and other activities. The amount will be determined by multiplying assets and off-balance sheet liabilities by a required stable funding (RSF) factor. The required amount of stable funding is equal to the sum of such amounts. RSF factors therefore reflect the amount of stable funding that the Basel Committee considers is necessary to support such activities²⁵⁶. Unsurprisingly, more liquid assets attract lower RSF factors. The intention is to measure the percentage value of a particular asset that could not be realised either through sale or by use as collateral on an extended basis during a one year liquidity stress. Such amounts are required to be covered by stable funding²⁵⁷. The same applies to off-balance sheet items likely to generate funding requirements.

Secured funding transactions that mature over the 12 month period will be subject to a ‘look through’ approach. This means that the bank will be required to apply the RSF factor to the asset that will be used to settle the transaction. If this is cash, the RSF will be 0%²⁵⁸. Encumbered assets will receive an RSF of 100%²⁵⁹.
The RSF factors for various asset classes are listed below:

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>RSF Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash immediately available to meet obligations and not held for planned use</td>
<td>0%</td>
</tr>
<tr>
<td>Unencumbered short-term unsecured instruments and transactions with a maturity of under one year</td>
<td>0%</td>
</tr>
<tr>
<td>Unencumbered securities with a remaining maturity of under one year</td>
<td>0%</td>
</tr>
<tr>
<td>Unencumbered securities held where the institution has an offsetting reverse repurchase transaction on the same security</td>
<td>0%</td>
</tr>
<tr>
<td>Unencumbered loans to financial entities with a maturity of less than one year</td>
<td>0%</td>
</tr>
<tr>
<td>Unencumbered marketable securities with a maturity of one year or greater issued or guaranteed by sovereigns, central banks or multi-lateral development banks risk-weighted 0% under the Basel standardised approach</td>
<td>5%</td>
</tr>
<tr>
<td>Unencumbered corporate bonds or covered bonds rated AA- or better with residual maturity of one year or greater constituting Level 2 assets for the purposes of the LCR</td>
<td>20%</td>
</tr>
<tr>
<td>Unencumbered marketable securities with a maturity of one year or greater issued or guaranteed by sovereigns, central banks or public sector entities risk-weighted 20% under the Basel standardised approach constituting Level 2 assets for the purposes of the LCR</td>
<td>20%</td>
</tr>
<tr>
<td>Unencumbered gold</td>
<td>50%</td>
</tr>
<tr>
<td>Unencumbered equities not issued by a financial institution or its affiliates if listed and included in a large cap market index</td>
<td>50%</td>
</tr>
<tr>
<td>Unencumbered corporate bonds and covered bonds not issued by financial institutions or their affiliates (except in the case of covered bonds) rated A+ to A- and traded in large, deep and active markets</td>
<td>50%</td>
</tr>
<tr>
<td>Unencumbered loans to non-financial corporates, sovereigns, central banks and public sector entities with a maturity of less than one year</td>
<td>50%</td>
</tr>
<tr>
<td>Unencumbered residential mortgages of any maturity eligible for a 35% risk weight under the Basel II standardised approach</td>
<td>65%</td>
</tr>
<tr>
<td>Other unencumbered loans, excluding loans to financial institutions, with a remaining maturity of one year or greater and risk-weighted 35% or lower under the Basel II standardised approach</td>
<td>65%</td>
</tr>
<tr>
<td>Unencumbered loans to retail customers and small businesses with a maturity of less than one year</td>
<td>85%</td>
</tr>
<tr>
<td>All other loans and assets</td>
<td>100%</td>
</tr>
</tbody>
</table>
The Basel Committee intends to gather data on buckets of assets and liabilities maturing within less than 12 months in order to assess if the NSFR can better match funded assets and liabilities (i.e. recognising that 10 months' funding is better than three)

Off-Balance Sheet Exposures

Off-balance sheet exposures may give rise to a significant reduction in liquidity in a stressed situation. It follows that banks will need to have stable funding in place to cover a proportion of their off-balance sheet exposures. Basel III sets a 5% RSF factor for currently undrawn conditionally revocable and irrevocable credit and liquidity facilities. For all other contingent funding obligations national supervisors will be free to specify their own RSF factors. This includes uncommitted credit and liquidity facilities, guarantees, letters of credit, other trade finance instruments and non-contractual obligations.

8.6 APPLICATION TO BANKING GROUPS

The LCR and NSFR will apply on a consolidated basis. Banks should therefore apply the rules of their home state supervisors to all entities within the consolidation group. An exception applies to the treatment of retail and small business exposures which should be assessed in accordance with the rules of the jurisdiction in which they were incurred. This applies for both branches and subsidiaries. The reason given is that the deposit run-off rates for such exposures are influenced by jurisdiction-specific factors such as the effectiveness of deposit insurance. Home jurisdiction rules for retail and small business deposits may be applied if there are no liquidity rules in specific host jurisdictions or if the home state considers that the host state rules are less strict than those applied by the home state.

Banks must not recognise excess liquidity in their consolidated LCR if there is reasonable doubt as to whether such liquidity would be available. Examples include ring-fencing measures, non-convertible currencies and foreign exchange controls.

8.7 MONITORING LIQUIDITY RISK

In addition to the LCR and NSFR, Basel III contemplates that supervisors will apply additional metrics to assess banks' liquidity risk. These further techniques are supervisory tools to enable regulators to identify potential problems at an institution rather than minimum requirements that must be met at all times. However, "supervisors should take action when potential liquidity difficulties are signalled through a negative trend in the metrics, or when a deteriorating liquidity position is identified, or when the absolute result of the metric identifies a current or potential liquidity problem".

Contractual Maturity Mismatch

This technique for liquidity risk monitoring seeks to identify gaps between contractual inflows and outflows for defined time bands and serves to measure the role of maturity transformation in a bank’s current loan book. Banks will be required to map inflows and outflows across specified time bands. Possible time bands are overnight, 7 days, 14 days, 1 month, 2 months, 3 months, 6 months, 9 months, 1 year, 2 years, 3 years, 5 years and over 5 years.

Banks will provide the raw data to supervisors based on contractual maturities without making behavioural assumptions. Banks will, however, be expected to carry out their own maturity mismatch analysis based on behavioural assumptions of inflows and outflows of funds in normal situations and under stress. This analysis will need to be shared and discussed with the bank's supervisor. Any gaps will need to be bridged.
**Concentration of Funding**
This metric aims to identify those sources of wholesale funding the withdrawal of which could trigger liquidity problems for a bank. Banks will need to identify funding sources for (i) each significant counterparty and (ii) each significant product or investment. Banks will need to monitor the size of such significant exposures as well as any significant increases in concentration of such exposures.

For this purpose a ‘significant counterparty’ is "a single counterparty or group of connected or affiliated counterparties accounting in aggregate for more than 1% of the bank’s total balance sheet, although in some cases there may be other defining characteristics based on the funding profile of the bank." A group of connected counterparties will be identified in accordance with applicable large exposure rules. A ‘significant product or investment’ is a single instrument or product or group of similar instruments or products that in aggregate amount to more than 1% of the bank’s total balance sheet.

Banks will also be required to provide a list of assets and liabilities in each significant currency. A currency is ‘significant’ for this purpose if the aggregate liabilities in that currency constitute more than 5% of the bank’s total liabilities.

The above metrics should be reported separately for time bands of less than one month, one to three months, three to six months, six to twelve months and over one year.

**Available Unencumbered Assets**
This tool seeks to provide regulators with information on the quality and key characteristics of banks’ available unencumbered assets. Such assets may be used to raise additional secured funding in secondary markets and/or be used as sources of liquidity for the bank.

Banks will need to report the amount, type and location of available unencumbered assets that could serve as collateral for secured borrowing. Likewise, banks will need to report the amount, type and location of available unencumbered assets that are eligible for secured funding with central banks. These reports must be made in aggregate and by significant currency. Banks will also be expected to report estimated haircuts that secondary market participants and/or central banks would require for each asset.

**LCR by Significant Currency**
The LCR applies in one currency. However, Basel III states that in order to better capture significant potential currency mismatches, banks and supervisors should also monitor the LCR in significant currencies to allow the tracking of potential currency mismatch issues. As mentioned above, banks will in any event be expected to meet their liquidity needs in each currency and maintain high-quality liquid assets consistent with the distribution of their liquidity needs by currency.

The definitions of assets and outflows match the LCR framework. A currency is considered to be significant if aggregate liabilities in that currency constitute 5% or more of the bank’s total liabilities. Basel III adds that supervisors may require notification if the foreign exchange LCR for a currency falls below a specified ratio.

**Market Monitoring Tools**
Basel III suggests that regulators monitor market data "as early warning indicators in monitoring potential liquidity difficulties at banks." Given the performance of banks and supervisors in the financial crisis, a degree of scepticism may be warranted as to the ability of market information to predict impending liquidity problems.
ENDNOTES

Unless otherwise stated, references in these Endnotes to paragraphs are (i) in Endnotes 17 to 172 inclusive, to paragraphs in Basel III: A global regulatory framework for more resilient banks and banking systems and (ii) in Endnotes 173 to 291 inclusive, to Basel III: International Framework for liquidity risk and measurement, standards and monitoring.

1 Turner Review pp. 44–45.
2 Turner Review p. 45.
3 In the UK the FSA has stated that it will use its powers to impose a risk weight of no less than 250% (capped at 1250%) of the risk weight that would otherwise apply to the relevant securitisation position if the failure to carry out investor due diligence occurred by reason of the firm’s “negligence or omission”. BIPRU 9.15.17G.
4 The FSA consulted on implementing CRD II and CRD III through CP 09/29 Strengthening Capital Standards 3 (December 2009), CP 10/17 Strengthening Capital Standards 3 – feedback to CP 09/29, final rules for CRD 2, and further consultation (July 2010) and CP 11/9 Strengthening Capital Standards 3 (May 2011). The Directives are implemented through amendments to GENPRU and BIPRU.
6 Available at http://www.bis.org/publ/bcbs164.pdf.
8 http://www.bis.org/publ/bcbs172.pdf.
11 http://www.financialstabilityboard.org/publications/r_c101111a.pdf. The report is dated 20 October but was released on 12 November.
15 A bank that holds capital in excess of the relevant limits cannot recognise that capital for regulatory purposes. However, such capital may be eligible to be included in a lower tier of capital if doing so would not exceed the relevant limit for that tier of capital.
16 Reasons include the desire to maintain a specified credit rating as well as meeting the expectation of a bank’s customers and counterparties.
18 Mutuals are generally not able to issue common equity.
19 Para 53.
20 Para 52.
21 See footnote 10.
22 At the time the guidelines were published, the functions currently carried out by the EBA were carried out by the Committee of European Banking Supervisors (CEBS).
24 Para 6 of the Basel Criteria requires that “[t]here are no circumstances under which the distributions are obligatory”. Footnote 17 prohibits dividend pushers and ACSM in respect of non-core Tier 1 capital. The same must apply a fortiori in respect of common equity. Dividend stoppers are not acceptable under paragraph 7. “there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital”.
25 Para 53 point 7. “there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital”.
26 EBA Guidelines, para 75.
27 Companies may reduce their share capital. The UK Companies Act 2006 permits a public company to reduce its share capital by special resolution confirmed by the court. However, this is not automatic and the consent of the court will not be given if the reduction would prejudice the company’s creditors.
28 Para 53.
29 Footnote 15 states that replacement “can be concurrent with but not after the instrument is called”.
30 Para 55.
31 A distribution of profits is made only to members of the company (including preference shareholders). The accounting treatment is not relevant to the treatment under company law.
32 As to which, see section 830 of the UK Companies Act 2006.
33 Footnote 17.
34 Para 55 point 11.
35 Possible Further Changes to the Capital Requirements Directive, February 2010, para 52.
36 It is unclear if this reserve will need to constitute a reserve for accounting purposes, or whether the write down will be sufficient.
37 Section 641 of the UK Companies Act 2006.
38 In EU jurisdictions this was subject to the terms of relevant state aid approval from the European Commission for those institutions receiving state aid.
41 The PRA will assume responsibility for the prudential regulation of banks under proposals announced by the UK Government to
restructure financial regulation. This is currently expected to occur by the end of 2012.


GENPRU 2.2.117AR(5)(c). For capital instruments within the 50% bucket the cap is 100% (i.e. conversion at par): GENPRU 2.2.115AR(6).

In the UK the creation of minority equity interests in a wholly-owned bank may result in de-grouping for tax purposes.

Para 55, point 14.

Footnote 18.

Para 65.

The new requirements are found in Chapter 2.2 of GENPRU.


See GENPRU 2.2.124R and 2.2.125R.

GENPRU 2.2.117BR.

GENPRU 2.2.64R(6)[b].

See Directive 2006/48/EC Article 66(1a)(a) and GENPRU 2.2.115AR.

GENPRU 2.2.115AR.

See para 55 point 11c.


Para 62.

Footnote 24. Obviously, this excludes minority interests funded by the bank itself or a member of its group.

Footnote 23.

Para 62.

Para 63.

Para 64.

Para 65.

Para 52.

Potentially this could include equity-accounted preference shares, although this will depend on how Basel III is implemented in the EU.

Para 56. The same applies to Tier 2 capital: para 57.

GENPRU 2.2.101R.

Footnote 10.

Paras 71-72.

From 1 January 2013, Tier 2 capital will need to meet the capital definition in Basel III. Existing non-compliant issues will be phased out as described below.

Footnote 20 states that replacement “can be concurrent with but not after the instrument is called”.

Para 58.

Para 91.

Para 92.

Basel consultation document para 16.

http://www.sif.admin.ch/dokumentation/00514/00519/00592/index.htm?lang=en&download=NHzLpZeg7Kljnp6I0NTU04212Z6ln1ad11Zn42q7pnC2Yq9276gpj6DdNz9Hym162epYbg2c_JjKbNoK5n6A--

Para 95.

See Para 94 (g).

Para 94 (f).

Para 67.

Para 68.

Para 69.

Para 70.

Para 71.

Para 72.

Para 73.

GENPRU 2.2.236R(1).

Para 74.

GENPRU 2.2.90R.

Para 75.

Para 76.

Para 76-77.

Para 78.

A bank’s holding of treasury stock does not provide any protection against losses. If relevant accounting standards do not permit recognition of treasury stock or other own shares on the balance sheet, no deduction will be required as there is no double counting of capital.

Para 78.

Para 79.

Para 80.

Para 81.

Para 83.

Para 70.

Para 71.

Para 72.

Para 73.

GENPRU 2.2.95R.

Para 74.

Para 75.

Para 76.

Para 76-77.

Para 78.

Para 80.

Para 79.

Para 80.

Para 83.

For example, under a contract for differences.
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102 Footnote 28.
103 Para 80.
104 Para 81.
105 Para 82.
106 Para 84.
107 See footnote 30.
108 Para 86.
109 Para 85.
110 Para 87.
111 Para 88.
112 Ibid.
113 Para 89.
114 See Para 94 (c) and (d).
115 Para 98.
116 Para 99.
117 Para 100.
118 Para 101.
119 Para 103.
120 Para 104.
121 Para 105.
122 Para 106.
123 Para 110.
124 Para 108.
125 Para 111.
126 Para 102.
127 Ibid.
128 Basel III uses US terminology. In the EU this will include insurance companies, reinsurers, credit institutions and (some) investment firms.
129 Para 118.
130 Para 119.
132 Para 120.
133 Ibid. The criteria on international access transparency were corrected in the June 2011 revision of Basel III.
134 Para 120.
135 Para 121.
136 Para 153.
137 Para 154.
138 Para 155.
139 Para 156.
140 Para 157.
141 Ibid.
142 Para 158.
143 Para 159.
144 Para 160.
145 Para 161.
146 Para 163.
147 Para 164.
148 Para 165.
149 Para 166.
150 Para 167.
151 Para 126.
152 Para 127.
153 Para 130.
154 Para 132(a).
155 Para 132(b).
156 Para 132(c).
157 Para 132(d).
158 FSA Policy Statement 10/14 Capital Planning Buffers, September 2010, p. 27.
160 Ibid.
161 Para 133.
162 Para 134.
163 Para 135.
164 Para 136.
165 Para 137.
166 Currently Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the UK and the United States.
167 Para 139.
168 Para 142.
169 See footnote 51.
170 Para 141.
171 Para 149.
Para 150. The same point is made at para 133.

Para 151. The same point is made at para 133.

Para 152. The same point is made at para 133.

Para 153. The same point is made at para 133.

Para 154. The same point is made at para 133.

Para 155. The same point is made at para 133.

Para 156. The same point is made at para 133.

Para 157. The same point is made at para 133.

Para 158. The same point is made at para 133.

Para 159. The same point is made at para 133.

Para 160. The same point is made at para 133.

Para 161. The same point is made at para 133.

Para 162. The same point is made at para 133.

Para 163. The same point is made at para 133.

Para 164. The same point is made at para 133.

Para 165. The same point is made at para 133.

Para 166. The same point is made at para 133.

Para 167. The same point is made at para 133.

Para 168. The same point is made at para 133.

Para 169. The same point is made at para 133.

Para 170. The same point is made at para 133.

Para 171. The same point is made at para 133.

Para 172. The same point is made at para 133.

Para 173. The same point is made at para 133.

Para 174. The same point is made at para 133.

Para 175. The same point is made at para 133.

Para 176. The same point is made at para 133.

Para 177. The same point is made at para 133.

Para 178. The same point is made at para 133.

Para 179. The same point is made at para 133.

Para 180. The same point is made at para 133.

Para 181. The same point is made at para 133.

Para 182. The same point is made at para 133.

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Para 200. The same point is made at para 133.

Para 201. The same point is made at para 133.

Para 202. The same point is made at para 133.

Para 203. The same point is made at para 133.

Para 204. The same point is made at para 133.

Para 205. The same point is made at para 133.