Linklaters

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Basel III: Capital Changes

Executive summary of Basel III Rules

On 16 December 2010, the Basel Committee (the "**Committee**") published its final rules to reform the global regulatory framework for banks.[1] The reforms to the Basel III capital rules are detailed in the document "*Basel III: A global regulatory framework for more resilient banks and banking systems*" while the new liquidity framework is contained in the document "*Basel III: International framework for liquidity risk measurement, standards and monitoring*". The liquidity rules and capital rules are together known as the "**Basel III Rules**". The Basel III Rules, first published as proposals in December 2009, have been, between then and late 2010, the subject of intensive lobbying and negotiation by banks, regulators and national governments. As a result of this lobbying process, amendments to certain aspects of the capital and liquidity proposals were provisionally agreed by the Committee in July 2010 and are reflected in the December 2010 papers. The transitional arrangements and calibration of the capital ratios were announced by the Committee in September 2010, while the G20 approved at the November Seoul meeting both the content and timing of the Basel III reform package. Additional loss absorbency criteria in the form of a write down conversion mechanism for all additional Tier 1 and Tier 2 instruments was added to the Basel III quality of capital rules by the Committee in an additional document published in January 2011.

The Basel III Rules are additional to reforms to the capital rules finalised by the Basel Committee in July 2009[2] which will come into effect at the end of 2011. These reforms focus on enhancing the trading book capital requirement for banks by introducing a new incremental default risk charge for trading bank assets, requiring market risk to be calculated by using stressed data inputs, bringing the treatment of securitisation exposures in the trading book into line with banking book exposures as well as making changes to the

[1] The proposals for reform of the Basel 2 capital rules were contained in the December 2009 Consultative Document, "Strengthening the resilience of the banking sector". The liquidity proposals were contained in the Consultative Document, "International framework for liquidity risk measurement, standards and monitoring".

[2] These rules are contained in the Basel Committee June 2009 publications, "Enhancements to the Basel II framework" and "Revisions to the Market Risk framework".

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securitisation framework to ensure re-securitisation exposures are sufficiently capitalised. The July 2009 rules are, of themselves expected, significantly to increase the capital requirements for trading book and securitisation exposures before the Basel III Rules take effect.

The Basel III Rules do not per se replace the existing Basel II Rules which for the most part remain unchanged. The Basel III Rules are focussed on five key areas of reform:

(i) **Increasing the quality and consistency of capital** – ensuring that bank's Tier 1 capital is mostly made up of ordinary shares termed "Common Equity Tier 1" ("**CET1**"). Non-common Equity Tier 1 capital (known as "**Additional Tier 1 capital**") is subject to strict conditions and must be capable of supporting a bank on a going concern basis. Significant changes are also made to Tier 2 capital while Tier 3 capital is removed. In addition, all non CET1 capital instruments must contain loss absorbency characteristics in the form of conversion into equity or principal write-down mechanism, triggered on the non viability of the issuer. The capital ratios have also changed from the Basel II minima. The Tier 1 capital ratio is to increase from the current 4.0% of risk weighted assets to 6%. The CET1 ratio is to increase from 2% to 4.5%. The minimum total capital ratio remains the same at 8%.

(ii) **Increasing counterparty credit risk charges** – ensuring that derivatives, repos and securities financing activities which are not cleared with a central counterparty are subject to (i) much higher capital requirements for counterparty credit risk than currently apply and (ii) more robust margining, collateral and disclosure requirements. These revisions, which must apply from 1 January 2013, are additional to the July 2009 securitisation revisions which will apply in the EU and other jurisdictions from 1 January 2012.

(iii) **Restricting leverage** – a leverage ratio of 3% is introduced as a supplementary measure to the risk-based requirement. During the transition phage between 1 January 2013 and 1 January 2017, the Committee will use Tier 1 capital as the capital measure for the ratio but it is leaving the door open to possibly limiting it to CET1 or expanding it to include Tier 2 capital.

(iv) **Reducing procyclicality and capital buffers** – banks will be subject to two new capital buffer requirements; a capital conservation buffer of up to 2.5% CET1 capital to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred, and a countercyclical buffer of 2% of Tier 1 capital to be deployed by national regulators when there is excess credit growth.

(v) **Increasing the quantity and quality of liquid assets and funding profile of banks** – banks will be subject to a liquidity coverage ratio and net stable funding ratio which will require banks to hold

substantially more liquidity than currently is the case to change the tenor of their funding to more adequately match their asset profile.

The Basel III Rules are subject to phased implementation and a transitional regime which commences on 1 January 2013.[3] The transitional timetable which effectively runs between 1 January 2013 and 1 January 2019, staggers implementation of the various rules. The timetable was established as a result of concerns over the negative impact that the reforms could have on the fragile economic recovery if all implemented at the same time. Full implementation (after possible recalibration of the liquidity and leverage ratios) will take place by 1 January 2019. Annex 1 contains a tabular summary of the implementation dates and transitional timetable. The transitional timetable for each of the five key areas is also detailed in the respective summaries below.

Set out below is a summary of the five main areas of reforms. This note provides an initial summary and does not focus on the detailed drafting of the Basel III Rules, which requires further analysis and interpretation.

What counts as capital and capital ratios?

Changes to criteria for different tiers of capital

The first plank of reform is to make major changes to what qualifies as regulatory capital, including the definition of Tier 1 and Tier 2 capital. A key aspect of the regulatory capital criteria is the principle that banks risk exposures must be backed by a high quality capital base. Over a number of years, the quality of Tier 1 capital in particular had been eroded and, often banks could have as little as 2% of their assets backed by ordinary shares. The main changes to the constituents of capital are summarised below.

> **Common Equity Tier 1 capital ("CET1"):** The predominant form of capital must be CET1. The Basel 3 rules replace the concept of Core Tier 1 with a tougher categorisation of "common equity" which basically comprises of common shares[4] and retained earnings.[5] Most deductions must be applied at the level of CET1. The ratio of CET1 to risk weighted assets will increase from the current 2% minimum to 3.5% on 1 January 2013, 4% on 1 January 2014 and 4.5% on 1 January 2015.

> **Additional Tier 1 Capital:** This element of capital allows instruments other than common equity to be included as Tier 1 capital. The Committee considers innovative features such as step-ups to have eroded the quality of Tier 1 capital and therefore innovative Tier 1 capital (i.e. capital with incentives to redeem) is not permitted and will

[3] Other than the counterparty credit risk changes which apply on 1 January 2013 and are not phased in.

[4] Criteria for classification of common shares has been drawn up. These are generally unsurprising. The shares must represent the most subordinated claim in liquidation, the entitlement of a holder to the residual capital on liquidation must be proportionate to its share of issued capital, principal is perpetual, and there are no circumstances under which distributions are obligatory. Preferential dividends and distributions which are not in any way "tied or linked to the amount paid in at issuance" are expressly not permitted to be included in the common equity capital base.

[5] In certain circumstances, minority interests allowing for the issue of common shares by a full subsidiary of the bank may also be recognised as Common Equity Tier 1.

be phased out. The detailed set of criteria which an instrument will need to meet or exceed to qualify for inclusion in the Tier 1 Additional capital base is based on three key principles: the instrument must (a) help the firm avoid payment default through payments being discretionary; (b) help the firm avoid balance sheet insolvency by the instrument not contributing to liabilities exceeding assets; and (c) be able to bear losses while the firm remains a going concern. Criteria for an instrument to qualify as Additional Tier 1 include: it is fully subordinated to general creditors, there is full discretion to cancel coupons or dividends, there is no maturity date, there is no incentive to redeem early, and it does not count as "liabilities" for balance sheet purpose tests. For further detail on the entry criteria refer to Annex 2. See below as to write-down/conversion features.

> **Tier 1 capital:** The Total Tier 1 ratio is currently 4%. On 1 January 2013, required Total Tier 1 capital will increase to 4.5%, by January 2014, 5.5% and 1 January 2015 6%. Tier 1 capital is to be made up as to 4% of CET1 with Additional Tier 1 limited to 1.5% of Total Tier 1 from 1 January 2015.

> **Tier 2 capital:** Although the main focus of the Basel quality of capital rules is on Tier 1 capital, significant changes are also being made to Tier 2 capital. The upper and lower sub-categories of Tier 2 capital is to be eliminated. Instead, there will be one set of "entry criteria". All Tier 2 "should correspond to capital which…. absorbs losses on a gone concern basis".[6] For further detail on the entry criteria, refer to Annex 2.

> **Convertibility/write down of Tier 2 instruments:** These instruments must have a loss absorption provision that requires those instruments, on the occurrence of a trigger to either have the principal written off or be converted into common equity upon the occurrence of the trigger event. The trigger is the earlier of (i) a decision by the authority that write-off, without which the firm would become non-viable, is necessary and (ii) a decision to make public sector injection of capital or other support, without which the firm would not be viable. This requirement does not apply if the governing jurisdiction of the bank has a statutory regime that requires an equivalent outcome (i.e. conversion or write-down).

> **Tier 3 capital:** to be phased out completely.

Deductions from capital

Another substantial change made by the Committee is to ensure that deductions from capital are applied consistently throughout all jurisdictions to avoid the scope for regulatory arbitrage. Deductions must for the most part be made from CET1, rather than across Tier 1 and Tier 2 capital, as is currently often the case. This change will make a considerable and detrimental difference to the cost of deductions for banks.

[6] Basel Proposals, paragraph 70. Note that under current GENPRU requirements, upper Tier 2 capital instruments must absorb losses on a going concern basis, but in practice it arguably did not turn out that any Tier 2 capital really had this effect.

Items to be fully deducted from capital include most deferred tax assets (specifically those that rely on future profitability of the bank to be realised), cash flow hedge reserves, shortfall on the amount of provisions to expected losses, gains on sale related to securitisation transactions, cumulative gains and losses due to changes in credit risk on fair valued liabilities, deferred benefit pension fund assets and liabilities, investments in own shares, reciprocal cross holdings in other financial institutions and excess holdings in the capital of banks and finance institutions which either individually or aggregated are material holdings, (basically 10% or more of the capital of the issuer) which do not fall within the 10% basket (see below). Although unrealised gains and losses will not be deducted from CET1, the Committee will continue to review the appropriate treatment of unrealised gains to take into account changes in accounting standards.

The original December 2009 proposal required full deduction of minority interests, mortgage servicing rights, deferred tax assets that arose from temporary timing differences and significant investments in the common shares of unconsolidated financial institutions. However, after considerable lobbying, the final rules relax these requirements. Minority interests will be recognised for capital inclusion provided certain criteria are met. In addition, mortgage servicing rights, significant investments in the common shares of unconsolidated financial institutions, and deferred tax assets that arise from temporary differences are recognised, with a cap of 10% of the bank's equity component for each item. This means that if any of these items account for over 10% of a bank's CET1, the bank must deduct the excess amount over 10%. In addition, if these items when aggregated exceed 15% of a bank's CET1, it must deduct the excess.

Timetable for quality of capital reforms and grandfathering of capital instruments

The minimum CET1 and Tier 1 requirements will be phased in between 1 January 2013 and 1 January 2015. At 1 January 2013, banks should have 3.5% CET1, 4.5% Tier 1 capital and 8% total capital. In 2014, this increases to 4% CET1, 5.5% Tier 1 and 8% total capital. The full ratios must be in force by January 2015, namely 4.5% CET1, 6% Tier 1 and 8% total capital.

Capital instruments which do not meet the criteria for inclusion as CET1 cannot count as such from 1 January 2013. There are no grandfathering arrangements for CET1 (other than in the case of non joint stock companies whose Core Tier 1 will be grandfathered on a declining basis over a certain period provided certain conditions are met). There are, however, grandfathering arrangements for Additional Tier 1 and Tier 2 instruments. These instruments are grandfathered over a ten year period, starting on 1 January 2013. In order to qualify for the grandfathering arrangements, an instrument must have been entered into by a particular cut-off date. Any instrument entered into before 12 September 2010 which does not meet the new Basel III qualifying criteria for the particular tier of capital can be grandfathered. Instruments entered into after this date cannot be grandfathered unless they comply with all the new Basel III conditions. These Basel III compliant instruments do not however have to contain the January

2011 conversion or write down mechanism in order to qualify for grandfathering, but these instruments must be entered into before 1 January 2013 or they fall outside the grandfathering regime.

Deductions will be phased in, with 20% of the required deductions from CET1 applying on 1 January 2014 and increasing 20% per year thereafter until 100% of the deductions are made from common equity by 1 January 2018. During this transition period, the remainder not deducted from capital will continue to be subject to existing national treatment. As regards minority interests, where such capital is eligible for inclusion under the Basel III Rules, it can be included from 1 January 2013. Where such capital is not eligible for inclusion under Basel III, but is eligible under existing national treatment, 20% of this amount should be excluded from the relevant component of capital on 1 January 2014, increasing 20% each year to reach 100% on 1 January 2018.

Reforms to the capital treatment of derivatives, repos and securities financing transactions

Introduction

Under the current Basel II rules, positions which arise from financial derivative instruments, securities financing arrangements, and certain other types of arrangement are subject to a charge for counterparty credit risk ("**CCR**"). This is the risk that the counterparty to the transaction could default before the final settlement of the transaction's cash flows.[7] A loss would occur if the transaction or portfolio of transactions with the defaulting counterparty had a positive economic value at the time of default.

The current regulatory capital treatment of counterparty risk was, however, found to be insufficient in a number of respects. Firstly, defaults and deterioration in the credit-worthiness of counterparties occurred precisely at the time when market volatilities and therefore counterparty exposures were highest. Wrong way risk, namely the link between the increase in an exposure and the increase in likelihood of a counterparty defaulting was not properly incorporated into the framework. Secondly, most counterparty credit risk losses under derivative transactions occurred as a result of credit valuation adjustments ("**CVA**"), namely the loss arising from a deterioration in the credit-worthiness of a counterparty short of default e.g. ratings downgrade, not as a result of actual defaults. The current framework does not require banks to hold capital against CVA risk. Thirdly, large financial institutions were shown to be far more interconnected by virtue of the fact that as the downturn deteriorated, banks' counterparty exposures to other financial firms increased far more dramatically than exposures to non financial firms. This interconnectedness was again not reflected in the capital framework.

[7] This charge is additional to the market risk charge the bank would be subject to cover the risk of movements in the value of the underlying instrument if held in the trading book as a result of changes in market conditions.

These fault-lines in the current framework have led the Committee to make a series of relatively major changes to the counterparty risk capital framework. These changes will all take effect from 1 January 2013. One of the main effects of these changes is that banks with substantial structured finance and derivatives trading activities will have to hold far more capital against these exposures than they currently do. The major increase in the capital cost of these transactions may compel banks to clear a large number of derivatives transactions through an eligible clearing house as cleared transactions are subject to a nominal counterparty risk charge.

Summary of counterparty credit risk changes

The main changes to the counterparty credit risk framework are set out below. These measures will apply to banks from 1 January 2013.

> Banks which have permission to use the internal models method must calculate the potential exposure amount known as the expected positive exposure ("**EPE**")[8] of the derivative using data that includes a period of stressed market conditions. A bank must then use the EPE based on the stressed market data[9] if higher than the output behind the current market data.

> Banks must hold capital (as part of the counterparty credit risk charge) to capture credit valuation adjustment risk ("**CVA**"). This is the risk of mark-to-market losses arising from credit deterioration of the counterparty which may occur during the life of the transaction. CVA is effectively the difference between the inherent value of the contract and its value given the actual counterparty. The current Basel III counterparty credit risk rules covers default risk[10] but does not cover the risk of the counterparty's credit study declining, such as by virtue of a ratings downgrade. The method used to calculate the new CVA capital charge depends upon the bank's approved method of calculating capital charges for counterparty credit risk and specific interest rate risk. Banks with permission to use the internal model method approach and specific interest rate risk VaR model approach must use the Advanced CVA risk capital charge. All other banks must use the Standardised CVA risk capital charge.[11] This CVA charge is additional to the existing default risk change. A bank is not required to include in the CVA risk capital charge transactions with a central counterparty or securities financing transaction unless their supervisor determines that the bank's CVA loss exposures arising from securities financing transactions are unrated.

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[8] EPE is the weighted average over time of expected exposures where the weights are the proportion that an indicated expected exposure represents of the entire time interval. When calculating the main capital requirement, an average is taken over one year or earlier, over the time period of the longest maturity contract in the netting set.

[9] General wrong way risk is the risk of the probability of default of a counterparty being highly correlated with general market risk factors.

[10] Default risk is calculated using the standardised or internal ratings based approach for credit risk.

[11] The CVA risk capital charge consists of both general and specific credit risk spread rules, including stressed VaR, but excluding the incremental risk charge.

> As regards wrong-way risk, banks must identify exposures that give rise to a greater degree of general wrong-way risk than is normally the case and the way such risk is being managed. Wrong way risk is the risk of the probability of default of a counterparty being highly correlated with general market risk factors.

> Specific wrong-way risk is subject to more onerous requirements. Where a bank is identified to "specific wrong way risk" on an exposure, namely the risk of the future exposure of the counterparty being highly correlated with the counterparty's probability of default, the exposure at default calculation must reflect a higher value for counterparties with specific wrong way risk ("**EAD**"). As EAD is one of the four measures used in the capital requirement calculation, the result of a higher EAD is that the capital requirement for an exposure with specific wrong way risk will be significantly higher than an exposure without such wrong-way risk.

> Despite significant objections by banks who criticised the lack of risk-sensitivity of this approach to systemic risk, the Committee has imposed a multiplier of 1.25 to the counterparty risk charge calculation. Banks must apply the correlation multiplier to all exposures to regulated financial firms with assets of at least $100 billion (the original proposal was for the smaller threshold of $25 billion)) and to all exposures to unregulated financial firms (regardless of size). This measure aims to address systemic risk within the financial sector, by ensuring the capital requirement is higher for banks' derivative exposures to a financial counterparty than a non-financial counterparty, as exposures between members of the financial system are more correlated than exposures to non-financial entities. The most recent audited financial statement of the parent company and the consolidated subsidiaries must be used to determine asset size. A regulated financial institution is defined as a parent and its subsidiaries where any substantial legal entity in the consolidated group is supervised by a regulator that imposes prudential requirements consistent with international norms. These include, but are not limited to banks, broker dealers and insurance companies. Unregulated financial institutions are legal entities whose main business includes the management of financial assets, lending and the provision of a number of other financial services.

> The Committee is strengthening margining practice to increase the margin periods of risk. The rules extend the margin period of risk to 20 days for OTC derivatives and securities financing transactions (SFTs), netting sets that are large (i.e. over 5,000 trades), have illiquid collateral, or represent hard-to-replace derivatives. The current time frame is 5-10 days. In addition to strengthening initial margining provisions, the Committee is making collateral management practises more robust. Among reforms to collateral requirements are various improvements in both the calculation of EAD to promote more robust collateral management practices (e.g. disallow downgrade triggers

from being reflected in EAD) and in the operations and risk analysis supporting the collateral management process (e.g. re-use of collateral and organisation and operation of collateral management etc). There is also a separate supervisory haircut category for repo-style transactions using securitisation collateral and resecuritisations are prohibited as eligible financial collateral for regulatory capital treatment purposes;

> One of the stated aims of the Committee is to reduce systemic interconnectedness by incentivising the clearing of OTC derivatives through central counterparties ("**CCP**"). A risk weighting of 2% will be given to exposures to a CCP which meets various rigorous conditions proposed by IOSCO. These include that the CCP establishes a high specific level of initial margin and on-going collateral posting requirements; and has sufficient financial resources to withstand the default of significant participants.

Addressing reliances on external ratings and minimising cliff effects

The Basel III Rules contain a number of measures to mitigate the reliance of the Basel II framework on external ratings. The main changes made by the Committee are a requirement that banks must perform their own internal assessments of externally rated securitisation exposures. In addition, the cliff-effect produced by the current requirement that "eligible guarantors" be "externally rated A- or better" or "internally rated and associated with a PD equivalent to A- or better" has been eliminated for non-securitisation exposures. All corporate entities are eligible as guarantors. In the case of securitisation exposures, credit protection will be recognised if provided by an entity with a BBB- or better that was rated at A- or better at the time protection was provided.

Leverage ratio

The third key part of the reforms is the introduction of an unweighted leverage ratio to address the fact that one of the underlying features of the banking crisis was the build up of excessive on balance sheet and off balance sheet leverage which was not captured by the Basel II framework. The ratio is intended to achieve the direct objective of containing the build-up of leverage in the banking sector and thereby minimising the destabilising deleveraging process as well as reinforcing the risk-based capital adequacy requirements.

The current timetable is to test a minimum Tier 1 leverage ratio of 3% during the parallel run period, which runs from 1 January 2013 to January 2017. The Committee will use the transition period to monitor banks leverage data, on a semi-annual basis to assess the appropriateness over the cycle and design and calibration of ratio. The ratio will potentially be recalibrated on the basis of the results from the parallel run, and be fully effective from 1 January 2018. In addition, there will be a "supervisory monitoring period" running from 1 January 2011, with disclosure of the leverage ratio and its components to start from 1 January 2015. The supervisory monitoring period will focus on developing templates to track in a consistent manner the underlying components of the definition and resulting ratio.

One of the issues of contention in the design of the leverage ratio is whether it should include all off-balance sheet items as well as on balance sheet items and how off-balance sheet items should be treated. The Committee decided that all off balance sheet items, ranging from letters of credit to commitments to lend and guarantees are a source of potentially significant leverage and should therefore be included. However, all off-balance sheet items are subject to a universal 100% credit conversion factor (other than unconditionally cancellable items) which effectively means that, for the purposes of the leverage ratio, there is no difference between on balance sheet and off-balance sheet items. This treatment is more conservative and risk averse than that under the Basel II capital framework, which provides for CCF percentages between 0% and 100%.

The basis of the leverage ratio calculation is the average of the monthly leverage ratio over each quarter based on the capital measure divided by the exposure method. Set out below is a tabular summary of the leverage ratio.

Issue	**Baseline proposal**
Capital Measure	
Definition of Capital	New definition of Tier 1 capital (less deductions from capital). Items deducted from the capital measure are also deducted from the exposure measure.
Total exposure measure	
Exposure measurement: valuation adjustments and provisions.	Exposure measure to generally follow accounting treatment. On-balance sheet exposures are net of specific provisions and valuation adjustments (e.g. credit valuation adjustments).
Off-balance sheet items	All off-balance items in the Basel II framework, will have a 100% CCF other than those which are unconditionally cancellable which will have a 10% CCF. Off-balance sheet items in the Basel II framework include commitments to lend (including liquidity facilities), direct credit substitutions, acceptances, standby letters of credit and trade letters of credit. This means that trade finance commitments and most commitments to lend, including revolving loans, will receive a 100% CCF, which is substantially higher than the Basel II credit risk treatment. Written credit protection is included at

Issue	Baseline proposal
	notional value.
Credit risk mitigation and on-balance sheet netting	All types of collateral, guarantees and other forms of credit risk mitigation such as credit derivatives are not permitted to reduce on-balance sheet exposures.
	Netting of loans and deposits is not allowed.
Securitisations	Use accounting data
Derivatives (excluding credit derivatives)	Use the accounting measure of exposure plus an add on for potential future exposure calculated according to the "Current Exposure Method" of the Basel II framework. This ensures that all derivatives are converted in a consistent manner to a "loan equivalent" amount.
Netting of derivatives is permitted using the Basel II regulatory netting rules (though excluding cross-product netting).	
Repurchase agreements and securities finance.	Use Basel II netting rules for repo-style transactions.

Capital Buffers and Measures to reduce pro-cyclicality

Basel III sets out two key buffer measures to address pro-cyclicality a capital conservation buffer and a countercyclical capital buffer: Each of these two buffers is described in detail below.

Capital conservation buffer

The Committee is introducing a capital conservation buffer framework requiring banks to build up a buffer of CET1 capital in excess of the minimum CET ratio. The buffer requirement is aimed at preventing a re-occurrence of the recent financial crisis where a number of banks continued to make large distributions in the form of dividends, share buy backs and large compensation payments even though their financial condition was worsening. The framework reduces the discretion of banks which do not hold sufficient capital in excess of the regulatory minimum, to distribute earnings. The idea is that retaining a greater proportion of earnings during an upturn to build up a buffer will help ensure that capital remains available to support business operations during times of stress and therefore reduces procyclicality.

Banks must maintain a capital conservation buffer of 2.5% of risk weighted assets, over the regulatory minimum capital requirements. The buffer must be

comprised of CET1. The buffer is capable of being drawn down, but supervisors must be involved to ensure that the capital plans of the bank include rebuilding the buffers over an appropriate timeframe.

The framework is applied at the consolidated group level, i.e. restrictions are imposed on distributions out of the consolidated group. However, national supervisors can apply the regime at the solo lend to conserve resources in specific parts of the group.

Capital distribution constraints are imposed on a bank when its capital position falls within the conservation range. The constraints only relate to distributions, not the operation of the bank. Distributions are defined as dividends and share buybacks, discretionary bonus payments to staff and discretionary payments on other Tier 1 capital. The distribution constraints are greater as a bank's capital buffer range falls further towards the minimum capital requirement. At the top of the range, the constraints are minimal. This was a deliberate design of the Committee, on the basis that at certain times, a bank's capital levels may fall within the buffer range and should not be penalised harshly when this happens. Annex 2 contains a table setting out the minimum capital conservation ratios, expressed as a percentage of earnings that a bank must meet at various levels of CET1 capital ratios. For example, if the bank maintains a CET1 ratio of between 5.75% and 6.375% it is required to conserve 60% of its earnings (i.e. payment of not more than 40% in terms of dividends, share buy backs and discretionary bonus payments).

If the bank wants to make payments in excess of the distribution constraints, it would have the option of raising capital in the private sector equal to the amount above the constraint.

The conservation buffer will be phased in between 1 January 2016 and year end 2018, becoming fully effective on 1 January 2019. It will begin at 0.625% of RWAs on 1 January 2016, increase each subsequent year by 0.625% to reach its final level of 2.5% of RWAs on 1 January 2019. National authorities have the discretion to impose shorter transition periods. As of 1 January 2019, the capital buffer of 2.5% and the minimum CET1 ratio of 4.5% will be in effect, meaning that the minimum CET1 capital requirement (excluding the counter-cyclical capital buffer) will be 7%.

Counter-cyclical buffer

The recent financial crisis illustrated that losses incurred in the banking sector can be extremely substantial when a downturn is preceded by a period of excess credit growth, and that those losses can transmit into the real economy and back again. The countercyclical buffer requirement is aimed at ensuring that the banking sector builds up its capital defences in periods when credit has grown to excessive levels. The buffer should not just protect the banking sector in periods of excess credit growth, but also help moderate excess credit growth.

Each Basel Committee member jurisdiction will identify an authority to be responsible for the execution of the buffer. The authority will monitor credit

growth (credit to GDP) and assess whether growth is excessive, and if so, whether it should put in place a countercyclical buffer requirement. The buffer will vary between 0 and 2.5% of RWA. The principles that the National Authorities must follow are set out in the Basel Committee document published on 16 December 2010, "*Guidance for national authorities operating the counter-cyclical buffer*".

To give banks time to adjust to a buffer level, a jurisdiction will pre-announce by up to 12 months its decision to raise the level of the buffer. The buffer requirement only applies to private sector (which includes non-bank financial sector) credit exposures. The framework contains international reciprocity provisions for banks which operate in more than one jurisdiction (i.e. internationally active banks). The host authority will set a buffer requirement that it can apply to credit exposures held by legal entities (i.e. domestic banks) located in its jurisdiction. It will notify other Basel country authorities. Each Basel country authority has agreed to be responsible for ensuring that the banks they supervise impose a buffer requirement on exposures held in the host jurisdiction which has imposed the counter-cyclical buffer. Jurisdictions may choose to implement larger countercyclical buffer requirements. In such cases, the reciprocity provisions of the regime will not apply to the additional amounts. The home authorities can require banks they supervise to maintain higher buffers if they judge the host authorities' buffer to be insufficient. The reciprocity arrangements ensure there is a level playing field between domestic banks and foreign banks lending to counterparties in a particular jurisdiction.

The countercyclical buffer requirement is implemented through an extension of the capital conservation buffer. This means that the countercyclical buffer requirement is added on to the conservation range and the minimum conservation ratios are applied to the Common Equity Tier 1 ratio calculated by adding the minimum CET1 ratio of 4.5% with the two buffer ratios of 2.5% and 2% (maximum of 9.0% CET1 ratio). Restrictions on distributions described above in the capital conservation section, apply equally. Refer to Annex 3 for an example of the ratios and distribution restrictions. As with the conservation buffer, the countercyclical framework will be applied at the consolidated level, but national supervisors can apply it on a solo level.

The committee has clarified that it is still reviewing the question of permitting other fully loss absorbency capital beyond CET1 and what form it could take. Until the Committee has issued further guidance, the buffer is to be met with CET1 only.

The countercyclical buffer regime will be phased in parallel with the capital conservation buffer between 1 January 2016 and year 2019. Countries that experience excessive credit growth during the transition period can consider accelerating the build up of the capital conservation buffer and the countercyclical buffer.

New liquidity standards

The Committee has finalised a new liquidity regime, the foundation of which is two ratios, the Liquidity Coverage Ratio (“**LCR**”) and the Net Stable Funding Ratio (“**NSFR**”).

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Annex 1
Transitional arrangements (shading indicates transition periods)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
LEVERAGE RATIO	Supervisory monitoring		Parallel run 1 January 2013- 1 January 2017 Disclosure starts 1 January 2015					Migration to Pillar 1	
MINIMUM COMMON EQUITY CAPITAL RATIO			3.5%	4.0%	4.5%				
CAPITAL CONSERVATION BUFFER						0.625%	1.25%	1.875%	2.50%
MINIMUM COMMON EQUITY PLUS CAPITAL CONSERVATION BUFFER			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
PHASE-IN OF DEDUCTIONS FROM CET 1				20%	40%	60%	80%	100%	
MINIMUM TIER 1 CAPITAL			4.5%	5.5%	6.0%				
MINIMUM TOTAL CAPITAL			8.0%						
MINIMUM TOTAL CAPITAL PLUS CONSERVATION BUFFER			8.0%			8..625%	9.25%	9.875%	10.5%
CAPITAL INSTRUMENTS NO LONGER QUALIFY AS NON-CORE TIER 1 OR TIER 2 CAPITAL			Phased out over 10 year horizon beginning 2013						
LIQUIDITY COVERAGE RATIO	Observation period begins	Reporting to supervisors	Mid-2013: any revisions made		Minimum standard introduced				
NET STABLE FUNDING RATIO	Observation period begins	Reporting to supervisors				Mid-2016: any revisions made		Minimum standard introduced	

Annex 2
Criteria for inclusion in different Tiers of capital

Criteria for inclusion in Tier 1 Additional Going Concern Capital.

The main criteria include:

> Subordinated to depositors, general creditors and subordinated debt (rather than having to be "the most subordinated claim", as required of Common Equity which appears to allow Tier 1 Additional Going Concern Capital instruments to rank senior to common equity and pari passu with preference shares).

> No maturity date; no incentives to redeem or other "innovative" features.

> Callable at the initiative of the firm only after a minimum of five years subject to:

  > prior supervisory approval;

  > the firm not creating an expectation that the call will be exercised; and

  > the firm not exercising a call unless the called instrument is replaced with capital of the same or better quality or the firm demonstrating that its capital position is well above the minimum capital requirements after the call is exercised.

> The firm must have full discretion to cancel distributions/payments. Such cancellation of distributions/payments must not impose restrictions on the firm except in relation to distributions to common stockholders (but see below regarding not hindering recapitalisation).

> Dividends/coupons must be paid out of distributable items.

> Instruments classified as liabilities must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point.

> The instrument cannot have any features that hinder recapitalisation.

Criteria for inclusion in Tier 2 Capital.

The main criteria include:

> Subordinated to depositors and general creditors.

> Minimum original maturity of at least five years, no incentives to redeem.

> Recognition in regulatory capital in the remaining five years before maturity will be amortised on a straight line basis.

> Callable at the initiative of the firm only after a minimum of five years subject to:

  > prior supervisory approval;

  > the firm not creating an expectation that the call will be exercised; and

  > the firm not exercising a call unless the called instrument is replaced with capital of the same or better quality or the firm demonstrating that its capital position is well above the minimum capital requirements after the call is exercised.

> The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal) except in liquidation.

Annex 3
Buffer Ratios

Capital Conservation Buffer Conservation Ratios

Common Equity Tier 1 ratio	Minimum Capital Conservation ratio (% of earnings)
4.5% - 5.125%	100%
5.125% - 5.75%	80%
5.75% - 6.375%	60%
6.375% - 7.0%	40%
>7.0%	0%

Countercyclical Capital Buffer Conservation Ratios

Individual bank minimum capital conservation standards	
Common Equity Tier 1 (including other fully loss absorbing capital)	Minimum Capital Conservation Ratios (expressed as a percentage of earnings)
Within First quartile of buffer	100%
Within Second quartile of buffer	80%
Within Third quartile of buffer	60%
Within Fourth quartile of buffer	40%
Above top of buffer	0%