Basel Committee
on Banking Supervision

Basel III definition of capital - Frequently asked questions

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Contents

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The Basel Committee on Banking Supervision has received a number of interpretation questions related to the 16 December 2010 publication of the Basel III regulatory frameworks for capital and liquidity and the 13 January 2011 press release on the loss absorbency of capital at the point of non-viability. To help ensure a consistent global implementation of Basel III, the Committee has agreed to periodically review frequently asked questions and publish answers along with any technical elaboration of the rules text and interpretative guidance that may be necessary.

This document sets out the first set of frequently asked questions that relate to the definition of capital sections of the Basel III rules text. The questions and answers are grouped according to the relevant paragraphs of the rules text.

Paragraphs 52–53 (Criteria for Common Equity Tier 1)

1. Does retained earnings include the fair value changes of Additional Tier 1 and Tier 2 capital instruments?

Retained earnings and other reserves, as stated on the balance sheet, are positive components of Common Equity Tier 1. To arrive at Common Equity Tier 1, the positive components are adjusted by the relevant regulatory adjustments set out in paragraphs 66–90 of the Basel III rules text.

No regulatory adjustments are applied to fair value changes of Additional Tier 1 or Tier 2 capital instruments that are recognised on the balance sheet, except in respect of changes due to changes in the bank's own credit risk, as set out in paragraph 75 of the Basel III rules text.

For example, consider a bank with common equity of 500 and a Tier 2 capital instrument that is initially recognised on the balance sheet as a liability with a fair value of 100. If the fair value of this liability on the balance sheet changes from 100 to 105, the consequence will be a decline in common equity on the bank's balance sheet from 500 to 495. If this change in fair value is due to factors other than own credit risk of the bank, eg prevailing changes in interest rates or exchange rates, the Tier 2 capital instrument should be reported in Tier 2 at a valuation of 105 and the common equity should be reported as 495.

2. Where associates and joint ventures are accounted for under the equity method, are earnings of such entities eligible for inclusion in the Common Equity Tier 1 capital of the group?

Yes, to the extent that they are reflected in retained earnings and other reserves of the group and not excluded by any of the regulatory adjustments set out in paragraphs 66 to 90 of the Basel III rules text.

3. Criteria 14 requires common shares to be "clearly and separately disclosed on the bank's balance sheet. Does "balance sheet" refer to that in the audited and published financial statements? Is it only for the balance sheet at end of financial year? Does disclosure have to be both for the standalone bank and on a consolidated group basis?

This requirement is about the nature of the item, ie that it is separately disclosed on the face of a bank's balance sheet, and not about the frequency of the disclosure. In the context of the nature, yes, it is the balance sheet in the audited financial statements as published in the annual report. The Basel requirements are for consolidated group levels, and the treatment at an entity level should follow the domestic requirements. As for the frequency, where a bank publishes results on a half yearly or quarterly basis disclosure should also be made at those times.

Paragraphs 54–56 (Criteria for Additional Tier 1 capital)

4. Criteria 3 requires that Additional Tier 1 capital is "neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors". Where a bank uses a special vehicle to issue capital to investors and also provides support to the vehicle (eg by contributing a reserve), does the support contravene Criteria 3?

Yes, the provision of support would constitute enhancement and breach Criteria 3.

5. Criteria 4 for Additional Tier 1 capital. If a Tier 1 security is structured in such a manner that after the first call date the issuer would have to pay withholding taxes assessed on interest payments that they did not have to pay before, would this constitute an incentive to redeem? It is like a more traditional step-up in the sense that the issuers interest payments are increasing following the first call date, however, the stated interest does not change and the interest paid to the investor does not change?

Yes, it would be considered to be a step-up.

6. Criteria 7 sets out the requirements for dividend/coupon discretion for Additional Tier 1 capital. Are dividend stopper arrangements acceptable (eg features that stop the bank making a dividend payment on its common shares if a dividend/coupon is not paid on its Additional Tier 1 instruments)? Are dividend stopper arrangements acceptable if they stop dividend/coupon payments on other Tier 1 instruments in addition to dividends on common shares?

Dividend stopper arrangements that stop dividend payments on common shares or dividend/coupon payments on other Additional Tier 1 instruments are not prohibited by the Basel III rules text. However, stoppers must not impede the full discretion that bank must have at all times to cancel distributions/payments on the Additional Tier 1 instrument, nor must they act in a way that could hinder the recapitalisation of the bank (see criteria 13). For example, it would not be permitted for a stopper on an Additional Tier 1 instrument to:

- attempt to stop payment on another instrument where the payments on this other instrument were not also fully discretionary;

- prevent distributions to shareholders for a period that extends beyond the point in time that dividends/coupons on the Additional Tier 1 instrument are resumed;
- impede the normal operation of the bank or any restructuring activity (including acquisitions/disposals).

A stopper may act to prohibit actions that are equivalent to the payment of a dividend, such as the bank undertaking discretionary share buybacks.

7. Criteria 10 states that Additional Tier 1 instruments "cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law". Is this criteria irrelevant if national insolvency law does not include an assets exceeding liabilities test?

Yes, it is irrelevant where liabilities exceeding assets does not form part of the insolvency test under the national insolvency law that applies to the issuing bank. However, if a branch wants to issue an instrument in a foreign jurisdiction where insolvency law is different from the jurisdiction where the parent bank is based, the issue documentation must specify that the insolvency law in the parent bank's jurisdiction will apply.

8. Criteria 14 sets out requirements for Additional Tier 1 instruments that are issued out of non-operating entities (such as a special purpose vehicle – "SPV"). Is it correct to assume that regulators are to look at the form of instrument issued to the SPV as well as instruments issued by the SPV to end investors?

Yes, capital instruments issued to the SPV have to meet fully all the eligibility criteria as if the SPV itself was an end investor – ie the bank cannot issue capital of a lower quality (eg Tier 2) to an SPV and have an SPV issue higher quality capital to third party investors to receive recognition as higher quality capital.

Paragraphs 60–61 (Provisions)

9. Paragraphs 60 and 61 permit certain provisions/loan-loss reserves to be included in Tier 2. Are the eligible provisions net or gross of tax effects?

Gross

Paragraphs 62–65 (Minority interest and other capital that is issued out of consolidated subsidiaries that is held by third parties).

10. Does partial de-recognition of AT1 and T2 capital issued to third parties by subsidiaries, as laid out in paragraphs 63 and 64 of the Basel III rules text, apply to wholly-owned subsidiaries, or only to fully consolidated but partly owned subsidiaries?

The partial de-recognition of capital issued to third parties by subsidiaries applies to all fully consolidated subsidiaries, including wholly-owned and partly owned. Therefore the partial de-recognition will affect the Additional Tier 1 and Tier 2 provided to third parties by all such subsidiaries.

11. Does minority interest (ie non-controlling interest) include the third parties' interest in the retained earnings and reserves of the consolidated subsidiaries?

Yes. The Common Equity Tier 1 in the illustrative example in Annex 3 of the Basel III rules text should be read to include issued common shares plus retained earnings and reserves in Bank S.

Paragraphs 76–77 (Defined benefit pension fund assets and liabilities)

12. Does the requirement to deduct a defined benefit pension fund asset apply to the net asset on the balance sheet of the bank or to the gross assets of the pension plan or fund?

It applies to the net asset on the balance sheet of the bank in respect of each defined benefit pension plan or fund.

Paragraphs 79–85 (Investments in the capital of banking financial and insurance entities)

13. Regarding paragraph 87 of the Basel III rules text, what is the definition of a financial institution?

The definition is determined by national guidance/regulation at present.

14. How should banks treat investments in banks, insurance companies and other financial institutions that are included in the consolidated group in computing the capital ratio for the standalone parent bank entity?

The Basel framework is applied on a consolidated basis to internationally active banks. It captures the risks of a whole banking group. Although the framework recognises the need for adequate capitalisation on a stand-alone basis, it does not prescribe how to measure the solo capital requirements which is left to individual supervisory authorities (see paragraphs 20 to 23 of the June 2006 comprehensive version of Basel II).

15. Is provision of capital support by way of guarantee or other capital enhancements treated as capital invested in financial institutions?

Yes. It is treated as capital in respect of the maximum amount that could be required to be paid out on any such guarantee.

16. Under the corresponding deduction approach, the deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself. Furthermore, if the capital instrument of the entity in which the bank has invested does not meet the criteria for Common Equity Tier 1, Additional Tier 1 or Tier 2 capital of the bank, the capital is to be considered common shares for the purposes of the regulatory adjustment. However, in many jurisdictions the entry criteria for capital issued by insurance companies and other financial entities will differ from the entry

criteria for capital issued by banks. How should the corresponding deduction approach be applied in such cases?

In respect of capital issued by insurance companies and other financial entities, jurisdictions are permitted to give national guidance as to what constitutes a corresponding deduction in cases where the entry criteria for capital issued by these companies differs from the entry criteria for capital issued by the bank and where the institution is subject to minimum prudential standards and supervision. Such guidance should aim to map the instruments issued by these companies to the tier of bank capital which is of the closest corresponding quality.

Paragraphs 94–96 (Transitional arrangements)

17. "During the transition period, the remainder not deducted from Common Equity Tier 1 will continue to be subject to existing national treatments". Can you clarify what being subject to existing national treatments means?

If a deduction amount is taken off CET1 under the Basel III rules, the treatment for it in 2014 is as follows: 20% of that amount is taken off CET1, and 80% of it is taken off the tier where this deduction used to apply under existing national treatment. If the item to be deducted under Basel III is risk weighted under existing national treatment, the treatment for it in 2014 is as follows: 20% of the amount is taken off CET1, and 80% is subject to the risk weight that applies under existing national treatment.

Likewise, if an existing national adjustment is removed by the Basel III rules, then amounts are subtracted / added back from CET1 in accordance with the transition period. For example, if an existing national adjustment adds back certain unrealised losses to CET1, in 2014 the treatment is as follows: 80% of any amount currently added back to CET1 due to such adjustments continues to be added back.

18. If an instrument is derecognised at 1 January 2013, does it count towards fixing the base for grandfathering?

No. The base for grandfathering should only include instruments that will be grandfathered. If an instrument is derecognised on 1 January 2013, it does not count towards the base fixed on 1 January 2013.

19. Regarding paragraph 94 (g), does this mean that if there was a Tier 1 security that met all the requirements to qualify for Additional Tier 1 capital on a forward looking basis after its call date and it is called callable on 31 December 2014, on 1 January 2014, the security would count at 80% of notional but on 1 January 2015, if not called, it would count as 100% of Tier 1 capital.

Yes. However, it should be noted that the base that sets a cap on the instruments that may be included applies to all outstanding instruments that no longer qualify as non-common Tier 1. This means, for example, that if other non-qualifying Tier 1 instruments are repaid during 2014 it is possible for the instrument to receive recognition in excess of 80% during 2014.

20. The 13 January 2011 press release states that "instruments issued prior to 1 January 2013 that do not meet the criteria set out above, but that meet all of the entry criteria for Additional Tier 1 or Tier 2 capital set out in December 2010, (…) will be phased out from 1 January 2013 according to paragraph

94(g)". If an instrument issued before 12 September 2010 has an incentive to redeem and does not fulfil the non-viability requirement, but is otherwise compliant on a forward-looking basis, is it eligible for grandfathering?

If the instrument has an effective maturity date that occurs before 1 January 2013 and is not called, and complies with the entry criteria except for the non-viability requirement on 1 January 2013, then it is eligible for grandfathering as per the 13 January 2011 press release.

If the instrument has an effective maturity date that occurs after 1 January 2013, and therefore it does not comply with the entry criteria (including the non-viability requirement) as on 1 January 2013, it should be phased out until its effective maturity date and be derecognised after that date.

21. Some Tier 1 and Tier 2 instruments were not eligible to be recognised as such under Basel II because they exceeded the relevant limits for recognition (eg 15% innovative limit or Tier 2 limit). Can amounts that exceeded these limits be included in the base for the transitional arrangements established in paragraph 94 (g)?

No. The base for the transitional arrangements should reflect the outstanding amount that is eligible to be included in the relevant tier of capital under the national rules applied on 31 December 2012.

22. If a Tier 2 instrument eligible for grandfathering begins its final five-year amortisation period prior to 1 January 2013, is the full nominal amount or the amortised amount used in fixing the base for grandfathering?

For Tier 2 instruments that have begun to amortise before 1 January 2013, the base for grandfathering should take into account the amortised amount, not the full nominal amount.

23. If a Tier 2 instrument eligible for grandfathering begins its final five-year amortisation period prior to 1 January 2013, does it carry on amortising at a rate of 20% p.a. after 1 January 2013?

Individual instruments will continue to be amortised at a rate of 20% per year while the aggregate cap will be reduced at a rate of 10% per year.

24. Assume that on 1 January 2013 a bank has $100m of non-compliant Tier 1 securities outstanding. By 1 January 2017, the capital recognition has been reduced to 50% (10% per year starting at 90% on 1 January 2013). Now assume that $50m of the Tier 1 securities have been called between 2013 and end of 2016 - leaving $50m outstanding. Does the transitional arrangement established by paragraph 94 (g) mean the bank can fully recognise the remaining $50m of capital on 1 January 2017?

Yes.

25. Paragraph 94(g) calculation of the base used on 1 January 2013. The third bullet in 94(g) deals with instruments with an incentive to redeem between 12 September 2010 and 1 January 2013. If such an instrument is not called at its effective maturity date and it is still outstanding on 1 January 2013, is the nominal amount of this instrument included in the base?

No it is not included in the base, only instruments eligible for the phase out period are included in the base.

26. What happens to share premium (stock surplus) associated with grandfathered instruments?

Share premium (stock surplus) only meets the entry criteria if it is related to an instrument that meets the entry criteria. The share premium of instruments that do not meet the entry criteria, but which are eligible for the transitional arrangements, should instead be included in the base for the transitional arrangements.

27. Where regulatory adjustments are removed and not replaced by a new regulatory adjustment, is the removal of the old adjustments subject to the transitional arrangements in paragraph 94 (d)?

Yes, this is explicitly the case for the treatment of unrealised losses as described in footnote 10, but is also applicable to other current national regulatory adjustments that are removed in the implementation of Basel III, such as the filter applied in some countries to unrealised gains or adjustments made in respect of pension fund liabilities. Current adjustments which are removed by the final rules can be removed at a rate of 20% per year from 2014. This will result in 80% of the add-back or subtraction related to the regulatory adjustment that is being removed still being applied in 2014, 60% in 2015 etc.

28. During the transition, is the calculation of surplus capital issued by subsidiaries to third-party investors itself transitioned? For example, does the calculation of surplus Common Equity Tier 1 in 2014 reflect the minimum Common Equity Tier 1 in force at the time (4% of RWAs) and the capital conservation buffer in force at the time (0% of RWAs)?

No. Other things being equal, the example above would lead to higher deductions in the early years of the transition, since there would be more surplus Common Equity Tier 1. The levels detailed in the second bullet-points of paragraphs 62, 63 and 64 of the December text apply from 2014. That is: 7% for CET1, 8.5% for Tier 1, and 10.5% for total capital.

29. If the amount of the three threshold items (significant investment in common shares, DTAs, MSRs) set out in paragraph 87 of the Basel III rules text collectively exceeds the 15% limit, the excess needs to be deducted. From 2018, 100% of this excess will be deducted from Common Equity Tier 1. During the transition, this excess needs to be deducted partly from Common Equity Tier 1 and partly following 'existing national treatment'. If the excess consists in more than one of the three items, which 'existing national treatment' should be used for that part of the calculation?

A pro-rata approach should be followed. The firm should sum all amounts of the three items that it has included in Common Equity Tier 1 because they were below their individual 10% limits, and it should calculate the share represented by each of the three items. The 'existing national treatments' should be applied to the excess over 15% using the same proportions.

For example, assume that, after applying the 10% individual limits, a firm has 80 of significant investments, 30 of DTAs, and 10 of MSRs. During the transition, the share of the excess over 15% that is subject to 'existing national treatments' should be treated as follows: 67% (=80/120) treated as significant investments are currently treated; 25% (30/120) treated as DTAs are currently treated; and 8% (=10/120) treated as MSRs are currently treated.

30. Are the former deductions from capital that switch to a 1,250% risk-weighting (ie the 50:50 deductions described in paragraph 90 of the Basel III rules text) subject to the transitional arrangements?

No. These items are risk-weighted 1,250% from 1 January 2013.

Press release 13 January 2011 (Loss absorbency at the point of non-viability)

31. Does the option for loss absorbency at the point of non-viability to be implemented through statutory means, as described in the press release of 13 January 2011, release banks from the requirement of Basel III (Criterion 11 of the Additional Tier 1 entry criteria) to have a contractual principal loss absorption mechanism for Tier 1 instrument classified as liabilities?

No. The press release of 13 January 2011 does not release banks from any of the requirements of the Basel III rules text published in December 2010.

32. Regarding loss absorbency at the point of non-viability, the press release says in relation to disclosure "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) in this paragraph" Does this mean that if an instrument issued prior to 1 January 2013 meets all of the criteria set out in the December 2010 rules text and there is a statutory regime that meets the requirements of the 13 January 2011 press release, there is no Basel III requirement to disclose in its terms and conditions that it is subject to loss under the statutory regime in order for it to be compliant?

That is correct. The reference to "going-forward" was to avoid the necessity to amend existing contracts if the loss absorbency is implemented through statutory means. However, instruments issued on or after 1 January 2013 will need to have the relevant disclosure.

33. What jurisdictions have in place a statutory regime that meets the three criteria set out in the 13 January 2011 press release? What should a bank do if it is unsure whether the governing jurisdiction has the laws in place as set out in paragraph 1 of the press release of 13 January 2011?

The jurisdictions that have in place a statutory regime that meets the three criteria will depend on the outcome of a peer review process. The details of the peer review process have not yet been established. If a bank is unsure whether the governing jurisdiction has such laws in place it should seek guidance from the relevant national authority in its jurisdiction.

34. Regarding the press release of 13 January 2011, consider a bank that issues capital out of a foreign subsidiary, and wishes to use such capital to meet both the solo requirements of the foreign subsidiary and include the capital in the consolidated capital of the group. Is it correct that the relevant authority in jurisdiction of the consolidated supervisor must have the power to trigger write-down/conversion of the instrument in addition to the relevant authority in the jurisdiction of the foreign subsidiary?

Yes, this is correct.

35. For instruments with an incentive to redeem after 1 January 2013, paragraph 94 (g) of the Basel III rules text permits them to be included in capital after their call/step-up date if they meet the December 2010 criteria on a forward looking basis. Does this forward looking basis mean that they need to meet the loss absorbency criteria set out in the 13 January 2011 press release?

Yes, they need to meet the December 2010 and 13 January 2011 criteria on a forward looking basis or they will be derecognised from capital after their call/step-up date.

General questions

36. When there is not enough Additional Tier 1 (including both Tier 1 that is recognised as a result of the transitional arrangements and new qualifying Additional Tier 1) to "absorb" Additional Tier 1 deductions, are these deductions applied to Common Equity Tier 1? Also, when there is not enough Tier 2 (including both Tier 2 that is recognised as a result of the transitional arrangements and new qualifying Tier 2) to "absorb" Tier 2 deductions, are these deductions applied to Additional Tier 1?

Yes to both questions.