Amendments to the Basel III standard on the definition of capital

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Introduction

In November 2015, the Financial Stability Board (FSB) published an international standard for global systemically important banks (G-SIBs) on loss-absorbing and recapitalisation capacity in resolution. This standard was developed, in consultation with the Basel Committee on Banking Supervision (the Committee), in response to a call from G20 Leaders. The standard comprised a set of principles and a Term Sheet that implements those principles by setting a minimum requirement for total loss-absorbing capacity (TLAC).

Section 15 of the FSB TLAC Term Sheet states that:

In order to reduce the risk of contagion, G-SIBs must deduct from their own TLAC or regulatory capital exposures to eligible external TLAC instruments and liabilities issued by other G-SIBs in a manner generally parallel to the existing provisions in Basel III that require a bank to deduct from its own regulatory capital certain investments in the regulatory capital of other banks.

The Basel Committee on Banking Supervision (BCBS) will further specify this provision, including a prudential treatment for non-G-SIBs.

In November 2015, the Basel Committee consulted on its proposed deduction treatment for banks' investments in TLAC and its proposals on the extent to which instruments ranking pari passu with TLAC should be subject to the same deduction treatment. The Committee evaluated the feedback received on the consultative document in developing the final standard.

This document presents the final standard on the regulatory capital treatment of banks' investments in TLAC and pari passu instruments. The standard, set out in the Annex to this document, amends the Basel III standard on the definition of capital. The requirements take effect at the same time as the minimum TLAC requirements for each G-SIB, as described in Section 21 of the FSB TLAC Term Sheet. This means that the requirements take effect from 1 January 2019 for investments in most G-SIBs, but later for those whose headquarters are in emerging market economies.

Treatment of TLAC holdings

Tier 2 deduction approach

Internationally active banks (both G-SIBs and non-G-SIBs) must deduct their TLAC holdings that do not otherwise qualify as regulatory capital from their own Tier 2 capital. This reduces a significant source of


2 See www.bis.org/bcbs/publ/d342.htm.
contagion in the banking system. Without deduction, holdings of TLAC could mean that the failure of one G-SIB leads to a reduction in the loss absorbency and recapitalisation capacity of another bank. Deducting TLAC holdings from Tier 2 provides a single treatment that can be applied consistently by both G-SIBs and non-G-SIBs, as well as providing sufficient disincentives for banks to invest in TLAC.

Under the current Basel III framework, if the investing bank does not own more than 10% of the common shares of the issuer, then capital holdings are deducted only to the extent that they exceed a threshold. Amounts below the threshold are risk-weighted instead. The threshold is set at 10% of the investing bank’s common equity. The Committee has decided to extend this treatment to TLAC holdings. This means that TLAC holdings may be included within the 10% threshold previously only applied to regulatory capital holdings.

The Committee has also introduced an additional threshold that may be used for non-regulatory capital TLAC holdings only. This additional threshold reflects the importance of there being deep and liquid secondary markets for TLAC instruments, as well as the calibration of TLAC requirements in the FSB TLAC Term Sheet. This threshold is equivalent to 5% of the investing bank’s common equity, with holdings being measured on a gross long basis. As for the current 10% threshold that applies to holdings of capital instruments, this threshold only applies where the investing bank does not own more than 10% of the common shares of the issuer.

Where the investing bank is a G-SIB, the additional 5% threshold may be used only for TLAC holdings in the trading book that are sold within 30 business days. These conditions do not apply to the use of the threshold by banks that are not G-SIBs. Nonetheless, the Basel standards are minimum standards, and national authorities may choose to apply these stricter conditions to all or a subset of banks in their jurisdictions.

If the investing bank owns at least 10% of the common shares of the issuer, then TLAC holdings must be deducted in full from Tier 2 capital. Also, reciprocal cross-holdings of TLAC between G-SIBs must be fully deducted from Tier 2 capital.

A G-SIB’s holdings of its own non-regulatory-capital TLAC must be deducted from its own TLAC resources. Own-funded TLAC would generally not appear to meet the TLAC eligibility criteria. However, to the extent that such positions are recognised, reducing TLAC resources would more accurately reflect a G-SIB’s TLAC position than continuing to count such instruments in TLAC resources while deducting them from Tier 2 capital.

What constitutes a TLAC holding?

The FSB TLAC Term Sheet sets out eligibility criteria for TLAC-eligible instruments. In general, TLAC-eligible instruments must be subordinated to a list of excluded liabilities (eg insured deposits). Subordination may be embedded in contractual terms, prescribed in statute or achieved by being issued by a resolution entity that does not have any excluded liabilities that rank pari passu or junior to TLAC-eligible instruments (structural subordination). There are limited exemptions to the subordination requirements, which are set out in Section 11 of the FSB TLAC Term Sheet.

As discussed in the consultative document, to better meet the objective of limiting contagion, the Committee has defined TLAC holdings more broadly than those instruments that are actively being
recognised by the issuing G-SIB as TLAC. For the purpose of calculating regulatory capital requirements, the definition of relevant TLAC holdings:\footnote{The standard in the Annex uses the term “other TLAC liabilities” to denote relevant non-regulatory-capital TLAC holdings.}

- includes all direct, indirect and synthetic holdings of external TLAC. However, in the case of those instruments that are recognised as TLAC by virtue of the capped exemption in the penultimate paragraph of Section 11 the FSB TLAC Term Sheet, only a proportion of each instrument is included;
- includes all instruments ranking pari passu with subordinated forms of TLAC; and
- excludes all holdings of instruments or other claims listed in the “Excluded Liabilities” section of the FSB TLAC Term Sheet.

The proportionate deduction approach was one of the options considered by the Committee in the consultative document. In that document, the Committee noted that this approach could see the size of an investing bank’s deduction vary over time due to changes in recognition at the issuing G-SIB, even if the size of the investment remained fixed. In addition, the calculation of TLAC holdings is affected by a time lag with regard to the disclosure of TLAC information by the issuing G-SIB. To address these risks, the Committee agreed that G-SIBs applying the subordination exemptions in the antepenultimate and penultimate paragraphs of Section 11 of the FSB TLAC Term Sheet must disclose this fact. G-SIBs applying the capped exemption must also disclose, as at the reporting date, the percentage of funding ranking pari passu with excluded liabilities that is eligible to be recognised as TLAC and is in fact being recognised as such. Investing banks must use the latest available percentage published by each relevant G-SIB to calculate their TLAC holdings deduction. The deduction requirements for investing banks are set out in the Annex. The disclosure requirements for G-SIBs will be set out in the Committee’s Pillar 3 standard.

The Committee’s standard on TLAC holdings explains how internationally active banks should treat holdings of G-SIBs’ external TLAC in calculating their consolidated capital position, as anticipated in Section 15 of the FSB TLAC Term Sheet. The requirements on TLAC holdings do not apply to holdings of internal TLAC (described in Sections 16–19 of the FSB TLAC Term Sheet).

Other TLAC-related changes to Basel III

The TLAC regime also necessitates changes to Basel III to specify how G-SIBs must take account of the TLAC requirement when calculating their regulatory capital buffers. In particular, the change in the Annex to paragraph 131 and footnotes 47 and 53 means that any Common Equity Tier 1 capital that is being used to meet the TLAC requirement cannot be used to meet the regulatory capital buffers. This is consistent with the FSB TLAC Term Sheet, which requires that regulatory capital buffers must be met in addition to minimum TLAC requirements.
Annex

Changes to the Basel III standard

The text below shows changes to the Basel III standard, with insertions underlined and deletions struck out. Relevant and amended footnotes appear at the end of the standard.

5. Regulatory adjustments

66. This section sets out the regulatory adjustments to be applied to regulatory capital. In most cases these adjustments are applied in the calculation of Common Equity Tier 1.

66a. Global systemically important banks (G-SIBs) are required to meet a minimum total loss-absorbing capacity (TLAC) requirement, set in accordance with the Financial Stability Board’s (FSB) TLAC principles and term sheet. The criteria for an instrument to be eligible to be recognised as TLAC by the issuing G-SIB are set out in the FSB’s TLAC Term Sheet. Banks that invest in TLAC or similar instruments may be required to deduct them in the calculation of their own regulatory capital.25A

66b. For the purposes of this section, holdings of TLAC include the following, hereafter collectively referred to as "other TLAC liabilities”:

(i) All direct, indirect and synthetic investments in the instruments of a G-SIB resolution entity that are eligible to be recognised as external TLAC but that do not otherwise qualify as regulatory capital25B for the issuing G-SIB, with the exception of instruments excluded by paragraph 66c; and

(ii) All holdings of instruments issued by a G-SIB resolution entity that rank pari passu to any instruments included in (i), with the exceptions of: (1) instruments listed as liabilities excluded from TLAC in Section 10 of the FSB TLAC Term Sheet ("Excluded Liabilities"); and (2) instruments ranking pari passu with instruments eligible to be recognised as TLAC by virtue of the exemptions to the subordination requirements in section 11 of the FSB TLAC Term Sheet.

66c. In certain jurisdictions, G-SIBs may be able to recognise instruments ranking pari passu to Excluded Liabilities as external TLAC, up to a limit, in accordance with the exemptions to the subordination requirements set out in the penultimate paragraph of section 11 of the FSB TLAC Term Sheet. A bank’s holdings of such instruments will be subject to a proportionate deduction approach. Under this approach, only a proportion of holdings of instruments that are eligible to be recognised as external TLAC by virtue of the subordination exemptions will be considered a holding of TLAC by the investing bank. The proportion is calculated as: (1) the funding issued by the G-SIB resolution entity that ranks pari passu with Excluded Liabilities and that is recognised as external TLAC by the G-SIB resolution entity, divided by (2) the funding issued by the G-SIB resolution entity that ranks pari passu with Excluded Liabilities and that would be recognised as external TLAC if the subordination requirement was not applied.25C Banks must calculate their holdings of other TLAC liabilities of the respective issuing G-SIB resolution entities based on the latest available public information provided by the issuing G-SIBs on the proportion to be used.

66d. The regulatory adjustments relating to TLAC in paragraphs 78 to 85 apply to holdings of TLAC issued by G-SIBs from the date at which the issuing G-SIB becomes subject to a minimum TLAC requirement.25D

... [paragraphs 67-77 unchanged]
Investments in own shares (treasury stock), own other capital instruments or own other TLAC liabilities

78. All of a bank’s investments in its own common shares, whether held directly or indirectly, will be deducted in the calculation of Common Equity Tier 1 (unless already derecognised under the relevant accounting standards). In addition, any own stock which the bank could be contractually obliged to purchase should be deducted in the calculation of Common Equity Tier 1. The treatment described will apply irrespective of the location of the exposure in the banking book or the trading book. In addition:

- Gross long positions may be deducted net of short positions in the same underlying exposure only if the short positions involve no counterparty risk.
- Banks should look through holdings of index securities to deduct exposures to own shares. However, gross long positions in own shares resulting from holdings of index securities may be netted against short position in own shares resulting from short positions in the same underlying index. In such cases the short positions may involve counterparty risk (which will be subject to the relevant counterparty credit risk charge).

This deduction is necessary to avoid the double counting of a bank’s own capital. Certain accounting regimes do not permit the recognition of treasury stock and so this deduction is only relevant where recognition on the balance sheet is permitted. The treatment seeks to remove the double counting that arises from direct holdings, indirect holdings via index funds and potential future holdings as a result of contractual obligations to purchase own shares.

Following the same approach outlined above, banks must deduct investments in their own Additional Tier 1 in the calculation of their Additional Tier 1 capital and must deduct investments in their own Tier 2 in the calculation of their Tier 2 capital. G-SIB resolution entities must deduct holdings of their own other TLAC liabilities in the calculation of their TLAC resources.

Reciprocal cross holdings in the capital or other TLAC liabilities of banking, financial and insurance entities

79. Reciprocal cross holdings of capital that are designed to artificially inflate the capital position of banks will be deducted in full. Banks must apply a “corresponding deduction approach” to such investments in the capital of other banks, other financial institutions and insurance entities. This means 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. Reciprocal cross holdings of other TLAC liabilities that are designed to artificially inflate the TLAC position of G-SIBs must be deducted in full from Tier 2 capital.

Investments in the capital or other TLAC liabilities of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity

80. The regulatory adjustments described in this section applies to investments in the capital or other TLAC liabilities of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity. In addition These investments are deducted from regulatory capital, subject to a threshold. For the purpose of this regulatory adjustment:

- Investments include direct, indirect26 and synthetic holdings of capital instruments or other TLAC liabilities. For example, banks should look through holdings of index securities to determine their underlying holdings of capital or other TLAC liabilities.27
- Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (eg subordinated debt). Other TLAC liabilities are defined in paragraphs 66b and 66c.
• For capital instruments, it is the net long position that is to be included (i.e., the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year). For other TLAC liabilities, it is the gross long position that is to be included in paragraphs 80a, 80b and 80c and the net long position that is to be included in paragraph 81.
• Underwriting positions in capital instruments or other TLAC liabilities held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included.
• 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 this regulatory adjustment.28
• National discretion applies to allow banks, with prior supervisory approval, to exclude temporarily certain investments where these have been made in the context of resolving or providing financial assistance to reorganise a distressed institution.

80a. A G-SIB’s holdings of other TLAC liabilities must be deducted from Tier 2 capital resources, unless (1) the following conditions are met; or (2) the holding falls within the 10% threshold provided in paragraph 81.
• The holding has been designated by the bank to be treated in accordance with this paragraph;
• The holding is in the bank’s trading book;
• The holding is sold within 30 business days of the date of its acquisition; and
• Such holdings are, in aggregate and on a gross long basis, less than 5% of the G-SIB’s common equity (after applying all other regulatory adjustments in full listed prior to paragraph 80).

80b. If a holding designated under paragraph 80a no longer meets any of the conditions set out in that paragraph, it must be deducted in full from Tier 2 capital. Once a holding has been designated under paragraph 80a, it may not subsequently be included within the 10% threshold referred to in paragraph 81. This approach is designed to limit the use of the 5% allowance in paragraph 80a to holdings of TLAC instruments needed to be held within the banking system to ensure deep and liquid markets.

80c. If a bank is not a G-SIB, its holdings of other TLAC liabilities must be deducted from Tier 2 capital resources, unless (1) such holdings are, in aggregate and on a gross long basis, less than 5% of the bank’s common equity (after applying all other regulatory adjustments listed in full prior to paragraph 80); or (2) the holding falls within the 10% threshold provided in paragraph 81.

81. If the total of all holdings of capital instruments and other TLAC liabilities, as listed above in paragraph 80 and not covered by the 5% threshold described in paragraphs 80a and 80b (for G-SIBs) or 80c (for non-G-SIBs), in aggregate and on a net long basis exceed 10% of the bank’s common equity (after applying all other regulatory adjustments in full listed prior to this one paragraph 80) then the amount above 10% is required to be deducted. In the case of capital instruments, deduction should be made applying a corresponding deduction approach. This means 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. In the case of holdings of other TLAC liabilities, the deduction should be applied to Tier 2 capital. Accordingly, the amount to be deducted from common equity should be calculated as the total of all holdings of capital instruments and those holdings of other TLAC liabilities not covered by paragraphs 80a and 80b or 80c 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 of capital instruments and other TLAC liabilities not covered by paragraphs 80a and 80b or 80c. This would result in a common equity deduction which corresponds to the proportion of total capital the 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 of capital instruments and other TLAC liabilities not covered by paragraphs 80a and 80b or 80c 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. The amount to be deducted from Tier 2 capital should be calculated as the total of all holdings of capital instruments and other TLAC liabilities not covered by paragraphs 80a and 80b or 80c which in aggregate exceed 10% of the bank’s common equity (as per above) multiplied by the holdings of Tier 2 capital and other TLAC liabilities holdings as a percentage of the total capital holdings.

82. If, under the corresponding deduction approach, a 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 (e.g., if a bank does not have enough Additional Tier 1 capital to satisfy the deduction, the shortfall will be deducted from Common Equity Tier 1).

83. Amounts below the threshold, which are not deducted, will continue to be risk weighted. Thus, instruments in the trading book will be treated as per the market risk rules and instruments in the banking book should be treated as per the internal ratings-based approach or the standardised approach (as applicable). For the application of risk weighting the amount of the holdings must be allocated on a pro rata basis between those below and those above the threshold.

**Significant investments in the capital or other TLAC liabilities of banking, financial and insurance entities that are outside the scope of regulatory consolidation**

84. The regulatory adjustments described in this section apply to investments in the capital or other TLAC liabilities of banking, financial and insurance entities that are outside the scope of regulatory consolidation where the bank owns more than 10% of the issued common share capital of the issuing entity or where the entity is an affiliate of the bank. In addition:

- Investments include direct, indirect and synthetic holdings of capital instruments or other TLAC liabilities. For example, banks should look through holdings of index securities to determine their underlying holdings of capital or other TLAC liabilities.

- Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (e.g., subordinated debt). Other TLAC liabilities are defined in paragraphs 66b and 66c. It is the net long position that is to be included (i.e., the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year).

- Underwriting positions in capital instruments or other TLAC liabilities held for five working days or less can be excluded.

- 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 this regulatory adjustment.

- National discretion applies to allow banks, with prior supervisory approval, to exclude temporarily certain investments where these have been made in the context of resolving or providing financial assistance to reorganise a distressed institution.

85. All investments in capital instruments included above that are not common shares 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.
holdings of other TLAC liabilities included above (and as defined in paragraphs 66b and 66c ie applying the proportionate deduction approach for holdings of instruments eligible for TLAC by virtue of the penultimate paragraph of Section 11 of the FSB TLAC Term Sheet) must be fully deducted from Tier 2 capital. 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 (eg if a bank does not have enough Additional Tier 1 capital to satisfy the deduction, the shortfall will be deducted from Common Equity Tier 1).

... [paragraphs 86-121 unchanged]

III. Capital conservation buffer

... [paragraphs 122-130 unchanged]

131. The table below shows the minimum capital conservation ratios a bank must meet at various levels of the Common Equity Tier 1 (CET1) capital ratios. For example, a bank with a CET1 capital ratio in the range of 5.125% to 5.75% is required to conserve 80% of its earnings in the subsequent financial year (ie payout no more than 20% in terms of dividends, share buybacks and discretionary bonus payments). If the bank wants to make payments in excess of the constraints imposed by this regime, it would have the option of raising capital in the private sector equal to the amount above the constraint which it wishes to distribute. This would be discussed with the bank’s supervisor as part of the capital planning process. The Common Equity Tier 1 ratio includes amounts used to meet the 4.5% minimum Common Equity Tier 1 requirement, but excludes any additional Common Equity Tier 1 needed to meet the 6% Tier 1 and 8% Total Capital requirements, and also excludes any Common Equity Tier 1 needed to meet the TLAC requirement. For example, a bank with 8% CET1 and no Additional Tier 1 or Tier 2 capital, that has 10% of non-regulatory-capital TLAC instruments would meet all its minimum risk-based capital and risk-based TLAC requirements, but would have a zero conservation buffer and therefore be subject to the 100% constraint on capital distributions.
Relevant and amended footnotes


25B Tier 2 instruments that no longer count in full as regulatory capital (as a result of having a residual maturity of less than five years) continue to be recognised in full as a Tier 2 instrument by the investing bank for the regulatory adjustments in this section.

25C For example, if a G-SIB resolution entity has funding that ranks pari passu with Excluded Liabilities equal to 5% of RWAs and receives partial recognition of these instruments as external TLAC equivalent to 3.5% of RWAs, then an investing bank holding such instruments must include only 70% (= 3.5 / 5) of such instruments in calculating its TLAC holdings. The same proportion should be applied by the investing bank to any indirect or synthetic investments in instruments ranking pari passu with Excluded Liabilities and eligible to be recognised as TLAC by virtue of the subordination exemptions.

25D The conformance period is set out in section 21 of the FSB TLAC Term Sheet. In summary, firms that have been designated as G-SIBs before end-2015 and continue to be designated thereafter, with the exception of such firms headquartered in an emerging market economy, must meet the TLAC requirements from 1 January 2019. For firms headquartered in emerging market economies, the requirements will apply from 1 January 2025 at the latest; this may be accelerated in certain circumstances.

26 Indirect holdings are exposures or parts of exposures that, if a direct holding loses its value, will result in a loss to the bank substantially equivalent to the loss in value of the direct holding.

27 If banks find it operationally burdensome to look through and monitor their exact exposure to the capital or other TLAC liabilities of other financial institutions as a result of their holdings of index securities, national authorities may permit banks, subject to prior supervisory approval, to use a conservative estimate.

28 If the investment is issued out of a regulated financial entity and not included in regulatory capital in the relevant sector of the financial entity, it is not required to be deducted.

29 Investments in entities that are outside of the scope of regulatory consolidation refers to investments in entities that have not been consolidated at all or have not been consolidated in such a way as to result in their assets being included in the calculation of consolidated risk-weighted assets of the group.

30 An affiliate of a bank is defined as a company that controls, or is controlled by, or is under common control with, the bank. Control of a company 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.

31 If banks find it operationally burdensome to look through and monitor their exact exposure to the capital or other TLAC liabilities of other financial institutions as a result of their holdings of index securities, national authorities may permit banks, subject to prior supervisory approval, to use a conservative estimate.

32 If the investment is issued out of a regulated financial entity and not included in regulatory capital in the relevant sector of the financial entity, it is not required to be deducted.
Common Equity Tier 1 must first be used to meet the minimum capital and TLAC requirements if necessary (including the 6% Tier 1, and 8% Total capital and 18% TLAC requirements if necessary), before the remainder can contribute to the capital conservation buffer.

Consistent with the conservation buffer, the Common Equity Tier 1 ratio in this context includes amounts used to meet the 4.5% minimum Common Equity Tier 1 requirement, but excludes any additional Common Equity Tier 1 needed to meet the 6% Tier 1 and 8% Total Capital requirements and the 18% TLAC requirement.