

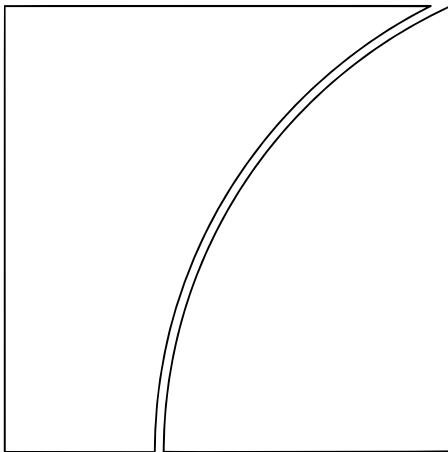
Basel Committee on Banking Supervision

CAP

Definition of capital

CAP30

Regulatory adjustments



This chapter describes adjustments that must be made to the components of regulatory capital in order to calculate the amount of a bank's capital resources that may be used to meet prudential requirements.

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BANK FOR INTERNATIONAL SETTLEMENTS

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Introduction

30.1

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.

30.2

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 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.

30.3

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

1. 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 capital for the issuing G-SIB, with the exception of instruments excluded by [CAP30.4](#); and
2. All holdings of instruments issued by a G-SIB resolution entity that rank pari passu to any instruments included in [CAP30.3\(1\)](#), 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.

30.4

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.

30.5

Under the proportionate deduction approach, 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.

30.6

The regulatory adjustments relating to TLAC in [CAP30.18](#) to [CAP30.31](#) 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.

Goodwill and other intangibles (except mortgage servicing rights)

30.7

Goodwill and all other intangibles must be deducted in the calculation of Common Equity Tier 1, including any goodwill included in the valuation of significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation. With the exception of mortgage servicing rights, the full amount is to be deducted net of any associated deferred tax liability (DTL) which would be extinguished if the intangible assets become impaired or derecognised under the relevant accounting standards. The amount to be deducted in respect of mortgage servicing rights is set out in the threshold deductions section below.

30.8

Subject to prior supervisory approval, banks that report under local GAAP may use the IFRS definition of intangible assets to determine which assets are classified as intangible and are thus required to be deducted.

Deferred tax assets

30.9

Deferred tax assets (DTAs) that rely on future profitability of the bank to be realised are to be deducted in the calculation of Common Equity Tier 1. DTAs may be netted with associated DTLs only if the DTAs and DTLs relate to taxes levied by the same taxation authority and offsetting is permitted by the relevant taxation authority. Where these DTAs relate to temporary differences (eg allowance for credit losses) the amount to be deducted is set out in [CAP30.32](#) to [CAP30.34](#). All other such assets, eg those relating to operating losses, such as the carry forward of unused tax losses, or unused tax credits, are to be deducted in full net of deferred tax liabilities as described above. The DTLs permitted to be netted against DTAs must exclude amounts that have been netted against the deduction of goodwill, intangibles and defined benefit pension assets, and must be allocated on a pro rata basis between DTAs subject to the threshold deduction treatment and DTAs that are to be deducted in full.

30.10

An overinstallment of tax or, in some jurisdictions, current year tax losses carried back to prior years may give rise to a claim or receivable from the government or local tax authority. Such amounts are typically classified as current tax assets for accounting purposes. The recovery of such a claim or receivable would not rely on the future profitability of the bank and would be assigned the relevant sovereign risk weighting.

Cash flow hedge reserve

30.11

The amount of the cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) should be derecognised in the calculation of Common Equity Tier 1. This means that positive amounts should be deducted and negative amounts should be added back.

30.12

This treatment specifically identifies the element of the cash flow hedge reserve that is to be derecognised for prudential purposes. It removes the element that gives rise to artificial volatility in common equity, as in this case the reserve only reflects one half of the picture (the fair value of the derivative, but not the changes in fair value of the hedged future cash flow).

Shortfall of the stock of provisions to expected losses

30.13

Banks using the internal ratings-based (IRB) approach for other asset classes must compare the amount of total eligible provisions, as defined in [CRE35.4](#), with the total expected loss amount as calculated within the IRB approach and defined in [CRE35.2](#). Where the total expected loss amount exceeds total eligible provisions, banks must deduct the difference from Common Equity Tier 1. The full amount is to be deducted and should not be reduced by any tax effects that could be expected to occur if provisions were to rise to the level of expected losses. Securitisation exposures will be subject to [CRE40.36](#) and will contribute to neither the total expected loss amount nor the total eligible provisions.

Gain on sale related to securitisation transactions

30.14

Banks must deduct from Common Equity Tier 1 any increase in equity capital resulting from a securitisation transaction, such as that associated with expected future margin income resulting in a gain on sale that is recognised in regulatory capital.

Cumulative gains and losses due to changes in own credit risk on fair valued liabilities

30.15

Derecognise in the calculation of Common Equity Tier 1, all unrealised gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk. In addition, with regard to derivative liabilities, derecognise all accounting valuation adjustments arising from the bank's own credit risk. The offsetting between valuation adjustments arising from the bank's own credit risk and those arising from its counterparties' credit risk is not allowed.

Defined benefit pension fund assets and liabilities

30.16

Defined benefit pension fund liabilities, as included on the balance sheet, must be fully recognised in the calculation of Common Equity Tier 1 (ie Common Equity Tier 1 cannot be increased through derecognising these liabilities). For each defined benefit pension fund that is an asset on the balance sheet, the net asset on the balance sheet in respect of the plan or fund should be deducted in the calculation of Common Equity Tier 1 net of any associated deferred tax liability which would be extinguished if the asset should become impaired or derecognised under the relevant accounting standards. Assets in the fund to which the bank has unrestricted and unfettered access can, with supervisory approval, offset the deduction. Such offsetting assets should be given the risk weight they would receive if they were owned directly by the bank.

30.17

This treatment addresses the concern that assets arising from pension funds may not be capable of being withdrawn and used for the protection of depositors and other creditors of a bank. The concern is that their only value stems from a reduction in future payments into the fund. The treatment allows for banks to reduce the deduction of the asset if they can address these concerns and show that the assets can be easily and promptly withdrawn from the fund.

Investments in own shares (treasury stock), own other capital instruments or own other TLAC liabilities

30.18

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:

1. Gross long positions may be deducted net of short positions in the same underlying exposure only if the short positions involve no counterparty risk.
2. 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).
3. Subject to supervisory approval, a bank may use a conservative estimate of investments in its own shares where the exposure results from holdings of index securities and the bank finds it operationally burdensome to look through and monitor its exact exposure.

30.19

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.

30.20

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. If 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, then the shortfall will be deducted from the next higher tier of capital. In the case of insufficient TLAC resources, then the holdings will be deducted from Tier 2.

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

30.21

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

30.22

The regulatory adjustment 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. These investments are deducted from regulatory capital, subject to a threshold. For the purpose of this regulatory adjustment:

1. 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.
2. 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 [CAP30.3](#) and [CAP30.4](#).
3. For capital instruments, it is the net long position that is to be included (ie 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). Banks are also permitted to net gross long positions arising through holdings of index securities against short positions in the same underlying index, as long as the maturity of the short position matches the maturity of the long position or has residual maturity of at least a year. For other TLAC liabilities, it is the gross long position in [CAP30.23](#), [CAP30.24](#) and [CAP30.25](#) and the net long position that is to be included in [CAP30.26](#).
4. 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.

5. 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.
6. 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.

30.23

A G-SIB's holdings of other TLAC liabilities must be deducted from Tier 2 capital resources, unless either the following conditions are met, or the holding falls within the 10% threshold provided in [CAP30.26](#).

1. The holding has been designated by the bank to be treated in accordance with this paragraph;
2. The holding is in the bank's trading book;
3. The holding is sold within 30 business days of the date of acquisition; and
4. Such holdings are, in aggregate and on a gross long basis, less than 5% of the G-SIB's common equity (after apply all other regulatory adjustments in full listed prior to [CAP30.22](#)).

30.24

If a holding designated under [CAP30.23](#) 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 [CAP30.23](#), it may not subsequently be included within the 10% threshold referred to in [CAP30.26](#). This approach is designed to limit the use of the 5% threshold in [CAP30.23](#) to holdings of TLAC instruments needed to be held within the banking system to ensure deep and liquid markets.

30.25

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 [CAP30.22](#)); or
2. the holdings fall within the 10% threshold provided in [CAP30.26](#).

30.26

If the total of all holdings of capital instruments and other TLAC liabilities, as listed in [CAP30.22](#) and not covered by the 5% threshold described in [CAP30.23](#) and [CAP30.24](#) (for G-SIBs) or [CAP30.25](#) (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 [CAP30.22](#)) 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 [CAP30.23](#) and [CAP30.24](#) or [CAP30.25](#) 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 holdings of capital instruments and other TLAC liabilities not covered by [CAP30.23](#) and [CAP30.24](#) or [CAP30.25](#). This would result in a common equity deduction which corresponds to the proportion of 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 [CAP30.23](#) and [CAP30.24](#) or [CAP30.25](#) 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. 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 [CAP30.23](#) and [CAP30.24](#) or [CAP30.25](#) which in aggregate exceed 10% of the bank's common equity (as per above) multiplied by holdings of the Tier 2 capital and other TLAC liabilities as a percentage of the total.

30.27

If 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 (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).

30.28

Amounts that 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 IRB 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

30.29

The regulatory adjustment 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 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:

1. 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.
2. 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 [CAP30.3](#) to [CAP30.4](#). It is the net long position that is to be included (ie 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). Banks are also permitted to net gross long positions arising through holdings of index securities against short positions in the same underlying index, as long as the maturity of the short position matches the maturity of the long position or has residual maturity of at least a

year.

3. 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.
4. 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.
5. 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.

30.30

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. All holdings of other TLAC liabilities included above (and as defined in [CAP30.3](#) to [CAP30.5](#) 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).

30.31

Investments included above that are common shares will be subject to the threshold treatment described in the next section.

Threshold deductions

30.32

Instead of a full deduction, the following items may each receive limited recognition when calculating Common Equity Tier 1, with recognition capped at 10% of the bank's common equity (after the application of all regulatory adjustments set out in [CAP30.7](#) to [CAP30.30](#)):

1. significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities) as referred to in [CAP30.29](#);
2. mortgage servicing rights; and
3. DTAs that arise from temporary differences.

30.33

The amount of the three items that remains recognised after the application of all regulatory adjustments must not exceed 15% of the Common Equity Tier 1 capital, calculated after all regulatory adjustments.

30.34

The amount of the three items that are not deducted in the calculation of Common Equity Tier

1 will be risk weighted at 250%.