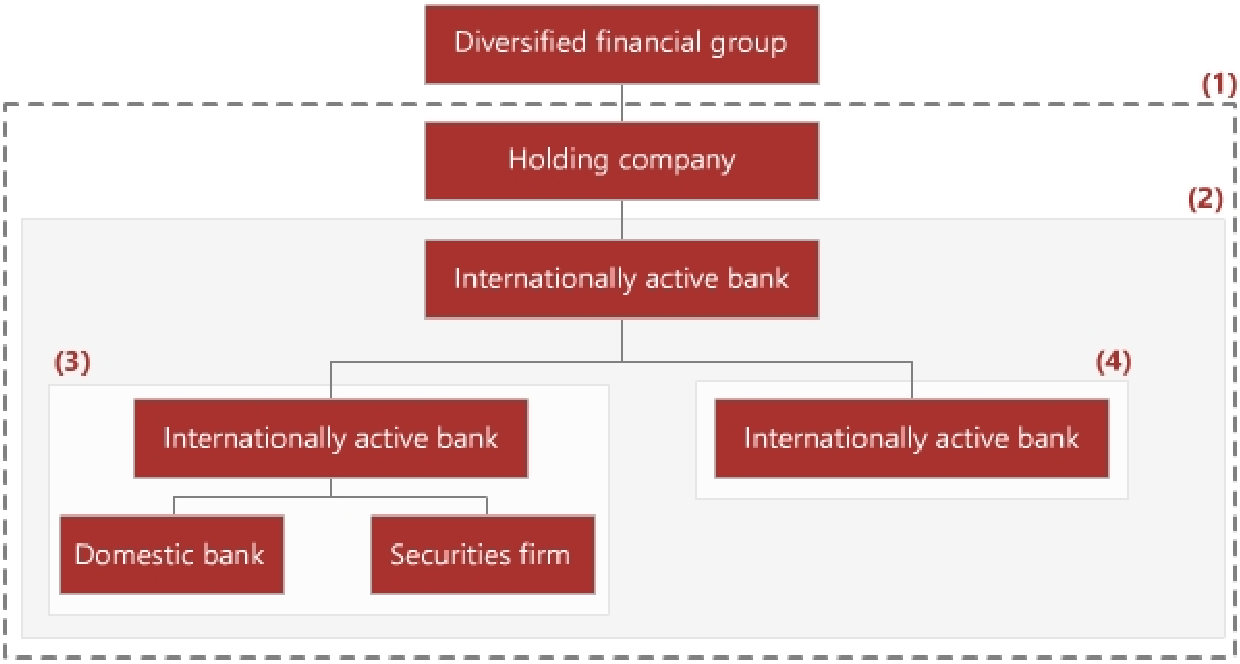
Basel Framework: Scope of application – Executive Summary

The Basel Framework refers, collectively, to the minimum risk-based capital, leverage, liquidity and large exposure standards, as well as the buffer requirements under Pillar 1; the supervisory review process under Pillar 2; and public disclosures under Pillar 3. The framework is designed to be applied on a consolidated basis to internationally active banks, though a number of jurisdictions apply some or all of the framework to their non-internationally active banks as well. This executive summary provides an overview of the Basel Framework's scope of application.

Regulatory perimeter – general considerations

The Basel Framework is designed to be applied to internationally active banks on a fully consolidated basis. In practice, this includes applying the framework to any holding company that is the parent entity within a banking group to ensure that it captures the risks of the banking group as a whole. As such, the framework applies on a consolidated basis to all internationally active banks at every tier within a banking group. This is the best way to preserve the integrity of capital in banks with subsidiaries by eliminating double-gearing. The scope of application is represented in the diagram below:



Source: Basel Committee on Banking Supervision, *Basel II: International convergence of capital measurement and capital standards: a revised framework – comprehensive version*, June 2006.

(1) denotes the boundary of the predominant banking group and where the Basel Framework should be applied on a consolidated basis up to the holding company level.

(2), (3) and (4): The framework should also be applied at lower levels to all internationally active banks on a consolidated basis. As an alternative to full subconsolidation, the application of the framework to the standalone bank would achieve the same objective, provided that the full book value of any investments in subsidiaries and significant minority-owned stakes is deducted from the bank's book value.

Entities subject to regulatory consolidation and risk-based capital

Banking, securities and other financial subsidiaries

All banking and other relevant financial activities[1] conducted within a group that contains an internationally active bank should be captured through consolidation. This includes majority-owned or -controlled banking entities, securities entities and other financial entities (excluding insurance entities).[2] There are a few exceptions[3] to this general principle and, for majority-owned securities and other financial subsidiaries that are not consolidated for capital purposes, all equity and other regulatory capital investments in the group will be deducted and the assets and liabilities, as well as third-party capital investments in the subsidiary, will be removed from the bank's balance sheet.

For less than wholly owned banking, securities and other financial entities that are fully consolidated, the minority interests (capital held by third parties) that arise can only be recognised in consolidated capital if they meet the applicable definition of capital under Basel III. Any minority interest in excess of the subsidiaries' minimum regulatory capital requirements is not recognised.

Entities not subject to regulatory consolidation and risk-based capital

Insurance entities

In assessing consolidated regulatory capital for banks, the Basel Committee on Banking Supervision requires the deduction of a bank's equity and other regulatory capital investments in insurance subsidiaries, including significant minority investments in insurance entities. For the purposes of calculating regulatory capital, this means that the bank removes from its balance sheet assets and liabilities and third-party capital investments in an insurance subsidiary. Under limited circumstances, supervisors may permit the recognition of any surplus capital held in a majority-owned or -controlled insurance entity in calculating a bank's consolidated capital adequacy.

Non-controlling investments in banking, financial and insurance entities

The treatment of banks' investments in banking, financial and insurance entities that are outside the scope of regulatory consolidation are subject to specific rules, as follows:

Minority investments ≤ 10% (of the issued common share capital) in each entity: If the total of all such holdings exceeds 10% of the bank's common equity, the excess is deducted from regulatory capital. Amounts below the threshold are not deducted and are subject to the applicable risk weight framework.

Significant investments > 10% (of the issued common share capital) in each entity: All investments that are not common shares must be fully deducted from the bank's regulatory capital. For investments in the common shares of each entity, recognition is capped at 10% of the bank's common equity and the amount that is not deducted is risk weighted at 250%.

[1] Financial activities do not include insurance activities, and financial entities do not include insurance entities.

[2] Examples of the types of activities other financial entities might be involved in include financial leasing, issuing credit cards, portfolio management, investment advising, custodial and safekeeping, and other similar activities that are ancillary to the banking business.

[3] Exceptions include cases where such holdings are acquired through debt previously contracted and held on a temporary basis or are subject to different regulation, or where non-consolidation for regulatory capital purposes is otherwise required by law.

Significant investments in commercial entities

Significant majority or minority investments in commercial entities that exceed certain materiality thresholds (set at 15% of the bank's capital for individual investments and 60% of the bank's capital for the aggregate of such investments) receive a 1,250% risk weight. Amounts below the threshold are risk weighted at 100%.[4]

Scope of application – other Pillar 1 requirements

The leverage, liquidity and large exposure rules follow the same scope of application as that applied in the risk-based capital framework.

Scope of application – Pillars 2 and 3

Pillars 2 and 3 are key components of the Basel Framework and generally follow the same scope of application as Pillar 1 requirements. With respect to Pillar 2, and as part of the consolidated risk assessment of a banking group, supervisors should also consider various risks that may not necessarily be subject to regulatory consolidation. One such risk, "step-in risk", is the risk that a bank decides to provide financial support to an unconsolidated entity that is facing stress in the absence of, or in excess of, any contractual obligations to provide such support.

If the supervisory assessment reveals that significant residual step-in risks have not been appropriately estimated or mitigated, a supervisor may use the measures that it determines to be appropriate based on the nature and extent of step-in risks identified. Some of these measures may include, for example, additional liquidity requirements; expansion of the stress testing framework to include entities that are not part of the scope of regulatory consolidation; and inclusion, within the scope of regulatory consolidation, of entities where significant residual step-in risk is present.

This Executive Summary and related tutorials are also available in FSI Connect, the online learning tool of the Bank for International Settlements.

[4] From 1 January 2022, investments below the threshold will be subject to the risk weights applicable for equities.