Basel Committee
on Banking Supervision

Basel III definition of capital - Frequently asked questions

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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 adds the third set of frequently asked questions (FAQs) that relate to the definition of capital sections of the Basel III rules text to the first and second sets published in July 2011 and October 2011 respectively. The questions and answers are grouped according to the relevant paragraphs of the rules text.

FAQs that have been added since the publication of the second version of this document are shaded yellow.

Two flowcharts are also included in the annexes. These flowcharts are designed to aid understanding of the application of the Basel III transitional arrangements to capital instruments issued by banks.

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.

4. Footnote 10 of paragraph 52 includes the sentence: "The Committee will continue to review the appropriate treatment of unrealised gains, taking into account the evolution of the accounting framework." Does the Committee have any further guidance on this issue?

The Committee continues to review the appropriate treatment of unrealised gains taking into account the evolution of the accounting framework and any other relevant information. Absent any new guidance, the minimum requirements established by Basel III do not apply any adjustment that would remove from Common Equity Tier 1 unrealised gains and losses.

5. Criterion 11 for common shares and criterion 1 for Additional Tier 1 and Tier 2. Does "paid-in" have to be paid-in with cash?

Paid-in capital generally refers to capital that has been received with finality by the bank, is reliably valued, fully under the bank's control and does not directly or indirectly expose the bank to the credit risk of the investor. The criteria for inclusion in capital do not specify how an instrument must be "paid-in". Payment of cash to the issuing bank is not always applicable, for example, when a bank issues shares as payment for the take-over of another company the shares would still be considered to be paid-in. However, a bank is required to have prior supervisory approval to include in capital an instrument which has not been paid-in with cash.

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

1. 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.

2. 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.

3. Criterion 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 are not prohibited by the Basel III rules text. Furthermore, dividend stopper arrangements that stop dividend payments on other Additional Tier 1 instruments are not prohibited. 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.

4. 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.

5. 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.

6. Criterion 2 for Additional Tier 1 (and criterion 2 for Tier 2 capital) requires subordination to general creditors of the bank. How should this be applied to issues by a holding company?

Subordination needs to apply to all general creditors of the holding company.

7. Criterion 4 for Additional Tier 1 capital. Can the Committee give additional guidance on what will be considered to be an incentive to redeem?

The Committee does not intend to publish an exhaustive list of what is considered an incentive to redeem and so banks should seek guidance from their national supervisor on specific features and instruments. However, the following list provides some examples of what would be considered to be an incentive to redeem:

- A call option combined with an increase in the credit spread of the instrument if the call is not exercised.
- A call option combined with a requirement or an investor option to convert the instrument into shares if the call is not exercised.
- A call option combined with a change in reference rate where the credit spread over the second reference rate is greater than the initial payment rate less the swap rate (ie the fixed rate paid to the call date to receive the second reference rate). For example, if the initial reference rate is 0.9%, the credit spread over the initial reference rate is 2% (ie the initial payment rate is 2.9%), and the swap rate to the call date is 1.2%, a credit spread over the second reference rate greater than 1.7% (2.9-1.2%) would be considered an incentive to redeem.

Conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in credit spread will not in itself be viewed as an incentive to redeem. However, as required by criteria 5, the bank must not do anything that creates an expectation that the call will be exercised.

Banks must not expect supervisors to approve the exercise of a call option for the purpose of satisfying investor expectations that a call will be exercised.

8. Regarding criterion 5b, can the Basel Committee give an example of an action that would be considered to create an expectation that a call will be exercised?

If a bank were to call a capital instrument and replace it with an instrument that is more costly (eg has a higher credit spread) this might create an expectation that the bank will exercise calls on its other capital instruments. As a consequence banks should not expect their supervisors to permit them to call an instrument if the bank intends to replace it with an instrument issued at a higher credit spread.

9. Criteria 4 and 5 for Additional Tier 1 capital. An instrument is structured with a first call date after 5 years but thereafter is callable quarterly at every interest payment due date (subject to supervisory approval). The instrument does not have a step-up. Does instrument meet criteria 4 and 5 in terms of being perpetual with no incentive to redeem?

Criterion 5 allows an instrument to be called by an issuer after a minimum period of 5 years. It does not preclude calling at times after that date or preclude multiple dates on which a call may be exercised. However, the specification of multiple dates upon which a call might be exercised must not be used to create an expectation that the instrument will be redeemed at the first call date, as this is prohibited by criterion 4.

10. Criterion 7 for Additional Tier 1 capital. If the instrument provides for an optional dividend to be paid, with prior supervisory approval, equal to the aggregate unpaid amount of any unpaid dividends, would it be considered as meeting criterion 7a? What if the optional dividend is not specifically linked to the unpaid dividends, but structured as a bonus to reward investors in good times?

No, this contravenes criterion 7 which requires the bank to extinguish dividend/coupon payments. Any structuring as a bonus payment to make up for unpaid dividends is also prohibited.

11. Criteria 7 and 8 for Additional Tier 1 capital. Can a bank allow investors to convert an Additional Tier 1 instrument to common equity upon non-payment of dividends?

No, this would impede the practical ability of the bank to exercise its discretion to cancel payments.

12. Criterion 9 for Additional Tier 1 capital (prohibition of credit sensitive dividend feature). Can the dividend/coupon rate be based on movements in a market index? Is resetting of the margin permitted at all? Does criterion 9 prevent the use of a reference rate for which the bank is a reference entity (eg LIBOR)?

The aim of criterion 9 is to prohibit the inclusion of instruments in Additional Tier 1 where the credit spread of the instrument will increase as the credit standing of the bank decreases. Banks may use a broad index as a reference rate in which the issuing bank is a reference entity, however, the reference rate should not exhibit significant correlation with the bank's credit standing. If a bank plans to issue capital instruments where the margin is linked to a broad index in which the bank is a reference entity, the bank should ensure that the dividend/coupon is not credit sensitive. National supervisors may provide guidance on the reference rates that are permitted in their jurisdictions or may disallow inclusion of an instrument in regulatory capital if they deem the reference rate to be credit sensitive.

13. Criterion 14 for Additional Tier 1 capital (and criterion 9 for Tier 2 capital). Does this mean that the Tier 2 capital issued by an SPV can be upstreamed as Tier 1 capital for the consolidated group?

If an SPV issues Tier 2 capital to investors and upstreams the proceeds by investing in Tier 1 issued by an operating entity or the holding company of the group, the transaction will be classified as Tier 2 capital for the consolidated group. Furthermore, the instrument issued by the operating entity or holding company must also be classified as Tier 2 for all other requirements that apply to that entity (eg solo or sub-consolidated capital requirements and disclosure requirements).

14. Criterion 14 for Additional Tier 1 capital. Can a SPV be used to direct capital to multiple operating and holding companies in a group or must a SPV only direct proceeds to one operating company or holding company in a group? What about when there are multiple holding companies in a group - if the proceeds are made available to an intermediate holding company of the bank

but not the holding company in the consolidated group would it be considered compliant?

Criterion 14 refers to "an operating company or the holding company" rather than operating companies or holding companies. The capital issued by the SPV should therefore only be made available to one operating entity or the holding company of the consolidated group.

15. Criterion 5 for Additional Tier 1 capital and Tier 2 capital states that instruments: "may be callable at the initiative of the issuer only after a minimum of five years". Are any call options permitted that would allow the instrument to be called within the first five years of a capital instrument?

The use of tax event and regulatory event calls are permitted. The exercise of the call remains subject to the requirements set out in points (a) to (c) of criterion 5. Supervisors will only permit the bank to exercise the call if in their view the bank was not in a position to anticipate the event at issuance.

16 Criterion 11 for Additional Tier 1 capital requires instruments classified as liabilities to have principal loss absorption through a conversion or write-down. Does the Basel Committee have any further guidance on permitted trigger levels and write-down mechanisms for these instruments?

Additional Tier 1 instruments accounted for as liabilities should at least comply with the following minimum standards:

- The trigger level for write-down/conversion must be at least 5.125% Common Equity Tier 1 (CET1).
- The write-down/conversion must generate CET1 under the relevant accounting standards and the instrument will only receive recognition in Additional Tier 1 up to the minimum level of CET1 generated by a full write-down/conversion of the instrument.
- The aggregate amount to be written-down/converted for all such instruments on breaching the trigger level must be at least the amount needed to immediately return the bank's CET1 ratio to the trigger level or, if this is not possible, the full principal value of the instruments.

Paragraphs 60–61 (Provisions)

1. 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)

1. 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.

2. 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.

3. Consider the case where the Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1) capital of a subsidiary are sufficient to cover the minimum total capital requirement of the subsidiary. For example, assume the minimum total capital requirement of the subsidiary is 15, the sum of CET1 and AT1 is 15 and the CET1 and AT1 are fully owned by the parent of the subsidiary (ie they are not issued to third parties). What is the capital treatment if the subsidiary issues Tier 2 capital of 5 to third party investors?

The treatment is set out in paragraph 64 of the Basel III rules text. The surplus total capital of the subsidiary is 5. The proportion of the total capital of 20 which is held by third party investors is 25% (ie 5/20*100%). Therefore the amount of the surplus total capital that is attributable to third party investors is 1.25 (=5*25%). Consequently, 1.25 of the Tier 2 will be excluded from consolidated Tier 2 capital. The residual 3.75 of Tier 2 capital will be included in consolidated capital Tier 2 capital.

4. Are the ratios used for the basis of computing the surplus capital attributable to third party investors phased-in?

The ratios used as the basis for computing the surplus (7.0%, 8.5% and 10.5% in paragraphs 62, 63 and 64 respectively) will not be phased-in.

5. Does the Committee have any further guidance on the definition of minority interest, subsidiary and SPVs? Are SPVs referred to in paragraph 65 those which are consolidated under IFRS (SIC 12) or all SPVs?

Guidance should be sought from national supervisors. SPVs referred to in paragraph 65 refer to all SPVs irrespective of whether they are consolidated under IFRS or other applicable accounting standards.

6. Regarding the treatment of capital issued out of subsidiaries, how should the surplus capital be calculated if the subsidiary is not regulated on a stand alone basis but is still subject to consolidated supervision?

For capital issued by a consolidated subsidiary of a group to third parties to be eligible for inclusion in the consolidated capital of the banking group, paragraphs 62 to 65 of the rules text requires the minimum capital requirements and definition of capital to be calculated for the subsidiary irrespective of whether the subsidiary is regulated on a stand alone basis. In addition the contribution of this subsidiary to the consolidated capital requirement of the group (ie excluding the impact of intra-group exposures) must be calculated. All calculations must be undertaken in respect of the subsidiary on a sub-consolidated basis (ie the subsidiary must consolidate all of its subsidiaries that are also included in the wider consolidated group). If this is considered too operationally burdensome the bank may elect to give no recognition in consolidated capital of the group to the capital issued by the subsidiary to third parties. Finally, as set out in paragraph 62, it should be noted that minority interest is only permitted to be included in consolidated Common Equity Tier 1 if: (1) the instrument would, if issued by the bank, meet all of the criteria for classification as common shares for regulatory purposes; and (2) the subsidiary that issued the instrument is itself a bank. The definition of a bank for this purpose is any institution that is subject to the same minimum prudential standards and level of supervision as a bank as mentioned in footnote 23.

Paragraphs 67–68 (Goodwill and other intangibles)

1. According to paragraph 67, 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 must be deducted. Does this apply to significant investments accounted for using the equity method?

Yes. Under the equity method, the carrying amount of the investment includes any goodwill. In line with paragraph 67 a firm should calculate a goodwill amount as at the acquisition date by separating any excess of the acquisition cost over the investor's share of the net fair value of the identifiable assets and liabilities of the banking, financial or insurance entity. In accordance with applicable accounting standards, this goodwill amount may be adjusted for any subsequent impairment losses and reversal of impairment losses that can be assigned to the initial goodwill amount.

Paragraphs 69–70 (Deferred tax assets)

1. Regarding the deduction of deferred tax assets, is it correct that DTAs resulting from net operating losses are not subject to the 10% threshold? Is it correct that the current test in some jurisdictions to check whether DTAs are realisable within one year is not applicable under Basel III?

All DTAs that depend on the future profitability of the bank to be realised and that arise from net operating losses are required to be deducted from Common Equity Tier 1 in full and so do not benefit from the 10% threshold. The test applied in certain jurisdictions to assess whether a DTA is realisable over a one year period is not applicable under Basel III.

2. Paragraph 69 states that: "Deferred tax assets may be netted with associated deferred tax liabilities (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." However, given that DTAs and DTLs are accounting concepts, what does it mean to say that offsetting is permitted by the relevant taxation authority?

It means that the underlying tax assets and tax liabilities must be permitted to be offset by the relevant taxation authority for any DTLs and DTAs created to be permitted to be offset in determining the deduction from regulatory capital.

3. Could the Basel Committee provide guidance on the treatment of deferred taxes in a tax regime in which DTAs arising from temporary differences are automatically transformed into a tax credit in case a bank is not profitable, is liquidated or is placed under insolvency proceedings? In the tax regime the tax credit can be offset against any tax liability of the bank or of any legal entity belonging to the same group as allowed under that national tax regime, and if the amount of such tax liabilities is lower than such tax credit, any exceeding amount of the tax credit will be cash refundable by the central government. Do banks have to deduct DTAs arising from temporary differences in such tax regimes?

No. Banks may apply a 100% risk weight for DTAs arising from temporary differences in such tax regimes.

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

1. 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.

2 Certain accounting standards currently allow the deferral of actuarial losses beyond a specified threshold (ie the corridor approach) without recognition in the financial statements. Is it correct that the deficit as included on the balance sheet should be deducted if the corridor approach is applied in accounting for pensions?

The liability as recorded on the balance sheet in respect of a defined benefit pension fund should be recognised in the calculation of Common Equity Tier 1. In other words, the creation of the liability on the balance sheet of the bank will automatically result in a reduction in the bank's common equity (through a reduction in reserves) and no adjustment should be applied in respect of this in the calculation of Common Equity Tier 1.

Paragraphs 78–89 (Investments in own shares, investments in the capital of banking financial and insurance entities and threshold deductions)

1. 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.

2. 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).

3. 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.

4. 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.

5. For investments in unconsolidated financial entities where banks find it operationally burdensome to look through and monitor index securities, national authorities may permit the use of a conservative estimate. Is this treatment available for investments in own shares?

For both investments in own shares and investments in unconsolidated financial entities national authorities may permit banks, subject to supervisory approval, to use a conservative estimate where exposures result from holdings of index securities and the bank finds it operationally burdensome to look through and monitor their exact exposure.

6. What would be the minimum standard for a firm to use a conservative estimate of its investments in the capital of banking, financial and insurance entities held through index securities (see Paragraph 80, footnote 27)?

National authorities will provide guidance on what is a conservative estimate; however, the methodology for the estimate should demonstrate that in no case will the actual exposure be higher than the estimated exposure.

7. Can the Basel Committee give some examples of what may be considered to be a financial institution / entity?

Guidance should be sought from national supervisors. However, examples of the types of activities that financial entities might be involved in include financial leasing, issuing credit cards, portfolio management, investment advisory, custodial and safekeeping services and other similar activities that are ancillary to the business of banking.

8. Regarding paragraphs 80 to 84, to what extent can long and short positions be netted for the purpose of computing the regulatory adjustments applying to investments in banking, financial and insurance entities?

There is no restriction on the extent to which a short position can net a long position for the purposes of determining the size of the exposure to be deducted, subject to the short position meeting the requirements set out in paragraphs 80-84.

9. Regarding paragraphs 80 to 84, how should exposures to the capital of other financial institutions be valued for the purpose of determining the amount to be subject to the threshold deduction treatment?

Exposures should be valued according to their valuation on the balance sheet of the bank. In this way the exposure captured represents the loss to Common Equity Tier 1 that the bank would suffer if the capital of the financial institution is written-off.

10. Can the Committee confirm that where positions are deducted from capital they should not also contribute to risk weighted assets? Where positions are held in the trading book firms might have market risk hedges in place, so that if the holdings were excluded while leaving the hedges behind in the market risk calculation RWAs could potentially increase. In such cases can banks choose to include such positions in their market risk calculations?

Gross long positions that exceed the relevant thresholds and are therefore deducted from capital can be excluded for the calculation of risk weighted assets. However, amounts below the thresholds for deduction must be included in risk weighted assets. Furthermore, any counterparty credit risk associated with short positions used to offset long positions must remain included in the calculation of risk weighted assets.

Regarding positions that are hedged against market risk, but where the hedge does not qualify for offsetting the gross long position for the purposes of determining the amount to be deducted, banks may choose to continue to include the long exposure in their market risk calculations (in addition to deducting the exposure). Where the hedge does qualify for offsetting the gross long position, both the hedged long and short position can be, but does not have to be, excluded from the market risk calculations.

11. Can further guidance be provided on the calculation of the thresholds for investments in the capital of other financial institutions, in particular the ordering of the application of the deductions?

For further guidance on this issue, please see the calculations as set out in the Basel III implementation monitoring workbook and the related instructions. This can be found at: http://www.bis.org/bcbs/qis/index.htm

12. Regarding paragraph 78 (investments in own shares), if a bank acts as market maker for its own capital instruments is this deemed to create any contractual obligations requiring deductions?

Not until the bank has agreed to purchase stock at an agreed price and either this offer has been accepted or cannot be withdrawn. The purpose of the rule is to capture existing contractual arrangements that could lead to the bank being required to make a purchase of its own capital instruments at a price agreed in the contract (eg a forward purchase or a written put option), such that the extent of the potential loss is know in advance. It was not intended to capture all potential contracts that a bank may enter into in the future.

13. For investments in own shares through holdings of index securities, banks may net gross long positions against short positions in the same underlying index. Can the same approach be applied to investments in unconsolidated financial entities?

For both investments in own shares and investments in unconsolidated financial entities that result from holdings of index securities, banks are permitted to net gross long positions 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 a residual maturity of at least one year.

14. Can significant investments in insurance entities, including fully owned insurance subsidiaries, be consolidated for regulatory purposes as an alternative to the deduction treatment set out in paragraphs 84 to 89 of the Basel III rules text?

Jurisdictions can permit or require banks to consolidate significant investments in insurance entities as an alternative to the deduction approach on the condition that the method of consolidation results in a minimum capital standard that is at least as conservative as that which would apply under the deduction approach, ie the consolidation method cannot result in banks benefiting from higher capital ratios than would apply under the deduction approach.

In order to ensure this outcome, banks that apply a consolidation approach are required to calculate their capital ratios under both the consolidation approach and the deduction approach, at each period that they report or disclose these ratios.

In cases when the consolidation approach results in lower capital ratios than the deduction approach (ie consolidation has a more conservative outcome than deduction), banks will report these lower ratios. In cases when the consolidation approach results in any of the bank's capital ratios being higher than the ratios calculated under the deduction approach (ie consolidation has a less conservative outcome than deduction), the bank must adjust the capital ratio downwards through applying a regulatory adjustment (ie a deduction) to the relevant component of capital.

15. What is the exact meaning of "Indirect" and "Synthetic" holdings? Can some specific examples be provided?

An indirect holding arises when a bank invests in an unconsolidated intermediate entity that has an exposure to the capital of an unconsolidated bank, financial or insurance entity and thus gains an exposure to the capital of that financial institution. A synthetic holding arises when a bank invests in an instrument where the value of the instrument is directly linked to the value of the capital of an unconsolidated bank, financial or insurance entity.

Paragraphs 80-84 require banks to capture their exposures to the capital of other financial institutions, even if they do not have direct holdings of the capital of unconsolidated banks, financial institutions and insurance entities. More specifically, these paragraphs require banks to capture the loss that a bank would suffer if the capital of the entity is permanently written-off, and subject this potential loss to the same treatment as a direct exposure. Set out below are some examples of indirect and synthetic holdings to help illustrate this treatment:

- The bank has an investment in the capital of an entity that is not consolidated for regulatory purposes and is aware that this entity has an investment in the capital of a financial institution.
- The bank enters into a total return swap on capital instruments of another financial institution.

- The bank provides a guarantee or credit protection to a third party in respect of the third party's investments in the capital of another financial institution.
- The bank owns a call option or has written a put option on the capital instruments of another financial institution.
- The bank has entered into a forward purchase agreement on the capital of another financial institution.

In all cases, the loss that the bank would suffer on the exposures if the capital of the financial institution is permanently written-off is to be treated as a direct exposure (ie subject to a deduction treatment).

16. Regarding paragraphs 80 to 84, can short positions in indexes that are hedging long cash or synthetic positions be decomposed to provide recognition of the hedge for capital purposes?

The portion of the index that is composed of the same underlying exposure that it is being hedged can be used to offset the long position only if all of the following conditions are met: (1) both the exposure being hedged and the short position in the index are held in the trading book; (2) the positions are fair valued on the bank's balance sheet; and (3) the hedge is recognised as effective under the bank's internal control processes assessed by supervisors.

17. Consider a bank that invests in an equity position (a long position) and sells it forward (a short position) to another bank (with maturity of forward sale below one year). Is it correct that both banks in this example will include a long position on the equity exposure, ie the selling bank cannot net the forward sale (as it has less than one year maturity) and the buying bank must recognise the forward purchase (as all long positions are added irrespective of maturity)? Also, given the fact that cash equity has no legal maturity, how does the maturity matching requirement apply?

In the example both banks will be considered to have long positions on the equity exposure. Furthermore, the Basel III rules require that the maturity of the short position must either match the maturity of the long position or have a residual maturity of at least one year. Therefore, in the case of cash equity positions the short position must have a residual maturity of at least one year to be considered to offset the cash equity position. However, after considering this issue, the Basel Committee has concluded that, for positions in the trading book, if the bank has a contractual right/obligation to sell a long position at a specific point in time and the counterparty in the contract has an obligation to purchase the long position if the bank exercises its right to sell, this point in time may be treated as the maturity of the long position. Therefore, if these conditions are met, the maturity of the long position and the short position are deemed to be matched even if the maturity of the short position is within one year.

Paragraphs 94–96 (Transitional arrangements)

1. "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.

2. 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.

3. 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.

4. 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.

5. 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.

6. 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.

7. 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.

8. 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.

9. 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.

10. 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.

11. 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 and losses 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.

For example, some jurisdictions currently apply a filter to both unrealised gains and unrealised losses on certain securities (eg debt held on the balance sheet as Available-For-Sale). If the bank had one security with an unrealised gain of $100 and another security with an unrealised loss of $100, both the recognition of the gain and the recognition of the loss should be phased-in. It would be inappropriate to recognise the removal of the filter on the unrealised gains on 1 January 2013, but to phase-in the removal of the filter on unrealised losses because this approach would result in the capital position of the bank initially diverging from the fully phased-in treatment of no filter applied to unrealised gains and losses.

However, the removal of certain filters will unambiguously move the capital position of the bank in the direction of the fully phased-in treatment. For example, some jurisdictions currently apply a filter to unrealised gains on certain assets but not unrealised losses (eg equities classified as Available-For-Sale). In this case the filter can be removed on 1 January 2013, without any phase-in, as the removal of this filter moves the capital position of the banks unambiguously in the direction of the fully phased-in treatment.

12. 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.

13. 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.

14. 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.

15. Capital instruments with call and step-up date on or after 1 January 2013, which are not called and will meet all of the new eligibility criteria on a forward looking basis, will be phased out starting 1 January 2013 until its effective maturity date and then recognised after that. What amount will be recognised – the actual amount of the instruments or the amount recognised as capital on the call date (ie after netting the phased out amount)?

The full amount of the instrument, or in the case of Tier 2 instruments the applicable amortised amount, will be recognised after the call date if the instrument meets all of the eligibility criteria after the call date.

16. Regarding paragraph 94 (g), how do the transitional arrangements apply to instruments denominated in a foreign currency along with any potential hedges of the nominal amount of those instruments?

The total amount of such instruments that no longer meet the criteria for inclusion in the relevant tier of capital are included in the base and limited by the cap from 1 January 2013 onwards. To calculate the base, instruments denominated in a foreign currency that no longer qualify for inclusion in the relevant tier of capital should be included using their value in the reporting currency of the bank as at 1 January 2013. The base will therefore be fixed in the reporting currency of the bank throughout the transitional period.

During the transitional period instruments denominated in a foreign currency should be valued as they are reported on the balance sheet of the bank at the relevant reporting date (adjusting for any amortisation in the case of Tier 2 instruments) and, along with all other instruments that no longer meet the criteria for inclusion in the relevant tier of capital, will be subject to the cap.

17. Regarding paragraph 94 (g), the third bullet of this paragraph fully derecognises instruments from capital on 1 January 2013 if they have a call and a step-up between 12 September 2010 and 1 January 2013, are not called at their effective maturity and do not meet the entry criteria on a forward looking basis. Are such amounts included in the base of the instruments subject to the transitional arrangements?

No, these instruments are not included in the base used to calculate the cap. Only instruments eligible for the transitional arrangements are included in the base.

18. Can ineligible Tier 1 instruments be 'cascaded' into Tier 2 and, if so, can a firm elect to do this at 1 January 2013 or a later date?

Paragraph 94 (g) states that: 'Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital will be phased out beginning 1 January 2013. Fixing the base at the nominal amount of such instruments outstanding on 1 January 2013, their recognition will be capped at 90% from 1 January 2013, with the cap reducing by 10 percentage points in each subsequent year.'

This rule does not prohibit instruments, in whole or in part, that exceed the cap on recognition in Additional Tier 1 being reallocated to Tier 2 if they meet all of the criteria for inclusion in Tier 2 that apply from 1 January 2013 (ie including the requirements of the 13 January 2011 press release). Any reallocation will have no effect on the calculation of the cap itself. This means that instruments that are phased-out of Additional Tier 1 and do not meet the requirements of the 13 January 2011 press release will not be permitted to be 'cascaded' into Tier 2, as Tier 2 is required to meet the requirements of the 13 January 2011 press release.

19. Paragraph 94 (g) (transitional arrangements). The fourth sub-bullet point of paragraph 94 (g) considers instruments with an incentive to redeem after 1 January 2013 and that will not meet the entry criteria on a forward looking basis. These must be derecognised from the relevant tier of capital at the effective maturity date and phased-out from the 1 January 2013. When the instrument is derecognised does this change the size of the base established in paragraph 94 for the phase out of instruments that no longer qualifies as Additional Tier 1 or Tier 2?

No, the level of the base is calculated on 1 January 2013 and does not change thereafter.

20. For capital instruments that are required to be phased out from 1 January 2013, the net amount allowed to be recognised each year onwards is determined on a portfolio basis according to paragraph 94(g). Regarding a bank that holds such instruments, ie the investing bank, could the Basel Committee explain how the corresponding deduction approach should be applied during the transitional phase? For example, if a non-common equity instrument is being phased out from Tier 1 by the issuing bank, should the bank use full value of the instrument or the amount recognised by the issuing bank (ie the phased-out value) to determine the size of the holding subject to the deduction treatment?

During the period in which instruments that do not meet the Basel III entry criteria are being phased out from regulatory capital (ie from 1 January 2013 to 1 January 2022) banks must use the full value of any relevant capital instruments they hold to calculate the amount to be subject to the deduction treatment set out in paragraphs 79 to 85 of Basel III. For example, assume that a bank holds a capital instrument with a value of 100 on its balance sheet and also assume that the issuer of the capital instrument is a bank that only recognises 50 in its Tier 1 capital due to the application of the phasing-out requirements of paragraph 94(g). In this case the investing bank must apply the corresponding deduction approach set out in paragraphs 79 to 85 of Basel III on the basis that it has an investment of 100 in Additional Tier 1 instruments.

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

1. 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.

2. 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.

3. 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.

4. 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.

5. 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.

6. The press release describes two scenarios. The first of these scenarios is where the governing jurisdiction of the bank has sufficient powers to write down Additional Tier 1 and 2 instruments. The second of these is where these powers are not deemed sufficient and contractual provisions (that amount to an embedded option that is to be triggered by the relevant authority) are required in these instruments. The ability of the relevant authority to exercise an embedded option in a regulatory instrument also requires that they have the authority to do so. What is the difference between the powers required in first and second scenarios?

In both cases the relevant authority must have the power to write-down or convert the instrument. In the first scenario the authorities have the statutory power to enact the conversion/write-down irrespective of the terms and conditions of the instrument. In the second scenario the authorities have the power to enact the conversion/write-down in accordance with the terms and conditions of the instrument. In both cases, the fact that the instrument is subject to loss as a result of the relevant authority exercising such power must be made clear. In the first scenario, there needs to be disclosure by the relevant regulator and by the issuing bank, in issuance documents going forward. In the second scenario, this needs to be specified in the terms and conditions of the instrument.

7. To ensure that the scope of application of the non-viability trigger is exercised consistently across jurisdictions does the Basel Committee intend to issue any further guidance on what constitutes the point of non-viability?

Banks should seek advice from their relevant national authority if they have questions about national implementation of the 13 January 2011 press release.

8. How and by whom will the peer group reviews be undertaken to confirm that a jurisdiction has the necessary laws in place to allow the recognition of non-common Tier 1 and Tier 2 instruments. How and when will the results of the peer reviews be made available?

The details of the peer review process have not yet been established.

9. How should conversion at the point of non-viability operate for issues out of SPVs?

The write-off of the instruments issued from the SPV to end investors should mirror the write-off of the capital issued from the operating entity or holding company to the SPV. Banks should discuss whether the specific arrangements of each instrument meet this broad concept with their relevant national authority.

General questions

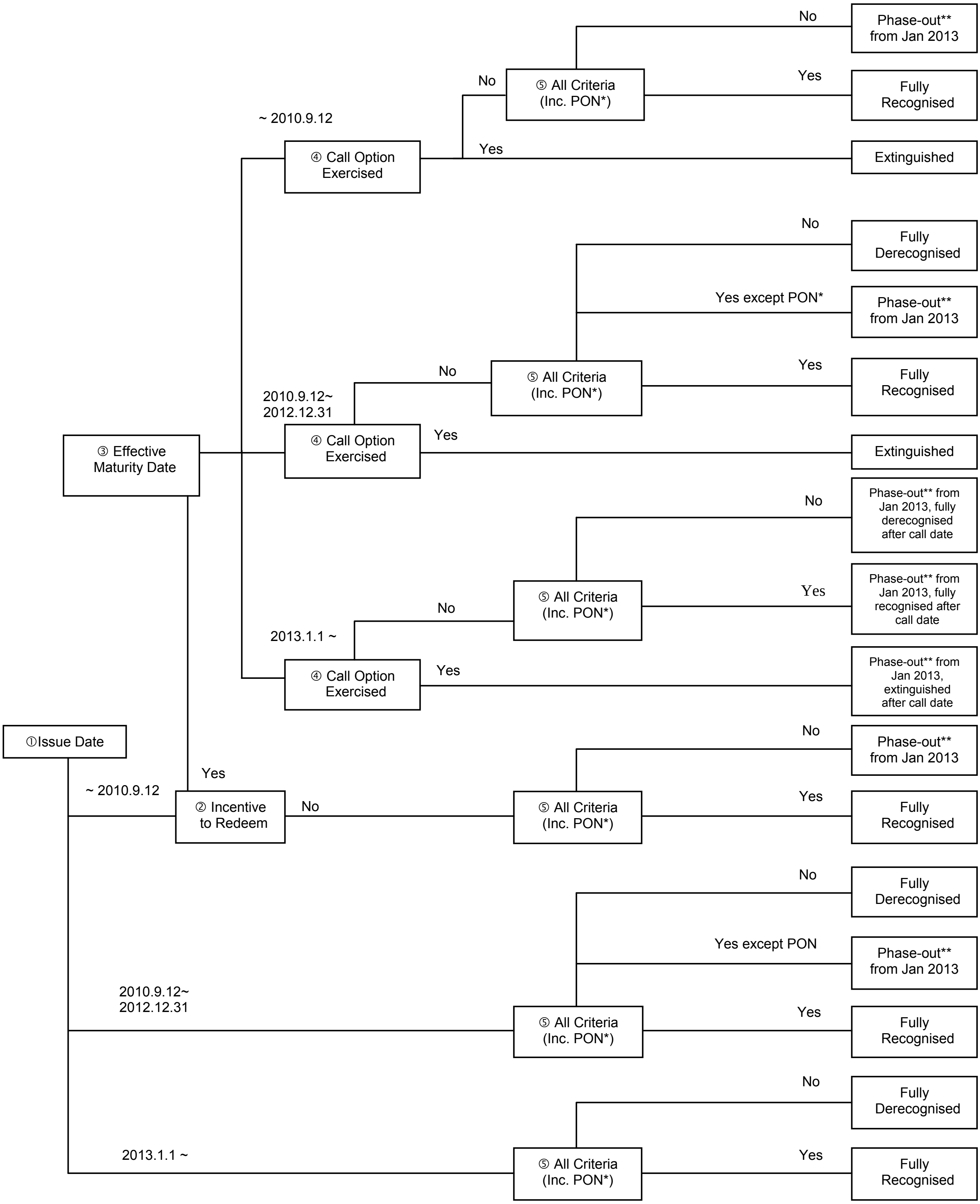
1. When there is not enough Additional Tier 1 (including both Tier 1 that is recognised as a result of the transitional arrangements and new qualifying Additional Tier 1) to "absorb" Additional Tier 1 deductions, are these deductions applied to Common Equity Tier 1? Also, when there is not enough Tier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

2. Can dividend/coupon payments be made on Common shares, Additional Tier 1 and Tier 2 in a form other than cash?

The criteria for inclusion in capital do not specify what can be used to make dividend/coupon payments. However, a bank must seek prior supervisory approval if it intends to include in capital an instrument which has its dividends paid in anything other than cash or shares. Furthermore, for instruments included in Common Equity Tier 1 and Additional Tier 1 capital, the bank must have full discretion to cancel such payments at all times. This requirement prohibits features that require the bank to make payments in kind.

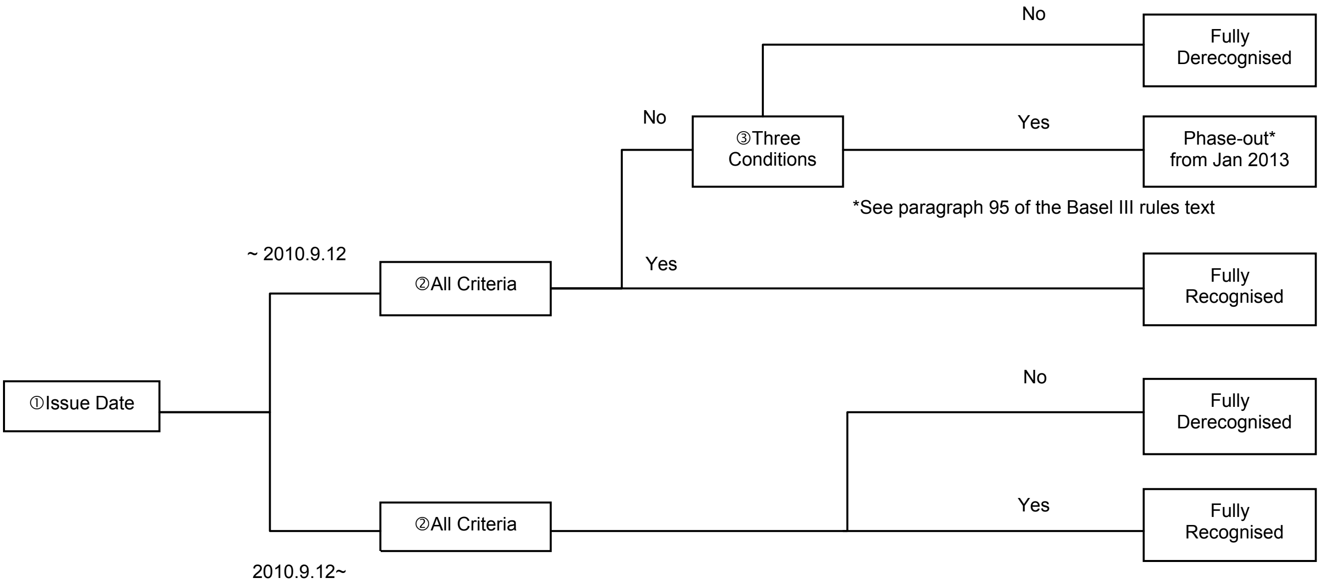
Annex 1: Flowchart to illustrate the application of transitional arrangements in paragraph 94(g) of the Basel III rules text



* "PON" refers to the point of non-viability requirements that are set out in the 13 January 2011 press release

** "Phase-out" refers to the transitional arrangements set out in paragraph 94(g) of the Basel III rules text

Annex 2: Flowchart to illustrate the application of transitional arrangements in paragraph 95 of the Basel III rules text



* The “Three Conditions” and “Phase-out” arrangements are set out in paragraph 95 of the Basel III rules text