Definition of Capital

*Capital serves as a buffer to absorb unexpected losses as well as to fund ongoing activities of the firm. A number of substantial changes have been made to the minimum level of capital required to be held by institutions and to the quality of instruments that comprise the capital base:*

- An increase to the minimum level of common equity Tier 1 capital (formerly Core Tier 1) and total Tier 1 capital
- An increase in the standards for instruments to qualify as Tier 1 capital
- Harmonisation of Tier 2 capital instruments and the elimination of Tier 3 capital
- An overhaul of eligible capital deductions and regulatory filters such as minority interests and deferred tax assets

1. Why it Matters
   1.1 It is essential that banks maintain adequate capital resources of sufficient quantity and quality commensurate with the nature and scale of their activities and the risks inherent in these activities. To allow an effective transition to the new standards the permitted constituents of regulatory capital and the extent to which they can be used will need to be clearly specified to allow banks to plan ahead and to continue to finance their activities on appropriate and efficient basis.

2. Summary of AFME Position
   2.1 Significant uncertainty remains in relation to elements of a bank's regulatory capital structure, calculation methodologies and linkages with wider prudential initiatives, including crisis management and SIFI frameworks. The aggregate impact of these has the potential to adversely affect the pace of financial recovery and the real economy.

3. Regulatory Context
   3.1 One of the main reasons the economic and financial crisis, which began in 2007, became so severe was that the banking sectors of many countries had built up excessive on and off balance sheet leverage. This had been accompanied by a gradual erosion of the level and quality of the capital base, and the banking system therefore was not able to absorb the resulting trading and credit losses.

   3.2 The Basel Committee is seeking to raise the resilience of the banking sector by strengthening the regulatory capital framework, building on the three pillars of the Basel II framework. The reforms raise both the quality and quantity of the regulatory capital base and aim to enhance the risk coverage of the capital framework.
4. **Overview of the Definition of Capital**

a  **General**

4.1 Capital serves as a buffer to absorb unexpected losses as well as to fund ongoing activities of the firm. In general, firms choose to hold a mixture of equity and debt capital that meets the risk and reward preferences of equity shareholders and debt investors. A firm’s capitalisation and gearing are crucial market indicators for potential investors as well as rating agencies and other interested parties. Banks are required by their regulators to hold minimum amounts of capital and the constituents and structure of capital qualifying for regulatory purposes can be summarised as follows.

b  **Tier 1 Capital**

4.2 The predominant form of Tier 1 capital must be common shares and retained earnings. The remainder of the Tier 1 capital base must be comprised of instruments that are subordinated, have fully discretionary non-cumulative dividends or coupons and have neither a maturity date nor an incentive to redeem. Innovative hybrid capital instruments with an incentive to redeem through features such as step-up clauses, currently limited to 15% of the Tier 1 capital base, will be phased out. Basel 3 requires Additional Tier 1 instruments to absorb losses on a going concern basis, either through a write down or conversion into ordinary shares. Whilst the Basel 3 text requires only those instruments classified as liabilities for accounting purposes to include such features, it is thought that European legislation will require all Additional T1 instruments (regardless of the accounting designation) to demonstrate going concern loss absorption. This could give rise to level-playing field implications, particularly in relation to the US which is expected to be the only major jurisdiction to continue to allow preference shares as qualifying Additional Tier 1 capital.

4.3 Common Equity Tier 1 must be at least 4.5% of risk-weighted assets at all times.

4.4 Tier 1 Capital must be at least 6.0% of risk-weighted assets at all times.

4.5 Total Capital (Tier 1 Capital plus Tier 2 Capital) must be at least 8.0% of risk-weighted assets at all times.
c Tier 2 Capital

4.6 Tier 2 capital was historically designed to provide loss absorbency on a gone concern basis. Under Basel II it was split between Upper Tier 2 (perpetual securities with step up and call features or other incentives to redeem) and Lower Tier 2 (dated subordinated debt). Given the Basel III focus on incentives to redeem only dated subordinated debt remains eligible as Tier 2 capital. In some jurisdictions Tier 2 may become the only available form of tax deductible regulatory capital.

d Minority Interests

4.7 Minority interests can support the risks in the subsidiary to which they relate but are not available to support risks in the group as a whole and in some circumstances may represent an interest in a subsidiary with little risk. In view of this, Basel III sets out specific criteria for the inclusion of minority interests in Common Equity Tier 1, Tier 1 or Tier 2 capital and also gives guidance on how the amount to be included in each classification of capital is calculated, depending on the characteristics of the instrument issued by the subsidiary.

4.8 Nevertheless, the calculation of the amounts to be included in Common Equity Tier 1, Tier 1 and Tier 2 capital provided in the Basel III text are simplistic. In reality this can be a complex area, and additional examples, including for instance consideration of the points below, would be welcomed.

- Other legal entities within the group, including non-banks and those which are not regulated on a stand-alone basis, but which are subject to consolidated supervision as part of a wider group;
• The recognition of capital surpluses between subsidiaries (i.e. subsidiaries at a local level); and,

• Subsidiaries incorporated in jurisdictions which have not implemented Basel III standards.

4.9 Without guidance on some of the more complex considerations, there is a risk of divergences in practice across member states creating uncertainty and the potential for competitive distortions.

e  Regulatory Adjustments

4.10 Deductions from capital and prudential filters have been harmonised internationally and generally applied/deducted at the level of common equity.

<table>
<thead>
<tr>
<th>Capital Items and Deductions</th>
<th>Core Tier 1 Treatment as at 16-Dec-2010 Release</th>
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</table>
| Preferred Stock Surplus Model Interest | • Surplus will only be permitted to be included in common equity if the corresponding shares are permitted equity
| Minority Interest | • Minority interests in subsidiaries which are not banks with genuine operating activities need to be discussed
| | • For genuine operating bank subsidiaries only the “surplus capital” attributable to minority shareholders is deducted
| | - Surplus capital is defined by including the capital conservation buffer, i.e. above 7% of Core Tier 1, above 8.5% of Tier 1 and above 10.5% of Total Capital
| Unrealised Gains / Losses on Debt, Loans, Equity | • Add-back of negative AFS reserves to capital, which is currently permitted in a number of jurisdictions, will no longer be permitted under Basel III
| | - Treatment of unrealised gains, i.e. positive AFS reserves has not been fully decided
| Goodwill & Other Intangibles | • All goodwill and intangibles should be deducted net of any deferred tax liability
| | - Includes goodwill and intangibles from significant investments in financial entities (e.g. insurance) which are considered to be unconsolidated for regulatory purposes
| | • If the accounting rules used for regulatory capital differ with regards to the definition of intangible assets, then the bank can choose to apply the definition of intangible assets as under IFRS
| | - As a result, banks not calculating regulatory capital under IFRS can opt for “the better of local or IFRS rules”.
| Deferred Tax Assets (DTAs) | • DTAs resulting from tax loss carry forwards (profit dependent) are to be deducted from Core Tier 1 in any case, net of corresponding deferred tax liabilities (if off-settable against same authority)
| | • DTAs from timing differences (“temporary DTAs) are only deducted from Core Tier 1 if they exceed 10% of Core Tier 1 after all other deductions except significant investments in financial institutions and MSRs
| | - If timing related DTAs combined with MSRs and investments in other financial institutions/insurers exceed 15% of Core Tier 1 after application of all deductions, then the excess also needs to be deducted
| | • Current tax assets that give rise to a claim from the government or local tax authority would be assigned the relevant sovereign risk weighting
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<th>Capital Items and Deductions</th>
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<tbody>
<tr>
<td>Investments in Own Shares</td>
<td>• A bank’s investments in its own common shares should be deducted from common equity, including equity that the bank may be contractually obliged to purchase</td>
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<td>- This includes bank trading books and holding with index securities</td>
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<tr>
<td>Investments in capital of banking, financial and insurance entities which are not consolidated for regulatory purposes</td>
<td>• All reciprocal holdings of capital &quot;designed to artificially inflate&quot; the capital positions of banks are to deducted on a corresponding basis (i.e. Core Tier 1, Tier 1 from Tier 1, etc.)</td>
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<td>• Investments that are not common shares must be fully deducted following a corresponding approach</td>
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<td>• Investments that are common shares are only deducted from Core Tier 1 if they exceed 10% of Core Tier 1 after application of all other deductions except timing-related DTAs and MSRs</td>
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<td>- If combined with timing-related DTAs and MSRs these investments exceed 15% of Core Tier 1 after application of all deductions, then the excess also needs to be deducted</td>
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<td>• Amounts that fall within these thresholds are not deducted from Core Tier 1 and risk-weighted at 250%</td>
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<tr>
<td>Shortfall of Provisions to Expected Losses</td>
<td>• Any difference between expected losses under the IRB approach and actual bank provisions should be deducted in full from the common equity</td>
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<td>Cash Flow Hedge Reserve</td>
<td>• Positive and negative cash flow hedge reserves are removed from Core Tier 1</td>
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<tr>
<td>Gains on Sales Related to Securitisation Transactions</td>
<td>• Gains resulting from securitisation transactions, e.g. From “future margin income” should be deducted from Core Tier 1</td>
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<tr>
<td>Cumulative Gains &amp; Losses Due on Fair Valued Financial Liabilities</td>
<td>• Derecognise gains and losses due to changes in own credit risk on all fair valued liabilities</td>
</tr>
<tr>
<td>Defined Benefit Pension Fund Assets</td>
<td>• Defined pension fund liabilities must be fully recognised in Core Tier 1</td>
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<td>• Defined benefit pension fund assets should be deducted from Core Tier 1, unless regulatory approval has been obtained and unrestricted and unfettered access can be proven</td>
</tr>
<tr>
<td>Mortgage Servicing Rights</td>
<td>• MSRs are only deducted from Core Tier 1 if they exceed 10% of Core Tier 1 after application of all other deductions, except timing-related DTAs and significant investments in financial institutions</td>
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<td>- If MSRs combined with timing-related DTAs and significant investments in financial institutions exceed 15% of Core Tier 1 after application of all deduction, then the excess also needs to be deducted</td>
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<tr>
<td>Any other deductions taken 50% from Total Capital and 50% from Tier 1</td>
<td>• 1250% risk-weighted</td>
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5. Commentary/analysis of the Definition of Capital

5.1 Below is a link to the Table of Issues that AFME has sent to BCBS on behalf of its members.

Table of Issues

5.2 A summary of the areas of primary concern can be presented as follows.

Loss absorbency at the point of non-viability

5.3 The BCBS' January 2011 Annex requires all Additional T1 and T2 capital to absorb losses at a point of non viability from 1.1.13. This can be achieved either through contractual write down/conversion features or by enactment of a "peer reviewed" resolution regime in a firm's home jurisdiction. Non compliance with these requirements at 1.1.13 will result in all current Additional T1 and T2 stock amortising at 10% per annum in accordance with the Basel 3 transitional provisions.

Whilst we understand that work continues at the FSA, Basel and EU level on resolution we need some degree of clarity/confidence that peer reviewed resolution regimes will be in place by the 1.1.13 deadline. In this regard it would be useful to understand what process is envisaged for the peer review.

SIFI buffer requirements

5.4 Linked to the discussions on Crisis Management is the question of how to solve for the so-called "Too Big to Fail" problem. It is as yet unclear what, if any, additional capital buffers SIFIs may be required to hold – and also what capital instruments could be used to finance any SIFI buffer (see further on CoCos below).

CoCos

5.5 Regulatory support for going concern loss absorbent contingent capital instruments remains unclear. Basel Additional T1 criteria seem to indicate that only accounting liabilities would require such features; whilst European direction is in favour of having all AT1 in going concern CoCos. We would welcome greater clarity on the policy goals underlying these instruments and a better understanding of where they could sit within a firm’s regulatory capital structure. In particular we would like to understand if a conversion ratio will be applied, in the event a 1:1 translation is not applied.

Components of capital and deductions

5.6 Clarification is needed also on the calculations in relation to minority interests, and investments in financial institutions and the associated limit structures.
Grandfathering

5.7 The Basel III package includes a number of important clarifications in regard to grandfathering arrangements agreed for regulatory capital instruments already issued. Although this clarification helps to create some certainty for banks, we remain unclear of all the implications of the agreed arrangements and their interaction with grandfathering arrangements in the existing EU capital requirements directives. In particular we need to understand what will be the grandfathering cut off date for issuance of “old style” capital instruments.

Front running

5.8 Although the transitional provisions (see below) are designed to assist firms to adapt to the new rules over a number of years, there is a risk that a number of jurisdictions will enforce them earlier. This increases the risks of unintended consequences, especially to the pace of the economic recovery. For example, new capital may exceed market appetite, when other regulatory responses could lead to a re-rating of banks by investors. Front-running also creates level playing field concerns.

6. Transitional Regime (refer also to supporting schedule)

6.1 Basel III proposes that the transitional arrangements only apply to instruments which were issued before 12 September 2010. The transitional arrangements present a phasing out of instruments which were issued before 12 September 2010 and qualified as Tier 1 or Tier 2 under the existing framework but do not qualify under Basel III. In Europe, the existing framework was already subject to transitional arrangements as included in CRD 2 (which extends to 31 December 2040 for instruments issued before 31 December 2010).

6.2 The transitional arrangement in Basel III allow for capital instruments which no longer qualify as non-common equity Tier 1 capital or Tier 2 capital to be phased out from 1 January 2013. The phasing works by capping the amount which can be included in capital from 90% on 1 January 2013 and reducing this cap by 10% in each subsequent year.

6.3 The transitional arrangements for implementing the new standards will help to ensure that the banking sector can meet the higher capital standards through reasonable earnings retention and capital raising, whilst still supporting lending to the economy.

6.4 National implementation by member countries will begin on 1 January 2013. Member countries must translate the rules into national laws and regulations before this date. As of 1 January 2013, banks will be required to meet the following new minimum requirements in relation to risk-weighted assets (RWAs):

- 3.5% Common Equity Tier 1/RWAs;
- 4.5% Tier 1 capital/RWAs; and
- 8.0% total capital/RWAs.

6.5 The minimum Common Equity Tier 1 and Tier 1 requirements will be phased in between 1 January 2013 and 1 January 2015. On 1 January 2013, the minimum Common Equity Tier 1 requirement will rise from the current 2% level to 3.5%. The Tier 1 capital requirement will rise from 4% to 4.5%. On 1 January 2014, banks will have to meet a 4% minimum Common Equity Tier 1 requirement and a Tier 1 requirement of 5.5%. On 1 January 2015, banks will have to meet the 4.5% Common Equity Tier 1 and the 6% Tier 1 requirements. The total capital requirement remains at the existing level of 8.0% and so does not need to be phased in. The difference between the total capital requirement of 8.0% and the Tier 1 requirement can be met with Tier 2 and higher forms of capital.