News Bulletin

September 15, 2010

The New Global Minimum Capital Standards Under Basel III

On 12 September 2010, the Group of Central Bank Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision ("BCBS"), issued a press release[1] announcing a substantial strengthening of the capital requirements, and its full endorsement of the agreement it had reached on 26 July 2010[2] in relation to the proposed reforms to the Basel II framework.[3] These elements are intended to form part of a package of reforms to be known as Basel III.

The press release contains a table summarising the new requirements on minimum regulatory capital and buffers, as well as a timetable for phasing in the new reforms.

The New Capital Requirements

Minimum common equity and Tier 1 capital requirements

The minimum requirement for common equity, the highest form of loss-absorbing capital, will be raised from the current 2% to 4.5% of total risk-weighted assets ("RWAs"). The overall Tier 1 capital requirement, comprising not only common equity but also other qualifying financial instruments, will increase from the current minimum of 4% to 6%.

There will be no change to the minimum total capital requirement, which will remain at the current 8% level.

Capital conservation buffer

In addition to the minimum capital requirements, banks will be required to hold a capital conservation buffer of 2.5%. This buffer may be used to absorb losses during periods of financial and economic stress, but if a bank's buffer falls below 2.5%, the bank will find itself subject to constraints on the payment of dividends and discretionary bonuses, until the buffer is replenished. This buffer must be funded with common equity, after application of deductions. This effectively mandates a minimum core Tier 1 capital ratio of 7%.

[1] BCBS press release: Group of Governors & Heads of Supervision announces higher global minimum capital standards (12 September 2010), http://www.bis.org/press/p100912.pdf.
[2] BIS Press Release: Group of Governors & Heads of Supervision reach broad agreement on Basel Committee capital & liquidity reform package (26 July 2010), http://www.bis.org/press/p100726.htm and Annex (26 July 2010), http://www.bis.org/press/p100726/annex.pdf.
[3] *See* Morrison & Foerster client alert: More, More, More: A Summary of the Basel Proposals (2 February 2010), http://www.mofo.com/files/Publication/2f280bc1-1b9a-4d98-929f-0a4554236d0f/Presentation/PublicationAttachment/7cf62184-8f7b-48c4-a4f8-1de08055cfe4/SummaryoftheBaselProposals02022010.pdf.

Countercyclical buffer

A requirement to maintain countercyclical buffer in the range of 0% to 2.5%, consisting of common equity or other fully loss-absorbing capital, will be phased in to protect the banking sector from periods of "excess aggregate credit growth," by effectively extending the required amount of the capital conservation buffer to counter a system-wide buildup of risk resulting from such credit growth. This would be implemented based on national circumstances.[4]

Leverage ratio

As a backstop to these risk-based measures, a non-risk-based leverage ratio will also be introduced in 2018. It is currently proposed that a minimum Tier 1 leverage ratio of 3% be tested during a parallel run period and then subjected to an appropriate review and calibration process, before migrating to Pillar 1 treatment.

Systemically important banks

The BCBS intends that systemically important banks should have loss-absorbing capacity beyond these minimum standards, and work is being carried out on this issue by the Financial Stability Board ("FSB") and the BCBS to develop an integrated approach which may include a combination of capital surcharges, contingent capital and bail-in debt. In addition, work is continuing to strengthen resolution regimes and to strengthen the loss-absorbency of non-common Tier 1 and Tier 2 capital instruments.[5]

Transitional Arrangements

The new rules will be phased in from 1 January 2013 to 1 January 2019. Member countries must transpose the new rules into their national laws prior to, and begin implementing them from, 1 January 2013. However, they may impose shorter transition periods, as appropriate.

Common equity and Tier 1 capital

The minimum common equity and Tier 1 capital requirements, in relation to RWAs, will be phased in between 1 January 2013 and 1 January 2015, as illustrated in Annex 1:

The BCBS had proposed in its December 2009 Consultative Document "Strengthening the resilience of the banking sector" and in its July 2010 paper that certain deductions and prudential filters should be applied in determining a bank's common equity Tier 1 capital, including deductions relating to minority interests, goodwill, deferred tax assets, investments in certain financial entities and mortgage servicing rights.

These regulatory adjustments to common equity will be phased in from 1 January 2014, starting at 20% of the deduction that would otherwise be required and rising by another 20% on each anniversary, until being fully deducted from common equity as from 1 January 2018.[6]

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[4] *See also* Morrison & Foerster client alert: A Little Bit Less and a Bit Longer: Update on Basel Capital and Liquidity Reforms (6 August 2010), http://www.mofo.com//files//Uploads/Images/100806BaselCapital.pdf.
[5] *See* BCBS Consultative Document: A proposal to ensure the loss absorbency of regulatory capital at the point of non-viability (19 August 2010), http://www.bis.org/publ/bcbs174.pdf?noframes=1 (comments deadline: 1 October 2010). *See also* Morrison & Foerster client alert: Super-Absorbent Bank Regulatory Capital (25 August 2010), http://www.mofo.com/files/Uploads/Images/100825SuperAbsorbent.pdf.
[6] See Annex 2.

Capital conservation buffer

The capital conservation buffer will be phased in at an initial level of 0.625% of RWAs from 1 January 2016 and increasing each subsequent year by 0.625%, to reach its final level of 2.5% of RWAs from 1 January 2019.

The BCBS has stated that countries experiencing excessive credit growth should consider accelerating their build-up of the capital conservation buffer and the countercyclical buffer.

Qualification/Recognition of Capital Instruments

Existing public sector injections of capital will be grandfathered until 1 January 2018.

In the case of existing capital instruments that no longer qualify as non-common equity Tier 1 or Tier 2 capital, they will be gradually "de-recognised" by 10% per year (of their nominal amount outstanding as at 1 January 2013) over a 10-year period, starting from 1 January 2013. In addition, where those instruments contain incentives to redeem (such as interest rate step-ups), such instruments will be de-recognised at their effective maturity date.

Instruments that no longer qualify as common equity Tier 1 capital will be excluded from common equity Tier 1 capital as from 1 January 2013,[7] provided that instruments containing the following features will be gradually de-recognised in the manner set out in the previous paragraph:

- they are issued by a non-joint stock company;
- they are treated as equity under the prevailing accounting standards; and
- they receive unlimited recognition as part of Tier 1 capital under current applicable national banking law.

Leverage ratio

As announced on 26 July 2010, the supervisory monitoring process will commence on 1 January 2011, followed by the parallel run period from 1 January 2013 to 1 January 2017. Disclosure of the leverage ratio and its components will start from 1 January 2015. Based on the results of the parallel run period, final adjustments will be made in the first half of 2017, with a view to the ratio being given Pillar 1 treatment under the Basel framework from 1 January 2018.[8]

Liquidity ratios

As also announced on 26 July 2010, BCBS intends to introduce (i) the liquidity coverage ratio ("LCR") from 1 January 2015 and (ii) the revised net stable funding ratio ("NSFR"), as a minimum standard by 1 January 2018, in each case following an observation phase.[9]

Next Steps

The new capital standards will be presented at the G20 summit meeting in Seoul on 11 – 12 November 2010 for endorsement before taking effect.

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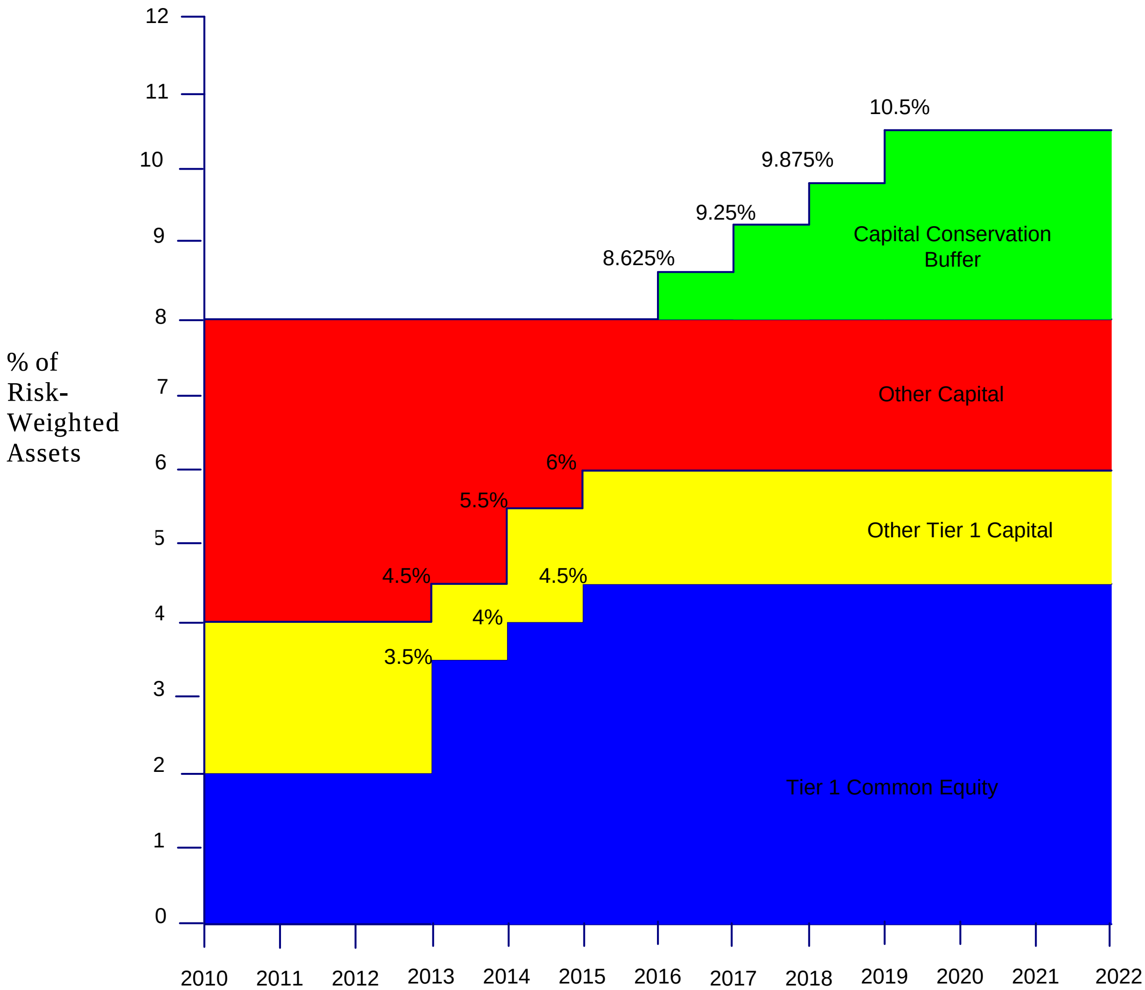
[7] See Annex 2.
[8] See Annex 2.
[9] See Annex 2.

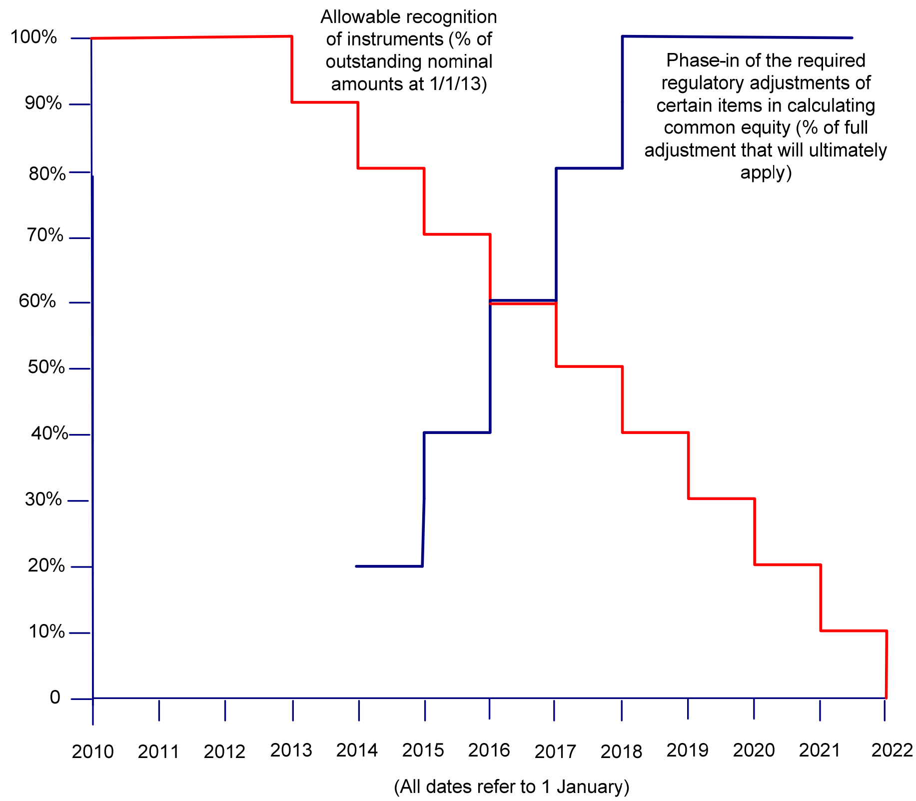
Annex 1

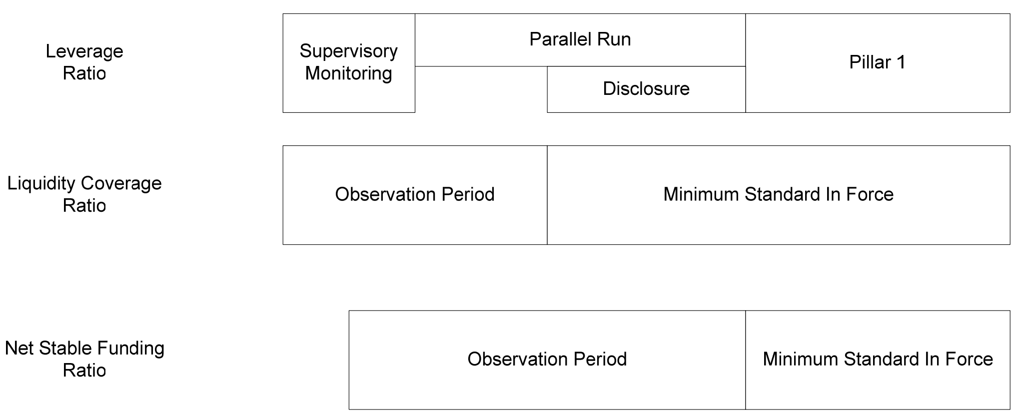
Basel III Minimum Capital Requirements



Annex 2

Recognition of (a) Non-common equity instruments (issued before 13 September 2010)[10] that no longer qualify as Tier 1 or Tier 2 capital, and (b) Certain non-joint stock company instruments no longer qualifying as Common Equity Tier 1 capital[11]





[10] Capital instruments issued after 12 September 2010 cannot benefit from the phase-out arrangements.
[11] Generally, capital instruments no longer meeting the requirements for inclusion in common equity Tier 1 capital will be excluded from common equity Tier 1 from 1 January 2013.

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