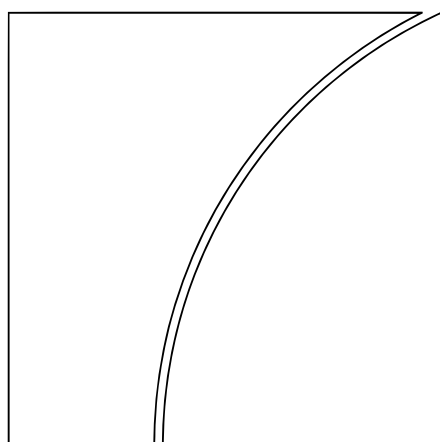


Basel Committee on Banking Supervision

CAP

Definition of capital

This standard describes the criteria that bank capital instruments must meet to be eligible to satisfy the Basel capital requirements, as well as necessary regulatory adjustments and transitional arrangements.



BANK FOR INTERNATIONAL SETTLEMENTS

This document has been generated on 01/02/2024 based on the Basel Framework data available on the BIS website (www.bis.org).

© Bank for International Settlements 2024. All rights reserved.

Contents

Definition of eligible capital	<u>4</u>
Regulatory adjustments	<u>28</u>
Prudent valuation guidance	<u>46</u>
Transitional arrangements	<u>50</u>
Application guidance	<u>57</u>

CAP10

Definition of eligible capital

Updated to include the following FAQs: CAP10.11
FAQ24 and CAP10.16 FAQ10.

Version effective as of 15 Dec 2019

Updated to include the following FAQs: CAP10.11
FAQ24 and CAP10.16 FAQ10.

Components of capital

- 10.1** Regulatory capital consists of three categories, each governed by a single set of criteria that instruments are required to meet before inclusion in the relevant category.
- (1) Common Equity Tier 1 (going-concern capital)
 - (2) Additional Tier 1 (going-concern capital)
 - (3) Tier 2 Capital (gone-concern capital)
- 10.2** Total regulatory capital is the sum of Common Equity Tier 1, Additional Tier 1 and Tier 2 capital, net of regulatory adjustments described in [CAP30]. Tier 1 capital is the sum of Common Equity Tier 1 and Additional Tier 1 capital, net of the regulatory adjustments in [CAP30] applied to those categories.
- 10.3** It is critical that banks' risk exposures are backed by a high-quality capital base. To this end, the predominant form of Tier 1 capital must be common shares and retained earnings.
- 10.4** Throughout [CAP10] the term "bank" is used to mean bank, banking group or other entity (eg holding company) whose capital is being measured.
- 10.5** 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.

Common Equity Tier 1

- 10.6** Common Equity Tier 1 capital consists of the sum of the following elements:
- (1) Common shares issued by the bank that meet the criteria for classification as common shares for regulatory purposes (or the equivalent for non-joint stock companies);
 - (2) Stock surplus (share premium) resulting from the issue of instruments included Common Equity Tier 1;
 - (3) Retained earnings;
 - (4) Accumulated other comprehensive income and other disclosed reserves;
 - (5) Common shares issued by consolidated subsidiaries of the bank and held by third parties (ie minority interest) that meet the criteria for inclusion in Common Equity Tier 1 capital. See [CAP10.20] to [CAP10.26] for the relevant criteria; and
 - (6) Regulatory adjustments applied in the calculation of Common Equity Tier 1.
- 10.7** Retained earnings and other comprehensive income include interim profit or loss. National authorities may consider appropriate audit, verification or review procedures. Dividends are removed from Common Equity Tier 1 in accordance with applicable accounting standards. The treatment of minority interest and the regulatory adjustments applied in the calculation of Common Equity Tier 1 are addressed in separate sections.

FAQ

FAQ1 *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 [CAP30].

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 [CAP30.15].

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.

FAQ2 *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 [CAP30].

Common shares issued by the bank

10.8 For an instrument to be included in Common Equity Tier 1 capital it must meet all of the criteria that follow. The vast majority of internationally active banks are structured as joint stock companies¹ and for these banks the criteria must be met solely with common shares. In the rare cases where banks need to issue non-voting common shares as part of Common Equity Tier 1, they must be identical to voting common shares of the issuing bank in all respects except the absence of voting rights.²

- (1) Represents the most subordinated claim in liquidation of the bank.
- (2) Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (ie has an unlimited and variable claim, not a fixed or capped claim).
- (3) Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).
- (4) The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.
- (5) Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).
- (6) There are no circumstances under which the distributions are obligatory. Non payment is therefore not an event of default. Among other things, this requirement prohibits features that require the bank to make payments in kind.
- (7) Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.
- (8) It is the issued capital that takes the first and proportionately greatest share of any losses as they occur.³ Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others.
- (9) The paid-in amount is recognised as equity capital (ie not recognised as a liability) for

determining balance sheet insolvency.

- (10) The paid-in amount is classified as equity under the relevant accounting standards.
- (11) It is directly issued and paid-in and the bank cannot directly or indirectly have funded the instrument or the purchase of the instrument.
- (12) The paid-in amount is neither secured nor covered by a guarantee of the issuer or related entity⁴ or subject to any other arrangement that legally or economically enhances the seniority of the claim.
- (13) It is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorised by the owners.
- (14) It is clearly and separately disclosed on the bank's balance sheet.⁵

Footnotes

- ¹ *Joint stock companies are defined as companies that have issued common shares, irrespective of whether these shares are held privately or publically. These will represent the vast majority of internationally active banks.*
- ² *The criteria also apply to non-joint stock companies, such as mutuals, cooperatives or savings institutions, taking into account their specific constitution and legal structure. The application of the criteria should preserve the quality of the instruments by requiring that they are deemed fully equivalent to common shares in terms of their capital quality as regards loss absorption and do not possess features which could cause the condition of the bank to be weakened as a going concern during periods of market stress. Supervisors will exchange information on how they apply the criteria to non-joint stock companies in order to ensure consistent implementation.*
- ³ *In cases where capital instruments have a permanent writedown feature, this criterion is still deemed to be met by common shares.*
- ⁴ *A related entity can include a parent company, a sister company, a subsidiary or any other affiliate. A holding company is a related entity irrespective of whether it forms part of the consolidated banking group.*
- ⁵ *The item should be clearly and separately disclosed in the balance sheet published in the bank's annual report. Where a bank publishes results on a half-yearly or quarterly basis, disclosure should also be made at those times. The requirement applies at the consolidated level; the treatment at an entity level should follow domestic requirements.*

FAQ

- FAQ1** *Regarding [CAP10.8](5), if a bank does not earn any distributable profit within a given period does this mean that the bank is prohibited from paying a dividend?*
- There are no Basel III requirements that prohibit dividend distributions as long as the bank meets the minimum capital ratios to which it is subject and does not exceed any of the distribution constraints of the capital conservation and countercyclical buffers (extended, as applicable, by any global or domestic systemically important bank higher loss absorbency capital surcharge). Accordingly, dividends may be paid out of reserves available for distribution (including those reserves accumulated in prior years) provided that all minimum ratios and buffer constraints are observed.*
- Distributable items in the criteria for common shares should be interpreted with reference to those items which are permitted to be distributed according to the relevant jurisdictional requirements, including any prohibitions that form part of*

those requirement.

For example, consider a jurisdiction in which distributable items consist of a company's retained earnings only and, as such, companies are not permitted to pay dividends (ie make distributions) to shareholders if the payment would result in negative retained earnings. Given that both the payment of dividends on shares reduces retained earnings, their declaration should be precluded in this jurisdiction if payment would result in (or increase) negative retained earnings.

FAQ2 *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.

FAQ3 *Does [CAP10.8](11) require an exclusion from regulatory capital where a bank provides funding to a borrower that purchases the capital instruments of the bank where: (a) the bank has full recourse to the borrower; and (b) the funding was not provided specifically for the purpose of purchasing the capital of the bank (eg it was provided for the purpose of holding a diversified portfolio of investments)?*

No. Banks must ensure full compliance with [CAP10.8](11) in economic terms irrespective of the specific legal features underpinning the transaction.

Additional Tier 1 capital

10.9 Additional Tier 1 capital consists of the sum of the following elements:

- (1) instruments issued by the bank that meet the criteria for inclusion in Additional Tier 1 capital (and are not included in Common Equity Tier 1);
- (2) stock surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital;
- (3) instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Additional Tier 1 capital and are not included in Common Equity Tier 1 capital. See [CAP10.20] to [CAP10.26] for the relevant criteria; and
- (4) regulatory adjustments applied in the calculation of Additional Tier 1 Capital.

FAQ

FAQ1 *Can subordinated loans be included in regulatory capital?*

Yes. As long as the subordinated loans meet all the criteria required for Additional Tier 1 or Tier 2 capital, banks can include these items in their regulatory capital.

10.10 The treatment of instruments issued out of consolidated subsidiaries of the bank and the regulatory adjustments applied in the calculation of Additional Tier 1 capital are addressed in separate sections.

10.11 The following criteria must be met or exceeded for an instrument issued by the bank to be included in Additional Tier 1 capital.

- (1) Issued and paid-in

- (2) Subordinated to depositors, general creditors and subordinated debt of the bank. In the case of an issue by a holding company, the instrument must be subordinated to all general creditors.
- (3) 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
- (4) Is perpetual, ie there is no maturity date and there are no step-ups or other incentives to redeem
- (5) May be callable at the initiative of the issuer only after a minimum of five years:
 - (a) To exercise a call option a bank must receive prior supervisory approval; and
 - (b) A bank must not do anything which creates an expectation that the call will be exercised; and
 - (c) Banks must not exercise a call unless:
 - (i) They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank;⁶ or
 - (ii) The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.⁷
 - (d) The use of tax event and regulatory event calls are permitted within the first five years of a capital instrument, but supervisors will only permit the bank to exercise such a call if in their view the bank was not in a position to anticipate the event at issuance.
- (6) Any repayment of principal (eg through repurchase or redemption) must be with prior supervisory approval and banks should not assume or create market expectations that supervisory approval will be given.
- (7) Dividend/coupon discretion:
 - (a) the bank must have full discretion at all times to cancel distributions/payments⁸
 - (b) cancellation of discretionary payments must not be an event of default
 - (c) banks must have full access to cancelled payments to meet obligations as they fall due
 - (d) cancellation of distributions/payments must not impose restrictions on the bank except in relation to distributions to common stockholders.
- (8) Dividends/coupons must be paid out of distributable items.⁹
- (9) The instrument cannot have a credit-sensitive dividend feature, that is a dividend/ coupon that is reset periodically based in whole or in part on the banking organisation's credit standing.
- (10) The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.
- (11) Instruments classified as liabilities for accounting purposes must have a principal loss-absorption mechanism. This must generate Common Equity Tier 1 under the relevant accounting standards and the instrument will only receive recognition in Additional Tier 1 up to the minimum level of Common Equity Tier 1 generated by the loss-absorption mechanism. The mechanism must operate through either:
 - (a) conversion to common shares at an objective pre-specified trigger point of at least

5.125% Common Equity Tier 1; or

- (b) a writedown mechanism which allocates losses to the instrument at a pre-specified trigger point of at least 5.125% Common Equity Tier 1. The writedown will have the following effects:
 - (i) Reduce the claim of the instrument in liquidation;
 - (ii) Reduce the amount repaid when a call is exercised; and
 - (iii) Partially or fully reduce coupon/dividend payments on the instrument.
- (12) The aggregate amount to be written down/converted for all instruments classified as liabilities for accounting purposes on breaching the trigger level must be at least the amount needed to immediately return the bank's Common Equity Tier 1 ratio to the trigger level or, if this is not possible, the full principal value of the instruments.
- (13) Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly fund the instrument or the purchase of the instrument.
- (14) The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.
- (15) If the instrument is not issued out of an operating entity or the holding company in the consolidated group (eg a special purpose vehicle - "SPV"), proceeds must be immediately available without limitation to a single operating entity¹⁰ or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital.
- (16) The terms and conditions must have a provision that requires, at the option of the relevant authority, the instrument to either be written off or converted into common equity upon the occurrence of a trigger event, unless the criteria in [CAP10.12] are met. Any compensation paid to instrument holders as a result of a write-off must be paid immediately in the form of common stock (or its equivalent in the case of non-joint stock companies) of either the issuing bank or the parent company of the consolidated group (including any successor in resolution) and must be paid prior to any public sector injection of capital (so that the capital provided by the public sector is not diluted). The issuing bank must maintain at all times all prior authorisation necessary to immediately issue the relevant number of shares specified in the instrument's terms and conditions should the trigger event occur. The trigger event:
 - (a) is the earlier of:
 - (i) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and
 - (ii) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority; and
 - (b) is determined by the jurisdiction in which the capital is being given recognition for regulatory purposes. Therefore, where an issuing bank is part of a wider banking group and the issuing bank wishes the instrument to be included in the consolidated group's capital in addition to its solo capital, the terms and conditions must specify an additional trigger event. This additional trigger event is the earlier of:
 - (i) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority in the home jurisdiction;

and

- (ii) the decision to make a public sector injection of capital, or equivalent support, in the jurisdiction of the consolidated supervisor, without which the firm receiving the support would have become non-viable, as determined by the relevant authority in that jurisdiction.

Footnotes

- [10](#) *An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.*
- [6](#) *Replacement issues can be concurrent with but not after the instrument is called.*
- [7](#) *Minimum refers to the regulator's prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.*
- [8](#) *A consequence of full discretion at all times to cancel distributions/payments is that "dividend pushers" are prohibited. An instrument with a dividend pusher obliges the issuing bank to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term "cancel distributions/payments" means extinguish these payments. It does not permit features that require the bank to make distributions/payments in kind. Banks may not allow investors to convert an Additional Tier 1 instrument to common equity upon non-payment of dividends, as this would also impede the practical ability of the bank to exercise its discretion to cancel payments.*
- [9](#) *It should be noted that, in many jurisdictions, distributions on Additional Tier 1 instruments (particularly those classified as liabilities but also, in some cases, on instruments that are equity-accounted) will be reflected as an expense item rather than as a distribution of profit (usually for tax reasons). The precondition of "distributable items" as a prudential criterion has therefore to be understood and applied in such a way that such distributions, even if not in violation of any legislation governing distributions by corporates, should not be allowed by the regulator if the distributable items are not adequate to provide for them.*

FAQ

- FAQ1 *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 takeover 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.
- FAQ10 *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 [CAP10.11](7)(a)? 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 [CAP10.11](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.

- FAQ11** *Is the term “distributable items” in [CAP10.11](8) intended to include “retained earnings”, as is the case in [CAP10.8](5) for common shares? If yes, then how would this requirement work in the case of an Additional Tier 1 instrument classified as an accounting liability?*
- Distributable items in the criteria for common shares and Additional Tier 1 should be interpreted with reference to those items which are permitted to be distributed according to the relevant jurisdictional requirements, including any prohibitions that form part of those requirement.*
- For example, consider a jurisdiction in which distributable items consist of a company’s retained earnings only and, as such, companies are not permitted to pay dividends (ie make distributions) to shareholders if the payment would result in negative retained earnings. Given that both the payment of dividends and coupons on shares / Additional Tier 1 instruments reduces retained earnings, their declaration (in the case of dividends) or payment (in the case of coupons) should be precluded in this jurisdiction if payment would result in (or increase) negative retained earnings.*
- It should be noted that in many jurisdictions distributions on Additional Tier 1 instruments (particularly those classified as liabilities but also, in some cases, on instruments which are equity accounted) will be reflected as an expense item rather than as a distribution of profit (usually for tax reasons). The precondition of “distributable items” as a prudential criterion has therefore to be understood and applied in such a way that such distributions even if not in violation of any legislation governing distributions by corporates, should not be allowed by the regulator if the distributable items are not adequate to provide for them.*
- FAQ12** *Can the dividend/coupon rate be based on movements in a market index? Is resetting of the margin permitted at all? Does [CAP10.11](9) prevent the use of a reference rate for which the bank is a reference entity (eg the London Interbank Offered Rate)?*
- The aim of [CAP10.11](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.*
- FAQ13** *Is [CAP10.11](10) 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.*
- FAQ14** *If a related party of the bank purchases the capital instrument but third-party investors bear all the risks and rewards associated with the instrument and there is no counterparty risk (eg a fund manager or insurance subsidiary invests for the*

benefit of fund investors or insurance policyholders), does this contravene [CAP10.11](13)?

The intention of the criterion is to prohibit the inclusion of instruments in capital in cases where the bank retains any of the risk of the instruments. The criterion is not contravened if the third-party investors bear all of the risks.

FAQ15 *Does [CAP10.11](13) require an exclusion from regulatory capital where a bank provides funding to a borrower that purchases the capital instruments of the bank where: (a) the bank has full recourse to the borrower; and (b) the funding was not provided specifically for the purpose of purchasing the capital of the bank (eg it was provided for the purpose of holding a diversified portfolio of investments)?*

No. Banks must ensure full compliance with [CAP10.11](13) in economic terms irrespective of the specific legal features underpinning the transaction.

FAQ16 *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.

FAQ17 *Can Tier 2 capital issued by an SPV 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).

FAQ18 *Regarding [CAP10.11](16), 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.

FAQ19 *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.

FAQ2 *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 [CAP10.11](3)?*

Yes, the provision of support would constitute enhancement and breach [CAP10.11] (3).

FAQ20 *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.

FAQ21 *Assuming compliance with all relevant legal conditions that may exist can the compensation upon the point of non-viability trigger be paid in the form of common shares of the holding company of the bank?*

Yes, national authorities may allow common shares paid as compensation to be those of the bank's holding company. This is permitted because neither the issuance of shares of the bank nor the issuance of shares of the holding company affect the level of common equity created at the bank when the liability represented by the capital instruments is written off. National authorities may require that banks that intend to do this seek the relevant authority's approval before the issuance of such capital instruments.

FAQ22 *While [CAP10.11](11) requires either writedown or conversion to equity of the Additional Tier 1 instrument (accounted for as a liability), the non-viability trigger (ie gone-concern trigger for all non-common equity Tier 1 and Tier 2 instruments) in [CAP10.11](16) requires either write-off or conversion to equity. Did the Basel Committee intend to differentiate the loss absorption mechanism between the writedown and write-off?*

Additional Tier 1 instruments accounted for as liabilities are required to meet both the requirements for the point of non-viability and the principal loss-absorbency requirements in [CAP10.11](11).

To meet the point-of-non-viability requirements, the instrument needs to be capable of being permanently written off or converted to common shares at the trigger event. Temporary writedown mechanisms cannot meet this requirement.

Regarding the writedown or conversion requirements for Additional Tier 1 instruments accounted for as liabilities, a temporary writedown mechanism is only permitted if it meets the conditions in [CAP10.11](11) and [CAP10.11](12).

FAQ23 *A deferred tax liability (DTL) could arise when a bank writes down or writes-off an instrument as a result of the principal loss-absorption or the non-viability requirement being triggered. Should the amount recognised as regulatory capital, both at the point of issuance and during the life of the instrument, be net of potential deferred tax liabilities that could arise when the instrument is written down or written off?*

Yes. The amount recognised as regulatory capital should be adjusted to account for any DTLs or tax payment resulting from the conversion or writedown or any other foreseeable tax liability or tax payment related to the instruments due at the moment of conversion or writedown or write-off. The adjustment should be made from the point of issuance. Institutions shall assess and justify the amount of any foreseeable tax liabilities or tax payments to the satisfaction of their supervisory authorities, taking into account in particular the local tax treatment and the structure of the group.

Where netting of DTLs against deferred tax assets is allowed, banks should seek guidance from supervisory authorities on the treatment of DTLs associated with the conversion, writedown or write-off of regulatory capital instrument.

FAQ24 *Regarding the reform of benchmark reference rates, will amendments to the contractual terms of capital instruments that are undertaken to prepare for the transition to the new benchmark rates result in a reassessment of their eligibility as regulatory capital?*

Amendments to the contractual terms of capital instruments could potentially trigger a reassessment of their eligibility as regulatory capital in some jurisdictions. A reassessment could result in an existing capital instrument being treated as a new instrument. This in turn could result in breaching the minimum maturity and call date requirements. Similarly, existing capital instruments issued under Basel II that are being phased out could also fail to meet eligibility requirements if they are treated as new instruments. The Committee confirms that amendments to capital instruments pursued solely for the purpose of implementing benchmark rate reforms will not result in them being treated as new instruments for the purpose of assessing the minimum maturity and call date requirements or affect their eligibility for transitional arrangements of Basel III.

FAQ3 *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 a step-up.

FAQ4 *Can the Committee give additional guidance on what will be considered 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 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 the 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 [CAP10.11](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.

FAQ5 *An Additional Tier 1 capital instrument must be perpetual, which is further clarified as there being no maturity date, step-ups or other incentives to redeem. In some jurisdictions, domestic law does not allow direct issuance of perpetual debt. If, however, a dated instrument's terms and conditions include an automatic rollover feature, would the instrument be eligible for recognition as Additional Tier 1 capital? What about instruments with mandatory conversion into common shares on a pre-defined date?*

Dated instruments that include automatic rollover features are designed to appear as perpetual to the regulator and simultaneously to appear as having a maturity to the tax authorities and/or legal system. This creates a risk that the automatic rollover could be subject to legal challenge and repayment at the maturity date could be enforced. As such, instruments with maturity dates and automatic rollover features should not be treated as perpetual.

An instrument may be treated as perpetual if it will mandatorily convert to common shares at a pre-defined date and has no original maturity date prior to conversion. However, if the mandatory conversion feature is combined with a call option (ie the mandatory conversion date and the call are simultaneous or near-simultaneous), such that the bank can call the instrument to avoid conversion, the instrument will be treated as having an incentive to redeem and will not be permitted to be included in Additional Tier 1. Note that there may be other facts and circumstances besides having a call option that may constitute an incentive to redeem.

FAQ6 *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 the instrument meet [CAP10.11](4) and [CAP10.11](5) in terms of being perpetual with no incentive to redeem?*

[CAP10.11](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 [CAP10.11](4).

FAQ7 *An Additional Tier 1 instrument can be redeemed within the first five years of issuance only on the occurrence of a tax event or regulatory event. Please advise whether: (a) a tax event must relate solely to taxation changes that adversely affect the tax treatment of dividend and interest payments from the issuer's perspective; (b) a tax event could also include tax changes from the holders' perspective, with or without the issuer seeking to compensate the investors with additional payments; and (c) issuers should be allowed to gross up distributions to compensate the investors with additional payments, or whether this should be regarded as akin to a step up and an incentive to redeem (either under a call option related to the "tax event" (if permitted), or otherwise when the five year call date is reached).*

A tax event must relate to taxation changes in the jurisdiction of the issuer that increase an issuer's cash outflows to holders of capital instruments or adversely affect the tax treatment of dividend, interest payments or principal repayments from the issuer's perspective.

Any taxation changes that result in an increase in the cost of the issuance for the bank may be regarded as a tax event where the change in tax law is in the jurisdiction of the issuer and could not be anticipated at the issue date of the instrument. For example, where the issuer is required by a change in taxation law to withhold or deduct amounts otherwise payable to instrument holders, and is also required under the terms of the instrument to make additional payments to ensure that holders receive the amounts they would otherwise have received had no withholding or deduction been required, such a change in taxation law may be regarded as a tax event. Any redemption on account of such a tax event will be subject to all of the conditions applicable to early redemptions within the

jurisdiction. In the example, the contractual additional payments required to make investors whole for withholding taxes or deductions, in effect, represent the adverse impact of the tax change on the issuer.

FAQ8 *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 banks intends to replace it with an instrument issued at a higher credit spread.

FAQ9 *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 standards. 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 a 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 [CAP10.11](14)). 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; or*
- 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.

10.12 The terms and conditions of Additional Tier 1 instruments must include a write-off or conversion provision activated at the option of the relevant authority upon the occurrence of the trigger event (as described in [CAP10.11](16)) unless the following criteria are met. The same criteria apply in the case of the requirement for a write-off or conversion provision in Tier 2 instruments (as described in [CAP10.16](10)):

- (1) the governing jurisdiction of the bank has in place laws that:
 - (a) require such instruments to be written off upon such event, or
 - (b) otherwise require such instruments to fully absorb losses before tax payers are exposed to loss; and
- (2) it is disclosed by the relevant regulator and by the issuing bank, in issuance documents issued on or after 1 January 2013, that such instruments are subject to loss under [CAP10.12](1).

FAQ

FAQ1 *Does the option for loss absorbency at the point of non-viability to be implemented through statutory means release banks from the requirement of [CAP10.11](11) to*

have a contractual principal loss absorption mechanism for Tier 1 instrument classified as liabilities?

No, this option does not release banks from any of the requirements in [CAP].

FAQ2 *What should a bank do if it is unsure whether the governing jurisdiction has the laws in place as set out in [CAP10.12]?*

It should seek guidance from the relevant national authority in its jurisdiction.

FAQ3 *[CAP10.11](16) and [CAP10.12] describe two scenarios. In the latter, the governing jurisdiction of the bank has sufficient powers to write down Additional Tier 1 and Tier 2 instruments. In the former, 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 latter scenario the authorities have the statutory power to enact the conversion/writedown irrespective of the terms and conditions of the instrument. In the former scenario the authorities have the power to enact the conversion/writedown 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 latter scenario, there needs to be disclosure by the relevant regulator and by the issuing bank, in issuance documents going forward. In the former scenario, this needs to be specified in the terms and conditions of the instrument.

10.13 Stock surplus (ie share premium) that is not eligible for inclusion in Common Equity Tier 1, will only be permitted to be included in Additional Tier 1 capital if the shares giving rise to the stock surplus are permitted to be included in Additional Tier 1 capital.

Tier 2 capital

10.14 Tier 2 capital consists of the sum of the following elements:

- (1) instruments issued by the bank that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital);
- (2) stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital;
- (3) instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital. See [CAP10.20] to [CAP10.26] for the relevant criteria;
- (4) certain loan-loss provisions as specified in [CAP10.18] and [CAP10.19]; and
- (5) regulatory adjustments applied in the calculation of Tier 2 capital.

FAQ

FAQ1 *Can subordinated loans be included in regulatory capital?*

Yes. As long as the subordinated loans meet all the criteria required for Additional Tier 1 or Tier 2 capital, banks can include these items in their regulatory capital.

10.15 The treatment of instruments issued out of consolidated subsidiaries of the bank and the regulatory adjustments applied in the calculation of Tier 2 capital are addressed in

separate sections.

10.16 The objective of Tier 2 is to provide loss absorption on a gone-concern basis. Based on this objective, the following criteria must be met or exceeded for an instrument to be included in Tier 2 capital.

- (1) Issued and paid-in
- (2) Subordinated to depositors and general creditors of the bank. In the case of an issue by a holding company, the instrument must be subordinated to all general creditors.
- (3) 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 depositors and general bank creditors
- (4) Maturity:
 - (a) Minimum original maturity of at least five years
 - (b) Recognition in regulatory capital in the remaining five years before maturity will be amortised on a straight line basis.
 - (c) There are no step-ups or other incentives to redeem.
- (5) May be callable at the initiative of the issuer only after a minimum of five years:
 - (a) To exercise a call option a bank must receive prior supervisory approval;
 - (b) A bank must not do anything that creates an expectation that the call will be exercised;¹¹ and
 - (c) Banks must not exercise a call unless:
 - (i) they replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank;¹² or
 - (ii) the bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.¹³
 - (d) The use of tax event and regulatory event calls are permitted within the first five years of a capital instrument, but supervisors will only permit the bank to exercise such a call if in their view the bank was not in a position to anticipate the event at issuance.
- (6) The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.
- (7) The instrument cannot have a credit-sensitive dividend feature, that is a dividend/ coupon that is reset periodically based in whole or in part on the banking organisation's credit standing.
- (8) Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the instrument or the purchase of the instrument.
- (9) If the instrument is not issued out of an operating entity or the holding company in the consolidated group (eg an SPV), proceeds must be immediately available without limitation to a single operating entity¹⁴ or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 capital.
- (10) The terms and conditions must have a provision that requires, at the option of the relevant authority, the instrument to either be written off or converted into common

equity upon the occurrence of a trigger event, unless the laws of the governing jurisdiction meet the criteria in [CAP10.12]. Any compensation paid to instrument holders as a result of a write-off must be paid immediately in the form of common stock (or its equivalent in the case of non-joint stock companies) of either the issuing bank or the parent company of the consolidated group (including any successor in resolution) and must be paid prior to any public sector injection of capital (so that the capital provided by the public sector is not diluted). The issuing bank must maintain at all times all prior authorisation necessary to immediately issue the relevant number of shares specified in the instrument's terms and conditions should the trigger event occur. The trigger event:

(a) is the earlier of:

- (i) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and
- (ii) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority; and

(b) is determined by the jurisdiction in which the capital is being given recognition for regulatory purposes. Therefore, where an issuing bank is part of a wider banking group and the issuing bank wishes the instrument to be included in the consolidated group's capital in addition to its solo capital, the terms and conditions must specify an additional trigger event. This additional trigger event is the earlier of:

- (i) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority in the home jurisdiction; and
- (ii) the decision to make a public sector injection of capital, or equivalent support, in the jurisdiction of the consolidated supervisor, without which the firm receiving the support would have become non-viable, as determined by the relevant authority in that jurisdiction.

Footnotes

[11](#) *An option to call the instrument after five years but prior to the start of the amortisation period will not be viewed as an incentive to redeem as long as the bank does not do anything that creates an expectation that the call will be exercised at this point.*

[12](#) *Replacement issues can be concurrent with but not after the instrument is called.*

[13](#) *Minimum refers to the regulator's prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.*

[14](#) *An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.*

FAQ

FAQ1 *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 takeover 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.

FAQ10 *Regarding the reform of benchmark reference rates, will amendments to the contractual terms of capital instruments that are undertaken to prepare for the transition to the new benchmark rates result in a reassessment of their eligibility as regulatory capital?*

Amendments to the contractual terms of capital instruments could potentially trigger a reassessment of their eligibility as regulatory capital in some jurisdictions. A reassessment could result in an existing capital instrument being treated as a new instrument. This in turn could result in breaching the minimum maturity and call date requirements. Similarly, existing capital instruments issued under Basel II that are being phased out could also fail to meet eligibility requirements if they are treated as new instruments. The Committee confirms that amendments to capital instruments pursued solely for the purpose of implementing benchmark rate reforms will not result in them being treated as new instruments for the purpose of assessing the minimum maturity and call date requirements or affect their eligibility for transitional arrangements of Basel III.

FAQ2 *If a related party of the bank purchases the capital instrument but third-party investors bear all the risks and rewards associated with the instrument and there is no counterparty risk (eg a fund manager or insurance subsidiary invests for the benefit of fund investors or insurance policyholders), does this contravene [CAP10.16](8)?*

The intention of the criterion is to prohibit the inclusion of instruments in capital in cases where the bank retains any of the risk of the instruments. The criterion is not contravened if the third-party investors bear all of the risks.

FAQ3 *Does [CAP10.16](8) require an exclusion from regulatory capital where a bank provides funding to a borrower that purchases the capital instruments of the bank where: (a) the bank has full recourse to the borrower; and (b) the funding was not provided specifically for the purpose of purchasing the capital of the bank (eg it was provided for the purpose of holding a diversified portfolio of investments)?*

No. Banks must ensure full compliance with [CAP10.16](8) in economic terms irrespective of the specific legal features underpinning the transaction.

FAQ4 *Can 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).

FAQ5 *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 writedown / conversion of the instrument in addition to the relevant authority in the jurisdiction of the foreign subsidiary?*

Yes, this is correct.

FAQ6 *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.

FAQ7 *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.

FAQ8 *Assuming compliance with all relevant legal conditions that may exist can the compensation upon the point of non-viability trigger be paid in the form of common shares of the holding company of the bank?*

Yes, national authorities may allow common shares paid as compensation to be those of the bank's holding company. This is permitted because neither the issuance of shares of the bank nor the issuance of shares of the holding company affect the level of common equity created at the bank when the liability represented by the capital instruments is written off. National authorities may require that banks that intend to do this seek the relevant authority's approval before the issuance of such capital instruments.

FAQ9 *A deferred tax liability (DTL) could arise when a bank writes down or writes off an instrument as a result of the principal loss absorption or the non-viability requirement being triggered. Should the amount recognised as regulatory capital, both at the point of issuance and during the life of the instrument, be net of potential deferred tax liabilities that could arise when the instrument is written down or written off?*

Yes. The amount recognised as regulatory capital should be adjusted to account for any DTLs or tax payment resulting from the conversion or writedown or any other foreseeable tax liability or tax payment related to the instruments due at the moment of conversion or writedown or write-off. The adjustment should be made from the point of issuance. Institutions shall assess and justify the amount of any foreseeable tax liabilities or tax payments to the satisfaction of their supervisory authorities, taking into account in particular the local tax treatment and the structure of the group.

Where netting of DTLs against deferred tax assets is allowed, banks should seek guidance from supervisory authorities on the treatment of DTLs associated with the conversion, writedown or write-off of regulatory capital instrument.

10.17 Stock surplus (ie share premium) that is not eligible for inclusion in Tier 1 will only be permitted to be included in Tier 2 capital if the shares giving rise to the stock surplus are permitted to be included in Tier 2 capital.

10.18 Under the standardised approach to credit risk, provisions or loan-loss reserves held against future, presently unidentified losses are freely available to meet losses which subsequently materialise and therefore qualify for inclusion within Tier 2. Provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, should be excluded. Furthermore, general provisions/general loan-loss reserves eligible for inclusion in Tier 2, measured gross of tax effects, will be limited to a maximum of 1.25 percentage points of credit risk-weighted assets (RWA) calculated under the standardised approach.

FAQ

FAQ1 *Should credit valuation adjustment (CVA) RWA and RWA for exposures to central counterparties (CCPs) be included in the computation base to arrive at the amount of provisions eligible for inclusion in Tier 2 capital?*

CCP RWA should be included in the calculation base used to determine the cap on eligible provisions in Tier 2.

Historically, the understanding is that RWA are comprised of the sum of market capital charges multiplied by 12.5 plus credit RWA. Since CCP RWA are not currently included in the market risk framework, by default they are included in credit RWA for purposes of calculating the base to arrive at the amount of provisions eligible for inclusion in Tier 2 capital. On the other hand, CVA RWA are primarily market-driven risks, so should not be included the calculation base.

- 10.19** Under the internal ratings based approach, where the total expected loss amount is less than total eligible provisions (measured gross of tax effects), as explained in [CRE35], banks may recognise the difference in Tier 2 capital up to a maximum of 0.6% of credit risk-weighted assets calculated under the internal ratings-based approach. At national discretion, a limit lower than 0.6% may be applied.

Minority interest (ie non-controlling interest) and other capital issued out of consolidated subsidiaries that is held by third parties

- 10.20** Minority interest arising from the issue of common shares by a fully consolidated subsidiary of the bank may receive recognition in Common Equity Tier 1 only if:
- (1) the instrument giving rise to the minority interest would, if issued by the bank, meet all of the criteria for classification as common shares for regulatory capital purposes; and
 - (2) the subsidiary that issued the instrument is itself a bank.¹⁵¹⁶

Footnotes

¹⁵ *For the purposes of this paragraph, any institution that is subject to the same minimum prudential standards and level of supervision as a bank may be considered to be a bank.*

¹⁶ *Minority interest in a subsidiary that is a bank is strictly excluded from the parent bank's common equity if the parent bank or affiliate has entered into any arrangements to fund directly or indirectly minority investment in the subsidiary whether through an SPV or through another vehicle or arrangement. The treatment outlined above, thus, is strictly available where all minority investments in the bank subsidiary solely represent genuine third party common equity contributions to the subsidiary.*

- 10.21** The amount of minority interest meeting the criteria above that will be recognised in consolidated Common Equity Tier 1 will be calculated as follows:
- (1) Total minority interest meeting the two criteria above minus the amount of the surplus Common Equity Tier 1 of the subsidiary attributable to the minority shareholders.
 - (2) Surplus Common Equity Tier 1 of the subsidiary is calculated as the Common Equity Tier 1 of the subsidiary minus the lower of:
 - (a) the minimum Common Equity Tier 1 requirement of the subsidiary plus the capital conservation buffer (ie 7.0% of consolidated RWA); and
 - (b) the portion of the consolidated minimum Common Equity Tier 1 requirement plus

the capital conservation buffer (ie 7.0% of consolidated RWA) that relates to the subsidiary.

- (3) The amount of the surplus Common Equity Tier 1 that is attributable to the minority shareholders is calculated by multiplying the surplus Common Equity Tier 1 by the percentage of Common Equity Tier 1 that is held by minority shareholders.

FAQ

FAQ1 *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 [CAP99] should be read to include issued common shares plus retained earnings and reserves in Bank S.

FAQ2 *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, [CAP10.21] to [CAP10.26] 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 intragroup 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 [CAP10.20], it should be noted that minority interest is only permitted to be included in 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 [CAP10] (Footnote 15).

10.22 Tier 1 capital instruments issued by a fully consolidated subsidiary of the bank, whether wholly or partly owned, to third-party investors (including amounts under [CAP10.21]) may receive recognition in Tier 1 capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 capital.

10.23 The amount of this capital that will be recognised in Tier 1 will be calculated as follows:

- (1) Total Tier 1 of the subsidiary issued to third parties minus the amount of the surplus Tier 1 of the subsidiary attributable to the third-party investors.
- (2) Surplus Tier 1 of the subsidiary is calculated as the Tier 1 of the subsidiary minus the lower of:
 - (a) the minimum Tier 1 requirement of the subsidiary plus the capital conservation buffer (ie 8.5% of RWA); and
 - (b) the portion of the consolidated minimum Tier 1 requirement plus the capital conservation buffer (ie 8.5% of consolidated RWA) that relates to the subsidiary.
- (3) The amount of the surplus Tier 1 that is attributable to the third party investors is calculated by multiplying the surplus Tier 1 by the percentage of Tier 1 that is held by

third-party investors.

- (4) The amount of this Tier 1 capital that will be recognised in Additional Tier 1 will exclude amounts recognised in Common Equity Tier 1 under [CAP10.21].

FAQ

FAQ1 *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, [CAP10.21] to [CAP10.26] 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 [CAP10.20], it should be noted that minority interest is only permitted to be included in 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 [CAP10] (Footnote 15).

10.24 Total capital instruments (ie Tier 1 and Tier 2 capital instruments) issued by a fully consolidated subsidiary of the bank, whether wholly or partly owned, to third-party investors (including amounts under [CAP10.21] to [CAP10.23]) may receive recognition in Total Capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 or Tier 2 capital.

10.25 The amount of this capital that will be recognised in consolidated Total Capital will be calculated as follows:

- (1) Total capital instruments of the subsidiary issued to third parties minus the amount of the surplus Total Capital of the subsidiary attributable to the third-party investors.
- (2) Surplus Total Capital of the subsidiary is calculated as the Total Capital of the subsidiary minus the lower of:
 - (a) the minimum Total Capital requirement of the subsidiary plus the capital conservation buffer (ie 10.5% of RWA); and
 - (b) the portion of the consolidated minimum Total Capital requirement plus the capital conservation buffer (ie 10.5% of consolidated RWA) that relates to the subsidiary.
- (3) The amount of the surplus Total Capital that is attributable to the third-party investors is calculated by multiplying the surplus Total Capital by the percentage of Total Capital that is held by third-party investors.
- (4) The amount of this Total Capital that will be recognised in Tier 2 will exclude amounts recognised in Common Equity Tier 1 under [CAP10.21] and amounts recognised in Additional Tier 1 under [CAP10.23].

FAQ

FAQ1 Consider the case where the Common Equity Tier 1 and Additional Tier 1 capital of a subsidiary are sufficient to cover the minimum total capital requirement of the subsidiary. For example, assume the minimum total capital requirements of the subsidiary is 15, the sum of Common Equity Tier 1 and Additional Tier 1 is 15 and the Common Equity Tier 1 and Additional Tier 1 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?

This treatment is set out in [CAP10.25]. 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 $5/20 \times 100\%$). Therefore, the amount of the surplus total capital that is attributable to third-party investors is 1.25 ($= 5 \times 25\%$). 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 Tier 2 capital.

FAQ2 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, [CAP10.21] to [CAP10.26] 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 intragroup 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 [CAP10.20], it should be noted that minority interest is only permitted to be included in 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 [CAP10] (Footnote 15).

10.26 Where capital has been issued to third parties out of an SPV, none of this capital can be included in Common Equity Tier 1. However, such capital can be included in consolidated Additional Tier 1 or Tier 2 and treated as if the bank itself had issued the capital directly to the third parties only if it meets all the relevant entry criteria and the only asset of the SPV is its investment in the capital of the bank in a form that meets or exceeds all the relevant entry criteria¹⁷ (as required by [CAP10.11](15) for Additional Tier 1 and [CAP10.16](9) for Tier 2). In cases where the capital has been issued to third parties through an SPV via a fully consolidated subsidiary of the bank, such capital may, subject to the requirements of this paragraph, be treated as if the subsidiary itself had issued it directly to the third parties and may be included in the bank's consolidated Additional Tier 1 or Tier 2 in accordance with the treatment outlined in [CAP10.23] to [CAP10.26].

Footnotes

¹⁷ Assets that relate to the operation of the SPV may be excluded from this assessment if they are de minimis.

FAQ

FAQ1 *Does the Committee have any further guidance on the definition of SPVs? Are SPVs referred to in [CAP10.26] those which are consolidated under international financial reporting standards (IFRS) or all SPVs?*

Guidance should be sought from national supervisors. SPVs referred to in [CAP10.26] refer to all SPVs irrespective of whether they are consolidated under IFRS or other applicable accounting standards.

FAQ2 *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, [CAP10.21] to [CAP10.26] 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 intragroup 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 [CAP10.20], it should be noted that minority interest is only permitted to be included in 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 [CAP10] (Footnote 15).

CAP30

Regulatory adjustments

First version in the format of the consolidated framework.

Version effective as of 15 Dec 2019

First version in the format of the consolidated framework.

Introduction

30.1 This section sets out the regulatory adjustments to be applied to regulatory capital. In most cases these adjustments are applied in the calculation of Common Equity Tier 1.

30.2 Global systemically important banks (G-SIBs) are required to meet a minimum total loss-absorbing capacity (TLAC) requirement set in accordance with the Financial Stability Board's (FSB) TLAC principles and term sheet. The criteria for an instrument to be recognised as TLAC by the issuing G-SIB are set out in the FSB's TLAC Term Sheet. Bank that invest in TLAC or similar instruments may be required to deduct them in the calculation of their own regulatory capital.¹

Footnotes

¹ *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution, Total Loss-absorbing Capacity (TLAC) Term Sheet, Financial Stability Board, November 2015, available at www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf. The regulatory adjustments for TLAC set out in [CAP30] relate to Section 15 of the FSB TLAC Term Sheet.*

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

- (1) All direct, indirect and synthetic investments in the instruments of a G-SIB resolution entity that are eligible to be recognised as external TLAC but that do not otherwise qualify as regulatory capital² for the issuing G-SIB, with the exception of instruments excluded by [CAP30.4]; and
- (2) All holdings of instruments issued by a G-SIB resolution entity that rank pari passu to any instruments included in [CAP30.3](1), with the exceptions of:
 - (a) instruments listed as liabilities excluded from TLAC in Section 10 of the FSB TLAC Term Sheet ("Excluded Liabilities"); and
 - (b) instruments ranking pari passu with instruments eligible to be recognised as TLAC by virtue of the exemptions to the subordination requirements in Section 11 of the FSB TLAC Term Sheet.

Footnotes

² *Holdings of regulatory capital and other TLAC liabilities should reflect the investing bank's actual exposure to the issuer as regulatory capital or TLAC (ie it is not reduced by amortisation, derecognition or transitional arrangements). This means that Tier 2 instruments that no longer count in full as regulatory capital (as a result of having a residual maturity of less than five years) continue to be recognised in full as a Tier 2 instrument by the investing bank for the regulatory adjustments in this section. Similarly, holdings of other TLAC liabilities in the final year of maturity are still subject to the regulatory adjustments in this chapter even when such instruments no longer receive any recognition in TLAC for the issuer.*

30.4 In certain jurisdictions, G-SIBs may be able to recognise instruments ranking pari passu to Excluded Liabilities as external TLAC up to a limit, in accordance with the exemptions to the subordination requirements set out in the penultimate paragraph of Section 11 of the FSB TLAC Term Sheet. A bank's holdings of such instruments will be subject to a proportionate deduction approach. Under this approach, only a proportion of holdings of instruments that are eligible to be recognised as external TLAC by virtue of the subordination exemptions will be considered a holding of TLAC by the investing bank. The proportion is calculated as:

- (1) the funding issued by the G-SIB resolution entity that ranks pari passu with Excluded

Liabilities and that is recognised as external TLAC by the G-SIB resolution entity; divided by

- (2) the funding issued by the G-SIB resolution entity that ranks pari passu with Excluded Liabilities and that would be recognised as external TLAC if the subordination requirement was not applied.³

Footnotes

³ For example, if a G-SIB resolution entity has funding that ranks pari passu with Excluded Liabilities equal to 5% of risk-weighted assets (RWA) and receives partial recognition of these instruments as external TLAC equivalent to 3.5% of RWA, then an investing bank holding such instruments must include only 70% (= 3.5 / 5) of such instruments in calculating its TLAC holdings. The same proportion should be applied by the investing bank to any indirect or synthetic investments in instruments ranking pari passu with Excluded Liabilities and eligible to be recognised as TLAC by virtue of the subordination exemptions.

- 30.5** Under the proportionate deduction approach, banks must calculate their holdings of other TLAC liabilities of the respective issuing G-SIB resolution entities based on the latest available public information provided by the issuing G-SIBs on the proportion to be used.

- 30.6** The regulatory adjustments relating to TLAC in [CAP30.18] to [CAP30.31] apply to holdings of TLAC issued by G-SIBs from the date at which the issuing G-SIB becomes subject to a minimum TLAC requirement.⁴

Footnotes

⁴ The conformance period is set out in Section 21 of the FSB TLAC Term Sheet. In summary, firms that have been designated as G-SIBs before end-2015 and continue to be designated thereafter, with the exception of such firms headquartered in an emerging market economy, must meet the TLAC requirements from 1 January 2019. For firms headquartered in emerging market economies, the requirements will apply from 1 January 2025 at the latest; this may be accelerated in certain circumstances.

Goodwill and other intangibles (except mortgage servicing rights)

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

FAQ

FAQ1 Must 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 and accounted for using the equity method also be deducted?

Yes. Under the equity method, the carrying amount of the investment includes any goodwill. In line with [CAP30.7] 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.

FAQ2 *Most intangible assets are deducted from regulatory capital, while tangible assets generally are not. Is the lessee's recognised asset under the new lease accounting standards (the right-of-use, or ROU, asset) an asset that is tangible or intangible?*

For regulatory capital purposes, an ROU asset should not be deducted from regulatory capital so long as the underlying asset being leased is a tangible asset.

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

Deferred tax assets

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

FAQ

FAQ1 *Regarding the deduction of DTAs, 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.

FAQ2 *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.

FAQ3 *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.

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

Cash flow hedge reserve

- 30.11** The amount of the cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) should be derecognised in the calculation of Common Equity Tier 1. This means that positive amounts should be deducted and negative amounts should be added back.
- 30.12** This treatment specifically identifies the element of the cash flow hedge reserve that is to be derecognised for prudential purposes. It removes the element that gives rise to artificial volatility in common equity, as in this case the reserve only reflects one half of the picture (the fair value of the derivative, but not the changes in fair value of the hedged future cash flow).

Shortfall of the stock of provisions to expected losses

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

Gain on sale related to securitisation transactions

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

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

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

Defined benefit pension fund assets and liabilities

- 30.16** Defined benefit pension fund liabilities, as included on the balance sheet, must be fully recognised in the calculation of Common Equity Tier 1 (ie Common Equity Tier 1 cannot be increased through derecognising these liabilities). For each defined benefit pension fund that is an asset on the balance sheet, the net asset on the balance sheet in respect of the

plan or fund should be deducted in the calculation of Common Equity Tier 1 net of any associated deferred tax liability which would be extinguished if the asset should become impaired or derecognised under the relevant accounting standards. Assets in the fund to which the bank has unrestricted and unfettered access can, with supervisory approval, offset the deduction. Such offsetting assets should be given the risk weight they would receive if they were owned directly by the bank.

FAQ

FAQ1 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.

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

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

- 30.18** All of a bank's investments in its own common shares, whether held directly or indirectly, will be deducted in the calculation of Common Equity Tier 1 (unless already derecognised under the relevant accounting standards). In addition, any own stock which the bank could be contractually obliged to purchase should be deducted in the calculation of Common Equity Tier 1. The treatment described will apply irrespective of the location of the exposure in the banking book or the trading book. In addition:

- (1) Gross long positions may be deducted net of short positions in the same underlying exposure only if the short positions involve no counterparty risk.
- (2) Banks should look through holdings of index securities to deduct exposures to own shares. However, gross long positions in own shares resulting from holdings of index securities may be netted against short position in own shares resulting from short positions in the same underlying index. In such cases the short positions may involve counterparty risk (which will be subject to the relevant counterparty credit risk charge).
- (3) Subject to supervisory approval, a bank may use a conservative estimate of investments in its own shares where the exposure results from holdings of index securities and the bank finds it operationally burdensome to look through and monitor its exact exposure.

FAQ

FAQ1 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 known in advance. It was not intended to capture all potential contracts that a bank may enter to in the future.

FAQ2 *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.

FAQ3 *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?*

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.

30.19 This deduction is necessary to avoid the double-counting of a bank's own capital. Certain accounting regimes do not permit the recognition of treasury stock and so this deduction is only relevant where recognition on the balance sheet is permitted. The treatment seeks to remove the double-counting that arises from direct holdings, indirect holdings via index funds and potential future holdings as a result of contractual obligations to purchase own shares.

30.20 Following the same approach outlined above, banks must deduct investments in their own Additional Tier 1 in the calculation of their Additional Tier 1 capital and must deduct investments in their own Tier 2 in the calculation of their Tier 2 capital. G-SIB resolution entities must deduct holdings of their own other TLAC liabilities in the calculation of their TLAC resources. If a bank is required to make a deduction from a particular tier of capital and it does not have enough of that tier of capital to satisfy that deduction, then the shortfall will be deducted from the next higher tier of capital. In the case of insufficient TLAC resources, then the holdings will be deducted from Tier 2.

FAQ

FAQ1 *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 known in advance. It was not intended to capture all potential contracts that a bank may enter to in the future.

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

30.21 Reciprocal cross-holdings of capital that are designed to artificially inflate the capital position of banks will be deducted in full. Banks must apply a “corresponding deduction approach” to such investments in the capital of other banks, other financial institutions and insurance entities. This means the deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself. Reciprocal cross-holdings of other TLAC liabilities that are designed to artificially inflate the TLAC position of G-SIBs must be deducted in full from Tier 2 capital.

FAQ

FAQ1 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.

FAQ2 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 type 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.

FAQ3 How should exposures to the capital of other financial institutions be valued for the purpose of determining the amount of 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 exposures captured represents the loss to Common Equity Tier 1 that the bank would suffer if the capital of the financial institution is written-off.

FAQ4 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 [CAP90.1] to [CAP90.3]. 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 that they hold to calculate the amount to be subject to the deduction treatment set out in [CAP30.21] to [CAP30.30]. 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 [CAP90.1] to [CAP90.3]. In this case the investing bank must apply the corresponding deduction approach set out in [CAP30.21] to [CAP30.30] on the basis that it has an investment of 100 in Additional Tier 1 instruments.

Investments in the capital or other TLAC liabilities of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity

- 30.22** The regulatory adjustment described in this section applies to investments in the capital or other TLAC liabilities of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity. These investments are deducted from regulatory capital, subject to a threshold. For the purpose of this regulatory adjustment:
- (1) Investments include direct, indirect⁵ and synthetic holdings of capital instruments or other TLAC liabilities. For example, banks should look through holdings of index securities to determine their underlying holdings of capital or other TLAC liabilities.⁶
 - (2) Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (eg subordinated debt). Other TLAC liabilities are defined in [CAP30.3] and [CAP30.4].
 - (3) For capital instruments, it is the net long position that is to be included (ie the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year). Banks are also permitted to net gross long positions arising through holdings of index securities against short positions in the same underlying index, as long as the maturity of the short position matches the maturity of the long position or has residual maturity of at least a year. For other TLAC liabilities, it is the gross long position in [CAP30.23], [CAP30.24] and [CAP30.25] and the net long position that is to be included in [CAP30.26].
 - (4) Underwriting positions in capital instruments or other TLAC liabilities held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included.
 - (5) If the capital instrument of the entity in which the bank has invested does not meet the criteria for Common Equity Tier 1, Additional Tier 1, or Tier 2 capital of the bank, the capital is to be considered common shares for the purposes of this regulatory adjustment.⁷
 - (6) National discretion applies to allow banks, with prior supervisory approval, to exclude temporarily certain investments where these have been made in the context of resolving or providing financial assistance to reorganise a distressed institution.

Footnotes

- ⁵ *Indirect holdings are exposures or parts of exposures that, if a direct holding loses its value, will result in a loss to the bank substantially equivalent to the loss in value of the direct holding.*
- ⁶ *If banks find it operationally burdensome to look through and monitor their exact exposure to the capital or other TLAC liabilities of other financial institutions as a result of their holdings of index securities, national authorities may permit banks, subject to prior supervisory approval, to use a conservative estimate. The methodology should demonstrate that in no case will the actual exposure be higher than the estimated exposure.*
- ⁷ *If the investment is issued out of a regulated financial entity and not included in regulatory capital in the relevant sector of the financial entity, it is not required to be deducted.*

FAQ

- FAQ1** *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.

FAQ2 *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 type 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.

FAQ3 *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 [CAP30.22] to [CAP30.28].

FAQ4 *How should exposures to the capital of other financial institutions be valued for the purpose of determining the amount of 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 exposures captured represents the loss to Common Equity Tier 1 that the bank would suffer if the capital of the financial institution is written-off.

FAQ5 *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: (i) both the exposure being hedged and the short position in the index are held in the trading book; (ii) the positions are fair valued on the bank's balance sheet; and (iii) the hedge is recognised as effective under the bank's internal control processes assessed by supervisors.

FAQ6 *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.

FAQ7 Does the five working day exemption for underwriting positions begin on the day the payment is made by the underwriter to the issuing bank?

[CAP30.22] relates to deductions of investments in other financial institutions, where the underlying policy rationale is to remove the double counting of capital that exists when such investments are made. When a bank underwrites the issuance of capital by another bank, the bank issuing capital will only receive recognition for this capital when the underwriter makes the payment to the issuing bank to purchase the capital instruments. As such, the underwriting bank need not include the (committed) purchase within "investments in the capital of other financial institutions" prior to the day on which payment is made by the underwriting bank to the issuing bank. The five day underwriting exemption begins on the date on which this payment is made and effectively permits five working days where double counting can exist before the exposure must be subject to the deduction treatment outlined in [CAP30.22].

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

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

30.24 If a holding designated under [CAP30.23] no longer meets any of the conditions set out in that paragraph, it must be deducted in full from Tier 2 capital. Once a holding has been designated under [CAP30.23], it may not subsequently be included within the 10% threshold referred to in [CAP30.26]. This approach is designed to limit the use of the 5% threshold in [CAP30.23] to holdings of TLAC instruments needed to be held within the banking system to ensure deep and liquid markets.

30.25 If a bank is not a G-SIB, its holdings of other TLAC liabilities must be deducted from Tier 2 capital resources, unless:

- (1) such holdings are, in aggregate and on a gross long basis, less than 5% of the bank's common equity (after applying all other regulatory adjustments listed in full prior to [CAP30.22]); or
- (2) the holdings fall within the 10% threshold provided in [CAP30.26].

30.26 If the total of all holdings of capital instruments and other TLAC liabilities, as listed in [CAP30.22] and not covered by the 5% threshold described in [CAP30.23] and [CAP30.24] (for G-SIBs) or [CAP30.25] (for non-G-SIBs), in aggregate and on a net long basis exceed 10% of the bank's common equity (after applying all other regulatory adjustments in full listed prior to [CAP30.22]) then the amount above 10% is required to be deducted. In the case of capital instruments, deduction should be made applying a corresponding deduction approach. This means the deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself. In the case of holdings of other TLAC liabilities, the deduction should be applied to Tier 2 capital. Accordingly, the amount to be deducted from common equity should be calculated as the

total of all holdings of capital instruments and those holdings of other TLAC liabilities not covered by [CAP30.23] and [CAP30.24] or [CAP30.25] which in aggregate exceed 10% of the bank's common equity (as per above) multiplied by the common equity holdings as a percentage of the total holdings of capital instruments and other TLAC liabilities not covered by [CAP30.23] and [CAP30.24] or [CAP30.25]. This would result in a common equity deduction which corresponds to the proportion of the holdings held in common equity. Similarly, the amount to be deducted from Additional Tier 1 capital should be calculated as the total of all holdings of capital instruments and other TLAC liabilities not covered by [CAP30.23] and [CAP30.24] or [CAP30.25] which in aggregate exceed 10% of the bank's common equity (as per above) multiplied by the Additional Tier 1 capital holdings as a percentage of the total. The amount to be deducted from Tier 2 capital should be calculated as the total of all holdings of capital instruments and other TLAC liabilities not covered by [CAP30.23] and [CAP30.24] or [CAP30.25] which in aggregate exceed 10% of the bank's common equity (as per above) multiplied by holdings of the Tier 2 capital and other TLAC liabilities as a percentage of the total.

FAQ

FAQ1 *In many jurisdictions the entry criteria for capital issue 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.

FAQ2 *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 www.bis.org/bcbs/qis/index.htm.

FAQ3 *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 [CAP90.1] to [CAP90.3]. 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 that they hold to calculate the amount to be subject to the deduction treatment set out in [CAP30.21] to [CAP30.30]. 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 [CAP90.1] to [CAP90.3]. In this

case the investing bank must apply the corresponding deduction approach set out in [CAP30.21] to [CAP30.30] on the basis that it has an investment of 100 in Additional Tier 1 instruments.

30.27 If a bank is required to make a deduction from a particular tier of capital and it does not have enough of that tier of capital to satisfy that deduction, the shortfall will be deducted from the next higher tier of capital (eg if a bank does not have enough Additional Tier 1 capital to satisfy the deduction, the shortfall will be deducted from Common Equity Tier 1).

30.28 Amounts that are not deducted will continue to be risk weighted. Thus, instruments in the trading book will be treated as per the market risk rules and instruments in the banking book should be treated as per the IRB approach or the standardised approach (as applicable). For the application of risk weighting the amount of the holdings must be allocated on a pro rata basis between those below and those above the threshold.

FAQ

FAQ1 Can the Committee confirm that where positions are deducted from capital they should not also contribute to risk-weighted assets (RWA)? 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 calculations RWA 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 hedged long and short position can be, but does not have to be, excluded from the market risk calculations.

Significant investments in the capital or other TLAC liabilities of banking, financial and insurance entities that are outside the scope of regulatory consolidation

30.29 The regulatory adjustment described in this section applies to investments in the capital or other TLAC liabilities of banking, financial and insurance entities that are outside the scope of regulatory consolidation⁸ where the bank owns more than 10% of the issued common share capital of the issuing entity or where the entity is an affiliate⁹ of the bank. In addition:

- (1) Investments include direct, indirect and synthetic holdings of capital instruments or other TLAC liabilities. For example, banks should look through holdings of index securities to determine their underlying holdings of capital or other TLAC liabilities.¹⁰
- (2) Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (eg subordinated debt). Other TLAC liabilities are defined in [CAP30.3] to [CAP30.4]. It is the net long position that is to be included (ie the gross long position net of short positions in the same underlying exposure where the maturity of the short position

either matches the maturity of the long position or has a residual maturity of at least one year). Banks are also permitted to net gross long positions arising through holdings of index securities against short positions in the same underlying index, as long as the maturity of the short position matches the maturity of the long position or has residual maturity of at least a year.

- (3) Underwriting positions in capital instruments or other TLAC liabilities held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included.
- (4) If the capital instrument of the entity in which the bank has invested does not meet the criteria for Common Equity Tier 1, Additional Tier 1, or Tier 2 capital of the bank, the capital is to be considered common shares for the purposes of this regulatory adjustment.¹¹
- (5) National discretion applies to allow banks, with prior supervisory approval, to exclude temporarily certain investments where these have been made in the context of resolving or providing financial assistance to reorganise a distressed institution.

Footnotes

¹⁰ *If a bank finds it operationally burdensome to look through and monitor their exact exposure to the capital or other TLAC liabilities of other financial institutions as a result of their holdings of index securities, national authorities may permit banks, subject to prior supervisory approval, to use a conservative estimate.*

¹¹ *If the investment is issued out of a regulated financial entity and not included in regulatory capital in the relevant sector of the financial entity, it is not required to be deducted.*

⁸ *Investments in entities that are outside of the scope of regulatory consolidation refers to investments in entities that have not been consolidated at all or have not been consolidated in such a way as to result in their assets being included in the calculation of consolidated risk-weighted assets of the group.*

⁹ *An affiliate of a bank is defined as a company that controls, or is controlled by, or is under common control with, the bank. Control of a company is defined as (1) ownership, control, or holding with power to vote 20% or more of a class of voting securities of the company; or (2) consolidation of the company for financial reporting purposes.*

FAQ

FAQ1 *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.

FAQ2 *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 type 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.

FAQ3 *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 [CAP30.29] to [CAP30.31].

FAQ4 *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 [CAP30.28] to [CAP30.34]?*

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.

FAQ5 *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: (i) both the exposure being hedged and the short position in the index are held in the trading book; (ii) the positions are fair valued on the bank's balance sheet; and (iii) the hedge is recognised as effective under the bank's internal control processes assessed by supervisors.

FAQ6 *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.

- 30.30** All investments in capital instruments included above that are not common shares must be fully deducted following a corresponding deduction approach. This means the deduction should be applied to the same tier of capital for which the capital would qualify if it was issued by the bank itself. All holdings of other TLAC liabilities included above (and as defined in [CAP30.3] to [CAP30.5] ie applying the proportionate deduction approach for holdings of instruments eligible for TLAC by virtue of the penultimate paragraph of Section 11 of the FSB TLAC Term Sheet) must be fully deducted from Tier 2 capital. If the bank is required to make a deduction from a particular tier of capital and it does not have enough of that tier of capital to satisfy that deduction, the shortfall will be deducted from the next higher tier of capital (eg if a bank does not have enough Additional Tier 1 capital to satisfy the deduction, the shortfall will be deducted from Common Equity Tier 1).

FAQ

FAQ1 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.

FAQ2 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 [CAP90.1] to [CAP90.3]. 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 that they hold to calculate the amount to be subject to the deduction treatment set out in [CAP30.20] to [CAP30.29]. 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 [CAP90.1] to [CAP90.3]. In this case the investing bank must apply the corresponding deduction approach set out in [CAP30.20] to [CAP30.29] on the basis that it has an investment of 100 in Additional Tier 1 instruments.

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

Threshold deductions

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

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

FAQ

FAQ1 *What is the definition of a financial institution?*

The definition is determined by national guidance / regulation at present.

FAQ2 *How should exposures to the capital of other financial institutions be valued for the purpose of determining the amount of 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 exposures captured represents the loss to Common Equity Tier 1 that the bank would suffer if the capital of the financial institution is written off.

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

FAQ

FAQ1 *This FAQ is meant to clarify the calculation of the 15% limit on significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities); mortgage servicing rights, and DTAs arising from temporary differences (collectively referred to as specified items).*

The recognition of these specified items will be limited to 15% of Common Equity Tier 1 capital, after the application of all deductions. To determine the maximum amount of the specified items that can be recognised, banks and supervisors should multiply the amount of Common Equity Tier 1** (after all deductions, including after the deduction of the specified items in full) by 17.65%. This number is derived from the proportion of 15% to 85% (ie $15\%/85\% = 17.65\%$).*

As an example, take a bank with €85 of common equity (calculated net of all deductions, including after the deduction of the specified items in full). The maximum amount of specified items that can be recognised by this bank in its calculation of Common Equity Tier 1 capital is $€85 \times 17.65\% = €15$. Any excess above €15 must be deducted from Common Equity Tier 1. If the bank has specified items (excluding amounts deducted after applying the individual 10% limits) that in aggregate sum up to the 15% limit, Common Equity Tier 1 after inclusion of the specified items, will amount to $€85 + €15 = €100$. The percentage of specified items to total Common Equity Tier 1 would equal 15%.

** The actual amount that will be recognised may be lower than this maximum, either because the sum of the three specified items are below the 15% limit set out in this annex, or due to the application of the 10% limit applied to each item.*

*** At this point this is a "hypothetical" amount of Common Equity Tier 1 in that it is used only for the purposes of determining the deduction of the specified items.*

- 30.34** The amount of the three items that are not deducted in the calculation of Common Equity Tier 1 will be risk weighted at 250%.

FAQ

FAQ1 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.

CAP50

Prudent valuation guidance

First version in the format of the consolidated framework.

Version effective as of 15 Dec 2019

First version in the format of the consolidated framework.

Introduction

- 50.1** This section provides banks with guidance on prudent valuation for positions that are accounted for at fair value, whether they are in the trading book or in the banking book. This guidance is especially important for positions without actual market prices or observable inputs to valuation, as well as less liquid positions which raise supervisory concerns about prudent valuation. The valuation guidance set forth below is not intended to require banks to change valuation procedures for financial reporting purposes. Supervisors should assess a bank's valuation procedures for consistency with this guidance. One fact in a supervisor's assessment of whether a bank must take a valuation adjustment for regulatory purposes under [CAP50.11] to [CAP50.14] should be the degree of consistency between the bank's valuation procedures and these guidelines.
- 50.2** A framework for prudent valuation practices should at a minimum include the following.

Systems and controls

- 50.3** Banks must establish and maintain adequate systems and controls sufficient to give management and supervisors the confidence that their valuation estimates are prudent and reliable. These systems must be integrated with other risk management systems within the organisation (such as credit analysis). Such systems must include:
- (1) Documented policies and procedures for the process of valuation. This includes clearly defined responsibilities of the various areas involved in the determination of the valuation, sources of market information and review of their appropriateness, guidelines for the use of unobservable inputs reflecting the bank's assumptions of what market participants would use in pricing the position, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, end of the month and ad-hoc verification procedures; and
 - (2) Clear and independent (ie independent of front office) reporting lines for the department accountable for the valuation process. The reporting line should ultimately be to a main board executive director.

Valuation methodologies

Marking to market

- 50.4** Marking-to-market is at least the daily valuation of positions at readily available close out prices that are sourced independently. Examples of readily available close out prices include exchange prices, screen prices, or quotes from several independent reputable brokers.
- 50.5** Banks must mark-to-market as much as possible. The more prudent side of bid/offer should be used unless the institution is a significant market-maker in a particular position type and it can close out at mid-market. Banks should maximise the use of relevant observable inputs and minimise the use of unobservable inputs when estimating fair value using a valuation technique. However, observable inputs or transactions may not be relevant, such as in a forced liquidation or distressed sale, or transactions may not be observable, such as when markets are inactive. In such cases, the observable data should be considered, but may not be determinative.

Marking to model

- 50.6** Only where marking-to-market is not possible should banks mark-to-model, but this must be demonstrated to be prudent. Marking-to-model is defined as any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input. When marking

to model, an extra degree of conservatism is appropriate. Supervisory authorities will consider the following in assessing whether a mark-to-model valuation is prudent:

- (1) Senior management should be aware of the elements of the trading book or other fair-valued positions which are subject to mark to model and should understand the materiality of the uncertainty this creates in the reporting of the risk/performance of the business.
- (2) Market inputs should be sourced, to the extent possible, in line with market prices (as discussed above). The appropriateness of the market inputs for the particular position being valued should be reviewed regularly.
- (3) Where available, generally accepted valuation methodologies for particular products should be used as far as possible.
- (4) Where the model is developed by the institution itself, it should be based on appropriate assumptions, which have been assessed and challenged by suitably qualified parties independent of the development process. The model should be developed or approved independently of the front office. It should be independently tested. This includes validating the mathematics, the assumptions and the software implementation.
- (5) There should be formal change control procedures in place and a secure copy of the model should be held and periodically used to check valuations.
- (6) Risk management should be aware of the weaknesses of the models used and how best to reflect those in the valuation output.
- (7) The model should be subject to periodic review to determine the accuracy of its performance (eg assessing continued appropriateness of the assumptions, analysis of profit and loss versus risk factors, comparison of actual close out values to model outputs).
- (8) Valuation adjustments should be made as appropriate, for example, to cover the uncertainty of the model valuation (see also valuation adjustments in [CAP50.9] to [CAP50.14]).

Independent price verification

50.7 Independent price verification is distinct from daily mark-to-market. It is the process by which market prices or model inputs are regularly verified for accuracy. While daily marking-to-market may be performed by dealers, verification of market prices or model inputs should be performed by a unit independent of the dealing room, at least monthly (or, depending on the nature of the market/trading activity, more frequently). It need not be performed as frequently as daily mark-to-market, since the objective, ie independent, marking of positions, should reveal any error or bias in pricing, which should result in the elimination of inaccurate daily marks.

50.8 Independent price verification entails a higher standard of accuracy in that the market prices or model inputs are used to determine profit and loss figures, whereas daily marks are used primarily for management reporting in between reporting dates. For independent price verification, where pricing sources are more subjective, eg only one available broker quote, prudent measures such as valuation adjustments may be appropriate.

Valuation adjustments

50.9 As part of their procedures for marking to market, banks must establish and maintain procedures for considering valuation adjustments. Supervisory authorities expect banks

using third-party valuations to consider whether valuation adjustments are necessary. Such considerations are also necessary when marking to model.

- 50.10** Supervisory authorities expect the following valuation adjustments/reserves to be formally considered at a minimum: unearned credit spreads, close-out costs, operational risks, early termination, investing and funding costs, and future administrative costs and, where appropriate, model risk.

FAQ

FAQ1 Should valuation adjustments be performed on a portfolio level (ie adjustments to be made in the form of a reserve for a portfolio of exposures and not to be reflected in the valuation of the individual transactions) or on a transaction level (ie adjustments to be reflected in the valuation of the individual transactions)?

Supervisors expect that the valuation adjustment will be considered for positions individually.

Adjustment to the current valuation of less liquid positions for regulatory capital purposes

- 50.11** Banks must establish and maintain procedures for judging the necessity of and calculating an adjustment to the current valuation of less liquid positions for regulatory capital purposes. This adjustment may be in addition to any changes to the value of the position required for financial reporting purposes and should be designed to reflect the illiquidity of the position. Supervisory authorities expect banks to consider the need for an adjustment to a position's valuation to reflect current illiquidity whether the position is marked to market using market prices or observable inputs, third-party valuations or marked to model.
- 50.12** Bearing in mind that the assumptions made about liquidity in the market risk capital requirement may not be consistent with the bank's ability to sell or hedge out less liquid positions, where appropriate, banks must take an adjustment to the current valuation of these positions, and review their continued appropriateness on an on-going basis. Reduced liquidity may have arisen from market events. Additionally, close-out prices for concentrated positions and/or stale positions should be considered in establishing the adjustment. Banks must consider all relevant factors when determining the appropriateness of the adjustment for less liquid positions. These factors may include, but are not limited to, the amount of time it would take to hedge out the position/risks within the position, the average volatility of bid/offer spreads, the availability of independent market quotes (number and identity of market-makers), the average and volatility of trading volumes (including trading volumes during periods of market stress), market concentrations, the ageing of positions, the extent to which valuation relies on marking-to-model, and the impact of other model risks not included in [CAP50.11].
- 50.13** For complex products including, but not limited to, securitisation exposures and n-th-to-default credit derivatives, banks must explicitly assess the need for valuation adjustments to reflect two forms of model risk: the model risk associated with using a possibly incorrect valuation methodology; and the risk associated with using unobservable (and possibly incorrect) calibration parameters in the valuation model.
- 50.14** The adjustment to the current valuation of less liquid positions made under [CAP50.12] must impact Tier 1 regulatory capital and may exceed those valuation adjustments made under financial reporting standards and [CAP50.9] and [CAP50.10].

CAP90

Transitional arrangements

Amended transitional arrangements for the regulatory capital treatment of ECL accounting as set out in the 3 April 2020 publication.

Version effective as of 03 Apr 2020

Amended transitional arrangements for the regulatory capital treatment of ECL accounting as set out in the 3 April 2020 publication.

Transitional arrangements for certain capital instruments

90.1 Capital instruments that no longer qualify as non-common equity Tier 1 or Tier 2 capital are phased out beginning 1 January 2013. Fixing the base at the nominal amount of such instruments outstanding on 1 January 2013, their recognition is capped at 90% from 1 January 2013, with the cap reducing by 10 percentage points in each subsequent year.

90.2 This cap is applied to Additional Tier 1 and Tier 2 separately and refers to the total amount of instruments outstanding that no longer meet the relevant entry criteria. To the extent an instrument is redeemed, or its recognition in capital is amortised, after 1 January 2013, the nominal amount serving as the base is not reduced.

FAQ

FAQ1 *If a Tier 2 instrument eligible for transitional arrangements begins its final five-year amortisation period prior to 1 January 2013, does it carry on amortising at a rate of 20% per annum after 1 January 2013?*

Individual instruments continue to be amortised at a rate of 20% per year while the aggregate cap is reduced at a rate of 10% per year.

FAQ2 *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?*

[CAP90.1] states that, “Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital are phased out beginning 1 January 2013. Fixing the base at the nominal amount of such instruments outstanding on 1 January 2013, their recognition is 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. 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 point-of-non-viability requirements in [CAP10.11](16) will not be permitted to be “cascaded” into Tier 2, as Tier 2 is required to meet the point-of-non-viability requirements in [CAP10.16](10).

FAQ3 *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 [CAP90.1] and [CAP90.2]?*

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.

FAQ4 *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 transitional arrangements?*

For Tier 2 instruments that have begun to amortise before 1 January 2013, the base for transitional arrangements should take into account the amortised amount, not the full nominal amount.

FAQ5 *What happens to share premium (stock surplus) associated with instruments eligible for the transitional arrangements?*

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.

FAQ6 *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 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, are subject to the cap.

90.3 In addition, instruments with an incentive to be redeemed are treated as follows:

- (1) For an instrument that has a call and a step-up prior to 1 January 2013 (or another incentive to be redeemed), if the instrument is not called at its effective maturity date and on a forward-looking basis meets the new criteria for inclusion in Tier 1 or Tier 2, it continues to be recognised in that tier of capital.
- (2) For an instrument that has a call and a step-up on or after 1 January 2013 (or another incentive to be redeemed), if the instrument is not called at its effective maturity date and on a forward-looking basis meets the new criteria for inclusion in Tier 1 or Tier 2, it continues to be recognised in that tier of capital. After the call date, the full amount of a Tier 1 instrument, or the applicable amortised amount of a Tier 2 instrument, is recognised. Prior to the effective maturity date, the instrument would be considered an “instrument that no longer qualifies as Additional Tier 1 or Tier 2” and therefore is phased out from 1 January 2013.
- (3) For an instrument that has a call and a step-up between 12 September 2010 and 1 January 2013 (or another incentive to be redeemed), if the instrument is not called at its effective maturity date and on a forward-looking basis does not meet the new criteria for inclusion in Tier 1 or Tier 2, it is fully derecognised in that tier of regulatory capital from 1 January 2013 and not included in the base for the transitional arrangements.
- (4) For an instrument that has a call and a step-up on or after 1 January 2013 (or another incentive to be redeemed), if the instrument is not called at its effective maturity date and on a forward looking basis does not meet the new criteria for inclusion in Tier 1 or Tier 2, it is derecognised in that tier of regulatory capital from the effective maturity date. Prior to the effective maturity date, the instrument would be considered an “instrument that no longer qualifies as Additional Tier 1 or Tier 2” and therefore is phased out from 1 January 2013.
- (5) For an instrument that had a call and a step-up on or prior to 12 September 2010 (or another incentive to be redeemed), if the instrument was not called at its effective maturity date and on a forward looking basis does not meet the new criteria for inclusion in Tier 1 or Tier 2, it is considered an “instrument that no longer qualifies as Additional Tier 1 or Tier 2” and therefore is phased out from 1 January 2013.

FAQ

FAQ1 *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 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 equity 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.

FAQ2 *If an instrument issued before 12 September 2010 has an incentive to redeem and does not fulfil the non-viability requirement in [CAP10.11](16) or [CAP10.16](10), but is otherwise compliant on a forward-looking basis, is it eligible for transitional arrangements?*

If an 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 transitional arrangements.

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 derecognised after that date.

FAQ3 *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 the end of 2016 – leaving \$50m outstanding. Does the transitional arrangement mean the bank can fully recognise the remaining \$50m of capital on 1 January 2017?*

Yes.

FAQ4 *For instruments with an incentive to redeem after 1 January 2013, [CAP90.3] permits them to be included in capital after their call/step-up date if they meet the [CAP10] criteria on a forward-looking basis. Does this forward looking basis mean that they need to meet the loss absorbency criteria set out in [CAP10.11](16) and [CAP10.16] (10)?*

Yes, they need to meet all [CAP10] criteria on a forward looking basis or they will be derecognised from capital after their call/step-up date.

90.4 Capital instruments that do not meet the criteria for inclusion in Common Equity Tier 1 are excluded from Common Equity Tier 1 as of 1 January 2013. However, instruments meeting the following three conditions are phased out over the same horizon described in [CAP90.1]:

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

Footnotes

¹ *Non-joint stock companies were not addressed in the Basel Committee's 1998 agreement on instruments eligible for inclusion as they do not issue voting common*

shares.

90.5 The following instruments qualify for the above transition arrangements:

- (1) instruments issued before 12 September 2010; and
- (2) instruments issued prior to 1 January 2013 that meet all of the entry criteria for Additional Tier 1 or Tier 2 apart from the non-viability criteria in [CAP10.11](16) and [CAP10.16](10).

FAQ

FAQ1 *If the contractual terms of an instrument issued before 12 September 2010 are amended to remove features that make it ineligible for grandfathering (eg deletion of call options or other incentives to redeem) but without making the instrument fully compliant with the Basel III definition of capital, can the instrument be counted as eligible grandfathered regulatory capital (subject to the limits in [CAP90.1])?*

A material change in the terms and conditions of a pre-existing instrument shall be considered in the same way as the issuance of a new instrument. This means that the instrument may only be included in regulatory capital if the revised terms and conditions meet the Basel III eligibility criteria in full. Revisions to terms and conditions cannot be used to extend grandfathering arrangements. This reasoning holds true for all types of capital instruments.

90.6 Public sector capital injections made before 16 December 2010 and that do not comply with the eligibility criteria in [CAP10] receive no recognition in regulatory capital after 1 January 2018. The transitional arrangements in [CAP90.1] to [CAP90.4] do not apply to these instruments.

Transitional arrangements for expected credit loss accounting

90.7 The Committee has determined that it may be appropriate for a jurisdiction to introduce a transitional arrangement for the impact on regulatory capital from the application of expected credit loss (ECL) accounting. Jurisdictions applying a transitional arrangement must implement such an arrangement as follows.

90.8 The transitional arrangement must apply only to provisions that are “new” under an ECL accounting model. “New” provisions are provisions which do not exist under accounting approaches applied prior to the adoption of an ECL accounting model.

90.9 The transitional arrangement must adjust Common Equity Tier 1 capital. Where there is a reduction in Common Equity Tier 1 capital due to new provisions, net of tax effect, upon adoption of an ECL accounting model, the decline in Common Equity Tier 1 capital (the “transitional adjustment amount”) must be partially included (ie added back) to Common Equity Tier 1 capital over a number of years (the “transition period”) commencing on the effective date of the transition to ECL accounting.

90.10 Jurisdictions must choose whether banks under their supervision determine the transitional adjustment amount throughout the transition period by either:

- (1) calculating it just once, at the effective date of the transition to ECL accounting (ie static approach); or
- (2) recalculating it periodically to reflect the evolution of a bank’s ECL provisions within the transition period (ie dynamic approach).

90.11 The transitional adjustment amount may be calculated based on the impact on Common

Equity Tier 1 capital upon adoption of an ECL accounting model or from accounting provisions disclosed before and after the adoption of an ECL accounting model.

- 90.12** For internal ratings-based (IRB) portfolios, the calculation of transitional adjustment amounts must take account of the shortfall of the stock of provisions to expected losses, as set out in [CAP30.13]. In some circumstances, an increase in provisions will not be fully reflected in IRB Common Equity Tier 1 capital.
- 90.13** The transition period commences from the date upon which a bank adopts ECL accounting in a jurisdiction that requires or permits the implementation of an ECL accounting framework. The transition period must be no more than five years.
- 90.14** During the transition period, the transitional adjustment amount will be partially included in (ie added back to) Common Equity Tier 1 capital. A fraction of the transitional adjustment amount (based on the number of years in the transition period) will be included in Common Equity Tier 1 capital during the first year of the transition period, with the proportion included in Common Equity Tier 1 capital phased out each year thereafter during the course of the transition period on a straight line basis. The impact of ECL provisions on Common Equity Tier 1 capital must not be fully neutralised during the transition period.
- 90.15** The transitional adjustment amount included in Common Equity Tier 1 capital each year during the transition period must be taken through to other measures of capital as appropriate (eg Tier 1 capital and total capital), and hence to the calculation of the leverage ratio and of large exposures limits.
- 90.16** Jurisdictions must choose between applying the consequential adjustments listed below or a simpler approach to ensure that banks do not receive inappropriate capital relief. (An example of a simpler approach that would not provide inappropriate capital relief would be amortising the transitional arrangement more rapidly than otherwise.)
- (1) Account should be taken of tax effects in calculating the impact of ECL accounting on Common Equity Tier 1 capital.
 - (2) Any deferred tax asset (DTA) arising from a temporary difference associated with a non-deducted provision amount must be disregarded for regulatory purposes during the transitional period. This means that such DTA amount must not be considered for Common Equity Tier 1 capital, and in return must not be subject to deduction from Common Equity Tier 1 capital and must not be subject to risk weighting, as applicable.
 - (3) An accounting provision amount not deducted from Common Equity Tier 1 capital should not:
 - (a) be included in Tier 2 capital, even if the provision meets the definition of “general” or “excess” provisions;
 - (b) reduce exposure amounts in the standardised approach even if it meets the definition of a “specific” provision; or
 - (c) reduce the total exposure measure in the leverage ratio.
- 90.17** Jurisdictions must publish details of any transitional arrangement applied, the rationale for it, and its implications for supervision of banks (eg whether supervisory decisions will be based solely on regulatory metrics which incorporate the effect of the transitional arrangement). Jurisdictions that choose to implement a transitional arrangement must require their banks to disclose, as set out in [DIS20]:²
- (1) whether a transitional arrangement is applied; and

- (2) the impact on the bank's regulatory capital and leverage ratios compared to the bank's "fully loaded" capital and leverage ratios had the transitional arrangements not been applied.

Footnotes

² *In addition to the required disclosures under Pillar 3, banks may also provide this information prominently on their website.*

90.18 In light of the Covid-19 pandemic, the Committee agreed on the following amendments to the transitional arrangements for the regulatory capital treatment of ECLs set out in [CAP90.7] to [CAP90.17]:

- (1) Jurisdictions may apply the existing transitional arrangements, even if they were not initially implemented when banks first adopted the ECL model. They may also choose to apply the alternative transition set out in point (4) below.
- (2) Jurisdictions may permit banks to switch from the static approach to the dynamic approach to determine the transitional adjustment amount (even if they have previously switched the approach that they use).
- (3) In addition to the two existing approaches to calculate the transitional adjustment amount (the static and dynamic approach), jurisdictions may use alternative methodologies that aim to approximate the cumulative difference between provisions under the ECL accounting model and provisions under the prior incurred loss accounting model.
- (4) Irrespective of when a jurisdiction initially started to apply transitional arrangements, for the 2 year period comprising the years 2020 and 2021, jurisdictions may allow banks to add-back up to 100% of the transitional adjustment amount to CET1.³ The "add-back" amount must then be phased-out on a straight line basis over the subsequent 3 years.

Footnotes

³ *Jurisdictions that have already implemented the transitional arrangements may choose to add back less than 100% during 2020 and 2021, or take other measures to prevent the add-back from including ECL amounts established before the outbreak of Covid-19.*

90.19 The disclosure requirements of [CAP90.17] also apply when the modified transitional arrangements set out in [CAP90.18] are used.

CAP99

Application guidance

First version in the format of the consolidated framework.

Version effective as of 15 Dec 2019

First version in the format of the consolidated framework.

Minority interest illustrative example

99.1 Minority interest receives limited recognition in regulatory capital, as described in [CAP10.20] to [CAP10.26]. The following paragraphs provide an illustrative example of how to calculate the amount eligible for inclusion.

99.2 A banking group consists of two legal entities that are both banks. Bank P is the parent and Bank S is the subsidiary and their unconsolidated balance sheets are set out below.

Bank P balance sheet		Bank S balance sheet	
Assets		Assets	
Loans to customers	100	Loans to customers	150
Investment in Common Equity Tier 1 of Bank S	7		
Investment in the Additional Tier 1 of Bank S	4		
Investment in the Tier 2 of Bank S	2		
Liabilities and equity		Liabilities and equity	
Depositors	70	Depositors	127
Tier 2	10	Tier 2	8
Additional Tier 1	7	Additional Tier 1	5
Common equity	26	Common equity	10

99.3 The balance sheet of Bank P shows that in addition to its loans to customers, it owns 70% of the common shares of Bank S, 80% of the Additional Tier 1 of Bank S and 25% of the Tier 2 capital of Bank S. The ownership of the capital of Bank S is therefore as follows:

Capital issued by Bank S			
	Amount issued to parent (Bank P)	Amount issued to third parties	Total
Common Equity Tier 1	7	3	10
Additional Tier 1	4	1	5
Tier 1	11	4	15
Tier 2	2	6	8
Total capital	13	10	23

99.4 The consolidated balance sheet of the banking group is set out below:

Consolidated balance sheet	
Assets	
Loans to customers	250
Liabilities and equity	
Depositors	197
Tier 2 issued by subsidiary to third parties	6
Tier 2 issued by parent	10
Additional Tier 1 issued by subsidiary to third parties	1

Additional Tier 1 issued by parent	7
Common equity issued by subsidiary to third parties (ie minority interest)	3
Common equity issued by parent	26

- 99.5** For illustrative purposes Bank S is assumed to have risk-weighted assets of 100. In this example, the minimum capital requirements of Bank S and the subsidiary's contribution to the consolidated requirements are the same since Bank S does not have any loans to Bank P. This means that it is subject to the following minimum plus capital conservation buffer requirements and has the following surplus capital:

Minimum and surplus capital of Bank S		
	Minimum plus capital conservation buffer	Surplus
Common Equity Tier 1	7.0 (= 7.0% of 100)	3.0 (=10 – 7.0)
Tier 1	8.5 (= 8.5% of 100)	6.5 (=10 + 5 – 8.5)
Total capital	10.5 (= 10.5% of 100)	12.5 (=10 + 5 + 8 – 10.5)

- 99.6** The following table illustrates how to calculate the amount of capital issued by Bank S to include in consolidated capital, following the calculation procedure set out in [CAP10.20] to [CAP10.26]:

Bank S: amount of capital issued to third parties included in consolidated capital					
	Total amount issued (a)	Amount issued to third parties (b)	Surplus (c)	Surplus attributable to third parties (ie amount excluded from consolidated capital) (d) =(c) * (b)/(a)	Amount included in consolidated capital (e) = (b) – (d)
Common Equity Tier 1	10	3	3.0	0.90	2.10
Tier 1	15	4	6.5	1.73	2.27
Total capital	23	10	12.5	5.43	4.57

- 99.7** The following table summarises the components of capital for the consolidated group based on the amounts calculated in the table above. Additional Tier 1 is calculated as the difference between Common Equity Tier 1 and Tier 1 and Tier 2 is the difference between Total Capital and Tier 1.

	Total amount issued by parent (all of which is to be included in consolidated capital)	Amount issued by subsidiaries to third parties to be included in consolidated capital	Total amount issued by parent and subsidiary to be included in consolidated capital
Common Equity Tier 1	26	2.10	28.10
<i>Additional Tier 1</i>	7	0.17	7.17
Tier 1	33	2.27	35.27
<i>Tier 2</i>	10	2.30	12.30
Total capital	43	4.57	47.57

Indirect and synthetic holdings

- 99.8** [CAP30.18] to [CAP30.31] describes the regulatory adjustments applied to a bank's investments in its own capital or other total loss-absorbing capacity (TLAC) instruments or those of other financial entities, even if they do not have direct holdings. More specifically, these paragraphs require banks to capture the loss that a bank would suffer if the capital or TLAC instrument is permanently written off, and subject this potential loss to the same treatment as a direct exposure. This section defines indirect and synthetic holdings and provides examples.
- 99.9** 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.
- 99.10** 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.
- 99.11** Set out below are some examples of indirect and synthetic holdings to help illustrate this treatment:
- (1) 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.
 - (2) The bank enters into a total return swap on capital instruments of another financial institution.
 - (3) 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.
 - (4) The bank owns a call option or has written a put option on the capital instruments of another financial institution.
 - (5) The bank has entered into a forward purchase agreement on the capital of another financial institution.

FAQ

FAQ1 *What would be the prudential treatment applicable to a financial instrument where a bank commits itself to buy newly issued shares of an insurance company for a given amount should certain events occur? For example, consider the following case. Bank A enters into a contract with Firm B (an insurance company). The contract stipulates that, if any of the three events defined below occurs within the next three years, Bank A must buy for €10 million new shares of Firm B (leading to a capital increase for Firm B). The new shares are generally issued with a discount (eg 5%) on the average market price recorded on the trading days following the event. In such a case, Bank A has to provide the cash to Firm B within a predefined timeline (eg 10 days). Event 1: Firm B incurs a technical loss above a threshold (eg €1m) for a specific event (eg natural catastrophe). Event 2: The loss ratio of a given line of business is higher than 120% for two consecutive semesters. Event 3: The share price of Firm B falls below a given value. Bank A is not allowed to sell the financial instrument resulting from this contract to other entities.*

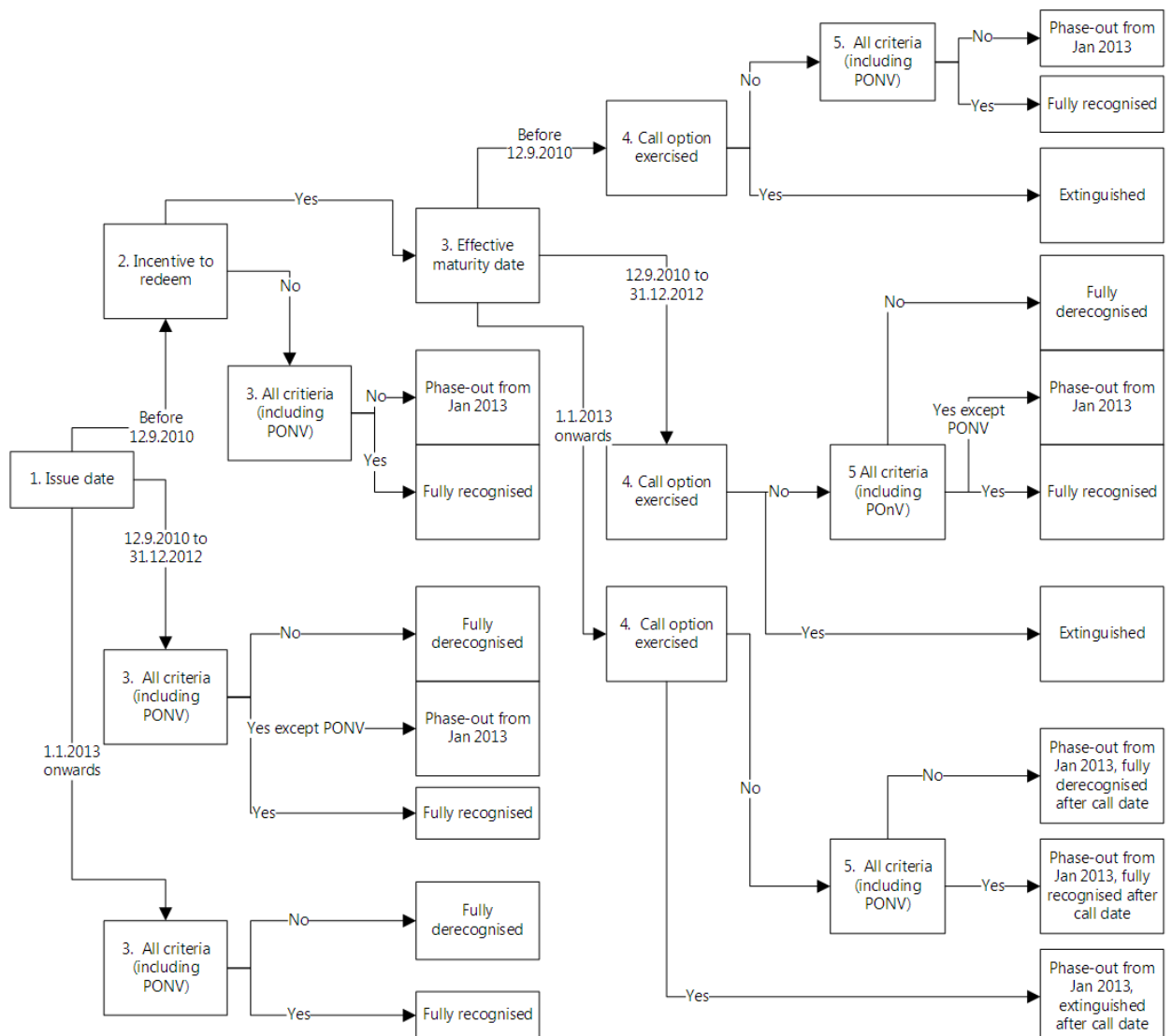
[CAP30.18] to [CAP30.31] provide that investments in the capital of banking, financial and insurance entities include direct, indirect and synthetic holdings of capital instruments. These instruments must be deducted following a corresponding deduction approach (potentially with the application of a threshold). [CAP99.8] to

[CAP99.12] defines indirect and synthetic holdings and provides examples. The transaction described above has to be regarded as a derivative instrument (in this case, a put option) that has a capital instrument (a share) of a financial sector entity as its underlying. Hence, it should be regarded as a synthetic holding to be deducted from Common Equity Tier 1 as per the applicable deduction rules.

- 99.12** 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).

Flowcharts illustrating transitional arrangements

- 99.13** The flowchart below illustrates the application of transitional arrangements in [CAP90.1] to [CAP90.3] and [CAP90.5]. "Phase-out" refers to those transitional arrangements. "PONV" refers to the non-viability requirements in [CAP10.11](16) and [CAP10.16](10).



- 99.14** The flowchart below illustrates the application of transitional arrangements in [CAP90.4], which also sets out the "three conditions" and "phase-out" arrangements.

