Basel III Capital Framework

Basel Committee Issues Final Minimum Requirements for Regulatory Capital Instruments to Ensure Loss Absorbency at the Point of Bank Non-Viability

SUMMARY

Further to its August 2010 consultative document entitled Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability,¹ the Basel Committee on Banking Supervision issued its final Minimum requirements to ensure loss absorbency at the point of non-viability on January 13, 2011. The August 2010 proposal (the “Loss Absorbency Proposal”) required that all non-common Tier 1 and Tier 2 instruments – for example, non-cumulative perpetual preferred stock and subordinated debt – issued by an internationally active bank have a provision that requires such instruments, at the option of the relevant authority, to either be written off or converted into common equity upon the occurrence of certain “trigger events”. Trigger events are defined with reference to whether the bank would become “non-viable” absent the conversion/write-off or a public sector injection of capital. The January 13, 2011 minimum requirements (the “Final Loss Absorbency Requirements”) implement the Loss Absorbency Proposal largely as proposed, with one very important exception, namely that the write-off/conversion requirement will not apply if, subject to peer group review and disclosure, the governing jurisdiction of the bank has in place laws that:

- require such Tier 1 and Tier 2 instruments to be written off upon the occurrence of a trigger event, or
- otherwise require such instruments to fully absorb losses before tax payers are exposed to loss.

The Final Loss Absorbency Requirements specify that instruments issued on or after January 1, 2013 must meet the new criteria to be included in regulatory capital. Instruments issued prior to January 1, 2013 that do not meet the criteria, but that meet all of the entry criteria for Additional Tier 1 or Tier 2...
capital, will be considered as an “instrument that no longer qualifies as Additional Tier 1 or Tier 2” and will be phased out from January 1, 2013 in accordance with the Basel III framework.2

BACKGROUND
During the recent financial crisis, a number of banking institutions around the world received public sector funds in the form of common equity or other Tier 1 capital which protected depositors of the distressed institutions. However, by preventing the failure of certain firms, such injections of public funds also prevented, in many cases, certain regulatory capital instruments from suffering losses that would have otherwise occurred in a bankruptcy or receivership. Through the Loss Absorbency Proposal, the Basel Committee attempted to remedy this perceived problem in situations where insolvency and liquidation would have occurred but for public sector assistance. Although the Loss Absorbency Proposal was not incorporated into the Basel III final framework released on December 16, 2010, a footnote to that text indicated that the Basel Committee was finalizing additional criteria for Additional Tier 1 capital and Tier 2 capital reflecting the proposal. Those criteria, which the Basel Committee has indicated are to be met or exceeded, have now been released.

DISCUSSION AND OBSERVATIONS
The only substantive change presented by the Final Loss Absorbency Requirements compared to the Loss Absorbency Proposal is the inclusion of a “statutory resolution regime” exception to the otherwise contractual requirement to provide for write-off or conversion upon the occurrence of a trigger event. The exception applies if:

- the governing jurisdiction of the bank has in place laws that (i) require such Tier 1 and Tier 2 instruments to be written off upon such event, or (ii) otherwise require such instruments to fully absorb losses before tax payers are exposed to loss;
- a peer group review confirms that such laws are in place; and
- it is disclosed by the relevant regulator and by the issuing bank, in issuance documents going forward, that the capital instruments are subject to loss under this provision.

As drafted and in the absence of any commentary from the Basel Committee, this exception results in a number of questions, including which jurisdictions’ laws will meet the test described in the first bullet of the preceding paragraph – most importantly, the test of otherwise requiring “such instruments to fully absorb losses before tax payers are exposed to loss.” The United States Bankruptcy Code and the Federal Deposit Insurance Act, after taking into account reforms included in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) would appear to meet this standard.3 Other questions include the definition of “peer group” and how the relevant regulator will make the disclosure contemplated by the third bullet in the preceding paragraph (perhaps by regulation).

In addition, many questions raised by the Loss Absorbency Proposal remain unanswered by the Final Loss Absorbency Requirements, including:

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The scope of banking institutions that national regulators, when they adopt regulations implementing Basel III, will choose to make subject to the Final Loss Absorbency Requirements with respect to loss absorbency. The Final Loss Absorbency Requirements specify that they will apply to "internationally active banks". The U.S. banking agencies, in determining the category of U.S. banks subject to the Basel II-based advanced internal ratings based "A-IRB" approach, have used the test of $250 billion or more of total assets or $10 billion or more of foreign exposures. That may or may not be the standard for the Final Loss Absorbency Requirements.

As with respect to the Loss Absorbency Proposal, there is inherent regulatory subjectivity in the "non-viability" trigger. It remains unclear whether a write-off would be triggered in the event of public sector capital injections into institutions which may not be at the brink of insolvency and liquidation at the time of such injection, as was probably the case with a substantial majority of the participants in the TARP Capital Purchase Program. Moreover, it is unclear how the regulatory determination of non-viability will interact with new resolution authority under the Dodd-Frank Act.

In conclusion, had the Loss Absorbency Proposal been implemented as proposed without the new exception, there is no question that it would have altered investor expectations concerning non-common stock regulatory capital elements and likely increased the cost of such instruments for banking institutions. For U.S. banks, the ultimate import and consequence of the Final Loss Absorbency Requirements will depend upon whether the exception for a legal regime requiring holders of Tier 1 and Tier 2 instruments to be written off before taxpayers are exposed applies.

*    *    *

ENDNOTES

1 See S&C’s memorandum to clients, dated September 9, 2010, entitled “Basel III Capital Proposals; Basel Committee Issues Proposal to Ensure Loss Absorbency of Regulatory Capital and the Point of Bank Non-Viability”.


3 The Dodd-Frank Act includes a number of provisions bearing upon this standard, including provisions that:
   • limit the Federal Reserve Board’s emergency authority to lend to non-depository institutions to programs and facilities with broad-based eligibility;
   • eliminate the Federal Deposit Insurance Corporation’s (the “FDIC”) ability to use the systemic exception in the Federal Deposit Insurance Act to provide open bank assistance; and
   • prohibit the FDIC from providing “equity in any form”.

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### January 14, 2011

**SC1:2981767.3**

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