



# Selected Highlights of the current Basel III Proposals

**Blair Keefe**

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bkeefe@torys.com  
416.865.8164

- **December proposals updated by July 26th preliminary agreement**
  - > Overview and timing
  - > Key elements of the proposals and detailed capital criteria
  - > Regulatory adjustments/deductions
- **Contingent capital proposals (August)**
- **Proposed countercyclical capital buffer (July) and capital conservation buffer (contained in December Proposal)**
- **Calibration and transitional Proposals (September)**

# Overview of the Proposals

- The quality, consistency, and transparency of the capital base will be raised - this will be a focus of this presentation
- Introducing a series of measures to promote the build up of capital buffers in good times that can be drawn upon in periods of stress – this will be a focus of this presentation
- Introduce a leverage ratio as a supplementary measure to the Basel II risk-based (to be discussed by Luigi De Ghenghi)

# Overview of the Proposals

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- Introducing a global minimum liquidity standard for internationally active banks that includes a 30-day liquidity coverage ratio requirement underpinned by a longer-term structural liquidity ratio (to be discussed by Luigi De Ghenghi)
- Changes to capital rules related to the trading book, securitizations and counterparty credit risk related to derivative, repos and securities financing activities, will not be addressed in this presentation

# Overview of the Proposals

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- **Timing**

- > Basel submitted its report to G-20 in October, 2010
- > Rules finalized at the G-20 in Seoul in November, 2010
- > Intended to be implemented on a phased in basis commencing on January 1, 2013
- > Full implementation of most rules by end of 2018 although transition will go longer
- > Appendix 2 provides the details of the phase in period

- **Introduction**

- > The existing definition of capital suffers from certain fundamental flaws:
  - Regulatory adjustments generally are not applied to common equity
  - There is no harmonised list of regulatory adjustments.
  - Weak transparency

# Key Elements of the Proposals

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- **Key elements of proposals**

- > The following key changes to the definition of capital are proposed:
  - The quality and consistency of the common equity element of Tier 1 capital will be significantly improved, with regulatory adjustments generally applied to this element
  - The required features for instruments to be included in Tier 1 capital outside of the common equity element will be strengthened

# Key Elements of the Proposals

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- Existing public sector capital injections will be grandfathered until 1 January 2018.
- Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital will be phased out over a 10 year horizon beginning 1 January 2013. Fixing the base at the nominal amount of such instruments outstanding on 1 January 2013, their recognition will be capped at 90% from 1 January 2013, with the cap reducing by 10 percentage points in each subsequent year. In addition, instruments with an incentive to be redeemed will be phased out at their effective maturity date

# Key Elements of the Proposals

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- The use of call options on Tier 1 capital will be subject to strict governance arrangements which ensure that the issuing bank is not expected to exercise a call on a capital instrument unless it is in its own economic interest to do so
  - Tier 2 will be simplified. There will be one set of entry criteria, removing subcategories of Tier 2
  - Tier 3 will be abolished to ensure that market risks are met with the same quality of capital as credit and operational risks
  - The transparency of capital will be improved, with all elements of capital required to be disclosed along with a detailed reconciliation to the reported accounts

- > Proposed harmonised structure of capital
  - It is proposed that the scope of application of the harmonised definition of capital be the same as for the Basel II capital requirements (i.e., the rules apply to banks and consolidated banking groups including bank holding companies)

## > Elements of capital

- Total regulatory capital will consist of the sum of the following elements:
  - Tier 1 Capital (going-concern capital)
    - a. Common Equity
    - b. Additional Going-Concern Capital
  - Tier 2 Capital (gone-concern capital)
- For each of the three categories above (1a, 1b and 2) there will be a single set of criteria which instruments are required to meet before inclusion in the relevant category

- *Limits* and minima
  - All elements above are net of regulatory adjustments and are subject to the following restrictions:
    - » Common Equity, Tier 1 Capital and Total Capital must always exceed explicit minima of 4.5%, 6% and 8% of risk-weighted assets, respectively
    - » A capital conservation buffer (discussed later) of 2.5% will be added to common share equity increasing the minimum to 7%, 8.5% and 10.5% respectively

# Detailed Proposal

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- » A countercyclical capital buffer of 0 - 2.5% to be added when required to common equity or other fully loss absorbing capital (This may include contingent capital discussed below)
- » Systemically important banks should have loss absorbing capacity beyond the announced standards and work continues on this issue at FSB and Basel. The FSB will present recommendations on “systemically important financial institutions” or SIFIs, a reference to the world’s 30 or so biggest banks whose failure would destabilize the broader financial system to G-20 in Seoul in November

# Detailed Proposal

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- » These rules are expected to be developed jointly by Basel and FSB and contain an integrated approach to dealing with SIFIs which could include combinations of capital surcharges, contingent capital and bail-in debt
- » These proposals are intended to be finalized by mid 2011 with some of the additional regulatory measures applied to them by the end of the year

- > The detailed proposals are set out in Appendix 3 or as noted below in the following slides:
  - Criteria governing inclusion in the Common Equity component of Tier 1 capital (Appendix 3)
  - Criteria governing the inclusion in Tier 1 Additional Going Concern Capital (Appendix 3)
  - Criteria governing the inclusion in Tier 2 Capital (Appendix 3)
  - Regulatory adjustments applied to the elements of capital
  - Disclosure requirements (Appendix 3)

# Regulatory Adjustments Applied to Regulatory Capital

## > Minority interests

- December proposal - Minority interests will not be eligible for inclusion in the Common Equity component of Tier 1
- July 26th preliminary agreement - the Committee will allow some prudent recognition of the minority interests supporting the risks of a subsidiary that is a bank. The excess capital above the minimum of a subsidiary that is a bank will be deducted in proportion to the minority interest share

# Regulatory Adjustments Applied to Regulatory Capital

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## Minority Interests *...cont'd*

- It is likely best to use an example. Say a banking subsidiary is 70% owned by the bank and the bank's investment is \$70, 30% owned by third party investors with an investment of \$30 and the capital requirements are \$60 for the banking subsidiary. In that case, \$18 of the minority interests will show up as consolidated common share equity on the parent bank's capital (Tier 1A capital) being 30% of the \$60 minimum capital requirements of the subsidiary but the balance of \$12 being 30% of the \$40 of excess would not show up as any tier of capital
- The reasoning is that the excess is attributable to minority shareholders and thus is not available to the parent bank

# Regulatory Adjustments Applied to Regulatory Capital

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- > Goodwill and other intangibles
  - December proposal - goodwill and other intangibles including mortgage servicing rights should be deducted from the Common Equity component of Tier 1. The amount deducted should be net of any associated deferred tax liability which would be extinguished if the goodwill becomes impaired or derecognized under the relevant accounting standards

# Regulatory Adjustments Applied to Regulatory Capital

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- July 26th preliminary agreement - allow IFRS treatment where different from national GAAP (eg software)
  - A level playing field is intended to be established through an option to use IFRS in determining the level of intangible assets if national GAAP results in a wider range of assets (eg certain software assets) being classified as intangible
- > December proposal - deferred tax assets which rely on future profitability of the bank to be realized should be deducted from the Common Equity component of Tier 1. The amount of such assets net of deferred tax liabilities should be deducted

# Regulatory Adjustments Applied to Regulatory Capital

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- > December proposal - investments in the capital of certain banking, financial and insurance entities which are outside the regulatory scope of consolidation
  - Banks should apply a “corresponding deduction approach” to investments in the capital of other banks, other financial institutions and insurance entities where these fall outside of the regulatory scope of consolidation. 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

# Regulatory Adjustments Applied to Regulatory Capital

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- All holdings of capital which form part of a reciprocal cross holding agreement or are investments in affiliated institutions (e.g., sister companies) are to be deducted in full on a corresponding basis. For all other holdings, the corresponding deduction approach will apply when the holdings exceed certain thresholds
- For holdings of common stock the thresholds work as follows:
  - If the bank has holdings of common stock in a financial institution which exceed 10% of the common stock of the financial institution then the full amount of this holding (not just the amount above 10%) should be deducted from the bank's common equity

# Regulatory Adjustments Applied to Regulatory Capital

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- If the bank has holdings of common stock in other financial institutions which in aggregate exceed 10% of the bank's common equity (after applying all other regulatory adjustments to common equity) then the amount above 10% is required to be deducted
- > July 26th Preliminary Agreement - instead of a full deduction, the following items may each receive limited recognition when calculating the common equity component of Tier 1, with recognition capped at 10% of the bank's common equity component:

# Regulatory Adjustments Applied to Regulatory Capital

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- Significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities). “Significant” means more than 10% of the issued share capital;
- Mortgage servicing rights (MSRs); and
- Deferred tax assets (DTAs) that arise from timing differences
- A bank must deduct the amount by which the aggregate of the three items above exceeds 15% of its common equity component of Tier 1 (calculated prior to the deduction of these items but after the deduction of all other deductions from the common equity component of Tier 1). The items included in the 15% aggregate limit are subject to full disclosure

# Regulatory Adjustments Applied to Regulatory Capital

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## September Transition Proposal

- The regulatory adjustments (ie deductions and prudential filters), including amounts above the aggregate 15% limit for investments in financial institutions, mortgage servicing rights, and deferred tax assets from timing differences, would be fully deducted from common equity by 1 January 2018
- In particular, the regulatory adjustments will begin at 20% of the required deductions from common equity on 1 January 2014, 40% on 1 January 2015, 60% on 1 January 2016, 80% on 1 January 2017, and reach 100% on 1 January 2018. During this transition period, the remainder not deducted from common equity will continue to be subject to existing national treatments

# Regulatory Adjustments Applied to Regulatory Capital

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## > Investments in other financial institutions

- The December 2009 reform package required that unconsolidated investments in financial institutions be deducted when the holdings exceed certain thresholds. These thresholds continue to apply (see slide 19 - 20). The December paper also stated that gross long positions may be deducted net of short positions only if the short positions involve no counterparty risk.
- In the July 26th Preliminary Agreement, the Committee agreed to eliminate this counterparty credit restriction on hedging of financial institution investments and to include an underwriting exemption

# Regulatory Adjustments Applied to Regulatory Capital

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- > Defined benefit pension fund assets and liabilities
  - Apply no filter to defined benefit pension fund liabilities
  - Deduct the value of any defined benefit pension fund asset from the Common Equity component of Tier 1. 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

- > In addition to the Tier 1 and Tier 2 criteria set out in the sections above, the December proposals indicated that that the Committee was continuing to review the role that contingent capital, convertible capital instruments and instruments with write-down features should play in a regulatory capital framework, both in the context of the entry criteria for regulatory capital and their use as buffers over the minimum requirement

- July 26th Preliminary Agreement - The Basel Committee has developed a proposal based on a requirement that the contractual terms of capital instruments will allow them at the option of the regulatory authority to be written-off or converted to common shares in the event that a bank is unable to support itself in the private market in the absence of such conversions.
- The paper was released in August with comments requested on the proposals by October 1, 2010
- Contingent capital may be eligible to meet the countercyclical capital buffer if it is considered fully loss absorbing capital discussed later or be required for systemically important institutions

# “Gone Concern” Contingent Capital – Proposed Minimum Requirements

- **Scope and post trigger instrument**
  1. All non-common Tier 1 instruments and Tier 2 instruments at internationally active banks must have a clause in their terms and conditions that requires them to be written-off on the occurrence of the trigger event
  2. Any compensation paid to the instrument holders as a result of the write-off must be paid immediately in the form of common stock (or its equivalent in the case of non-joint stock companies)

# “Gone Concern” Contingent Capital – Proposed Minimum Requirements

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3. The issuing bank must maintain at all times all prior authorization necessary to immediately issue the relevant number of shares specified in the instrument’s terms and conditions should the trigger event occur
- **Trigger event**
4. The trigger event is the earlier of: (1) 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 (2) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority

# “Gone Concern” Contingent Capital – Proposed Minimum Requirements

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5. The issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted

- **Group treatment**

6. The relevant jurisdiction in determining the trigger event is 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 if 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

# “Gone Concern” Contingent Capital – Proposed Minimum Requirements

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This trigger event is the earlier of: (1) 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; and (2) 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

# “Gone Concern” Contingent Capital – Proposed Minimum Requirements

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7. Any common stock paid as compensation to the holders of the instrument can either be common stock of the issuing bank or the parent company of the consolidated group
- Basel intends to finalize proposals by end of the year for “gone concern” contingent capital. Going concern contingent capital may form part of the Basel/FSB’s proposal for dealing with SIFIs to be finalized by mid 2011

# Introduction – Capital Buffer/Dealing with Procyclicality

- The four key objectives for a framework for dealing with procyclicality were set out in the December 2009 Consultative Document *Strengthening the resilience of the banking sector* as follows:
  1. Dampen any excess cyclical of the minimum capital requirement
    - Basel studying various alternative probability of default scenarios to be included in the Basel II framework
  2. Promote more forward looking provisions
    - moving from incurred losses for provisions to expected losses

## Introduction – Capital Buffer/Dealing with Procyclicality ...*cont'd*

3. Conserve capital to build buffers at individual banks and the banking sector that can be used in stress
  - outlined in the December proposal to limit distributions or other reductions in capital in certain circumstances
4. Achieve the broader macroprudential goal of protecting the banking sector from periods of excess credit growth
  - countercyclical capital buffer detailed in proposals - released in July

## > The proposed framework

- A buffer range is established above the regulatory minimum capital requirement and capital distribution constraints will be imposed on the bank when capital levels fall within this range. Banks will be able to conduct business as normal when their capital levels fall into this range as they experience losses. The constraints imposed only relate to distributions, not the operation of the bank
- The standard would be based on common equity capital instead Tier 1 or total capital (originally indicated to be based on Tier 1 in the December Proposals)

# Capital Conservation Buffer

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- The distribution constraints imposed on banks when their capital levels fall into the range increase as the banks' capital levels approach the minimum requirement. By design, the constraints imposed on banks with capital levels at the top of the range would be minimal. This reflects an expectation that banks' capital levels will from time to time fall into this range. The Basel Committee does not wish to impose constraints for entering the range that would be so restrictive as to result in the range being viewed as establishing a new minimum capital requirement
- An example is provided after the countercyclical capital buffer discussion

# Section 1 – Objective and Operation of Proposal Countercyclical Capital Buffer

- **Introduction**

- > Part of the suite of macroprudential tools
- > May be deployed every 10 - 20 years, 2 to 3 years in advance of crisis
- > Internationally active banks subject to small buffers more frequently

# Section 1 – Objective and Operation of Proposal Countercyclical Capital Buffer

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- **Objective**

- > Designed to protect the banking sector from excessive credit growth
- > Not banks specific but rather that the banking sector has the capital on hand to help maintain the flow of credit in the economy
- > Positive side effect is to moderate the build up phase in the credit cycle

# Section 1 – Objective and Operation of Proposal Countercyclical Capital Buffer

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- **National buffer decisions and jurisdictional reciprocity**
  - > Extension of capital conservation buffer
  - > 12 month phase in for new buffers, immediate phase out of buffers
  - > Subject to an upper limit of 2.5%

# Section 1 – Objective and Operation of Proposal Countercyclical Capital Buffer

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- **Common reference guide and principles to promote sound decision making**
  - > Zero add on if credit is near or below long term trend
  - > Positive add on when credit/GDP exceeds long term trend by certain measure
  - > Credit/GDP is a helpful guide but judgment is essential

# Further Details on Key Elements of the Proposal

- **Calculating bank specific buffers**
  - > Calculation methodology
    - reflects geographical composition of the bank's exposure.
    - international banks are less likely to ever have the full maximum buffer
  - > Data availability
    - location of the risks of the borrower (maybe difficult for borrowers involved in multi-jurisdictions particularly if it is uncertain where the funds will be utilized)

## Further Details on Key Elements of the Proposal ...*cont'd*

- > Location of the buffer
  - host country has right to require buffer in its jurisdiction
- > Frequency of calculation
  - likely quarterly
- > Interaction with Pillar 1 and Pillar 2.
  - not related to Pillar 2 as it is not relative to individual banks
  - capital used to meet Pillar 2 requirements should not be used for countercyclical requirements

## Further Details on Key Elements of the Proposal ...*cont'd*

- **Publishing the jurisdictional buffers and the bank specific buffers**
  - > Intended to have infrequent use
  - > At least annually to comment on state of credit markets
  - > More frequent communication if buffer actions taken
- **Treatment of surplus when buffer returns to zero**
  - > Theoretically unfettered, practically intended to be held to absorb potential losses

# Further Details on Key Elements of the Proposal

- **Selecting the authority to operate the buffer**
  - > Local discretion
- **International comparisons and exchanges of views**
  - > Basel subcommittee to be established

# Integrating the Countercyclical Capital Buffer and the Capital Conservation Buffer

- (Same chart from the December Basel III Proposals)

<b>Individual bank minimum capital conservation standards (Numbers are illustrative and do not represent a proposed calibration level)</b>	
Capital conservation range is established above the minimum requirement	
Amount by which a bank's capital exceeds the minimum requirement in terms of a percentage of the size of the conservation range	Minimum Capital Conservation Ratios (expressed as a percentage of earnings)
[< 25%]	[100%]
[25% - 50%]	[80%]
[50% - 75%]	[60%]
[75% - 100%]	[40%]
[> 100%]	[0%]

# Implementing the Countercyclical Capital Buffer Add-on

- Following the building block approach established by the Basel Committee, the buffer is designed to be able to sit on top of the capital conservation buffer. This means that the countercyclical capital buffer is presented as an add-on to the capital conservation buffer, effectively stretching the size of its range
- To use an example, common equity is set at a minimum of 4.5% and the capital conservation buffer has been set at 2.5% of risk weighted assets. Under this scenario a bank with a common equity capital ratio of 7.5% would not be subject to any restrictions on distributions of capital as restrictions are only imposed in the range of 4.5% – 7%

# Implementing the Countercyclical Capital Buffer Add-on ...*cont'd*

- Now assume that this bank becomes subject to a countercyclical capital buffer add-on of 2%. The consequence of this is that the range in which restrictions on distributions are imposed becomes 4.5% – 9%. Now the bank with a common equity capital ratio of 7.5% is in the third quartile of this range and so, using the numbers in the table above, would be required to conserve 60% of earnings
- To allow banks time to adjust to a buffer level that exceeds the fixed capital conservation range, they would be given 12 months to get their capital levels above the top of the extended range (common equity above 9% in the example), before restrictions on distributions are imposed

# Implementing the Countercyclical Capital Buffer Add-on ...*cont'd*

- This period of grace is intended to help reduce the chances that the market will view the countercyclical capital buffer add-on as a new minimum and avoid a rise in the buffer add-on in one jurisdiction having the potential to require banks to automatically restrict distributions, while being short enough to help ensure that the buffer is accumulated in time to cope with turns in the credit cycle
- During this 12 month period, banks will have the options of meeting the requirement through retaining earnings, raising capital or cutting lending growth. All three of these actions would seem to reinforce the objective of protecting the banking sector from periods of excess credit growth

# Implementing the Countercyclical Capital Buffer Add-on ...*cont'd*

- The effect of the above is that at any point in time, the sum of the capital conservation and countercyclical buffer requirements will set a target ratio. In 12 months time banks will need their reported common equity capital ratios to be above this target ratio to avoid becoming subject to restrictions on distributions implied by the position of their common equity capital ratios after 12 months relative to that target ratio
- However, it is important to ensure that banks will not need to wait 12 months before benefiting from the decision of a jurisdiction to release the buffer requirement. As a consequence the common equity capital ratio below which restrictions will apply at any point in time is capped at the target ratio applicable in 12 months time

# Annex 1 (Excerpt from Basel September 12, 2010 Press Release)

## Annex 1

Calibration of the Capital Framework			
Capital requirements and buffers (all numbers in percent)			
	Common Equity (after deductions)	Tier 1 Capital	Total Capital
Minimum	4.5	6.0	8.0
Conservation buffer	2.5		
Minimum plus conservation buffer	7.0	8.5	10.5
Countercyclical buffer range*	0 – 2.5		

\* Common equity or other fully loss absorbing capital

# Annex 2 (Excerpt from Basel September 12, 2010 Press Release)

Annex 2: Phase-in arrangements (shading indicates transition periods)  
(all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials )				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

## Annex 3

# Criteria Governing Inclusion in the Common Equity Component of Tier 1

- > Criteria for classification as common shares for regulatory capital purposes
  1. Represents the most subordinated claim in liquidation of the bank
  2. Entitled to a claim of the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e., has an unlimited and variable claim, not a fixed or capped claim)

# Criteria Governing Inclusion in the Common Equity Component of Tier 1

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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 national 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

# Criteria Governing Inclusion in the Common Equity Component of Tier 1

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5. Distributions are paid out of distributable items (retained earnings included). The level of distributions are not in any way tied or linked to the amount paid in at issuance and are not subject to a 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

# Criteria Governing Inclusion in the Common Equity Component of Tier 1

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7. Distributions are paid only after all legal and contractual obligation 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. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and pari passu with all the others

# Criteria Governing Inclusion in the Common Equity Component of Tier 1

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9. The paid in amount is recognised as equity capital (i.e., 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-up
12. The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity or subject to any other arrangement that legally or economically enhances the seniority of the claim

# Criteria Governing Inclusion in the Common Equity Component of Tier 1

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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

# Criteria for Inclusion in Tier 1 Additional Going Concern Capital

1. Issued and paid-in
2. Subordinated to depositors, general creditors and subordinated debt of the bank
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, i.e., there is no maturity date and there are no incentives to redeem

# Criteria for Inclusion in Tier 1 Additional Going Concern Capital

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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; or
    - ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised

# Criteria for Inclusion in Tier 1 Additional Going Concern Capital

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6. Any repayment of principal (e.g., 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

# Criteria for Inclusion in Tier 1 Additional Going Concern Capital

*...cont'd*

## 7. Dividend/coupon discretion:

- a. the bank must have full discretion at all times to cancel distributions/payments
- 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

# Criteria for Inclusion in Tier 1 Additional Going Concern Capital

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8. Dividends/coupons must be paid out of distributable items
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 organization's current credit standing
10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law

# Criteria for Inclusion in Tier 1 Additional Going Concern Capital

*...cont'd*

11. Instruments classified as liabilities must have principal loss absorption through either
- (i) conversion to common shares at an objective pre-specified trigger point or
  - (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:
    - a. Reduce the claim of the instrument in liquidation;
    - b. Reduce the amount re-paid when a call is exercised; and
    - c. Partially or fully reduce coupon/dividend payments on the instrument

# Criteria for Inclusion in Tier 1 Additional Going Concern Capital

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12. 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 purchase of the instrument
13. The instrument cannot have any features that hinder recapitalization, 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

# Criteria for Inclusion in Tier 1 Additional Going Concern Capital

*...cont'd*

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14. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g., a special purpose vehicle – “SPV”), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 1 Additional Going Concern Capital

# Criteria for Inclusion in Tier 1 Additional Going Concern Capital

*...cont'd*

## > Additional requirements

- The criteria above will also apply to instruments which appear in the consolidated accounts as minority interest
- This element of capital will be net of the appropriate corresponding deductions related to holding of non-common equity capital instruments in other financial institutions

## Criteria for Inclusion in Tier 2 Capital (Gone Concern Capital)

1. Issued and paid-in
2. Subordinated to depositors and general creditors of the bank
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

## Criteria for Inclusion in Tier 2 Capital (Gone Concern Capital)

*...cont'd*

### 4. Maturity:

- a. minimum original maturity of at least 5 years
- b. recognition in regulatory capital in the remaining 5 years before maturity will be amortised on a straight line basis
- c. there are no 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

## Criteria for Inclusion in Tier 2 Capital (Gone Concern Capital)

*...cont'd*

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- 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; or
  - ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised

## Criteria for Inclusion in Tier 2 Capital (Gone Concern Capital)

*...cont'd*

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 may not have a credit sensitive dividend feature, that is a dividend that is reset periodically based in whole or in part on the banking organisation's current credit standing
8. The bank or a related party cannot have knowingly purchased, or directly or indirectly have funded the purchase of, the instrument

## Criteria for Inclusion in Tier 2 Capital (Gone Concern Capital)

*...cont'd*

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9. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g., an SPV), proceeds must be immediately available without limitation to an operating entity 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 Additional requirements

## Criteria for Inclusion in Tier 2 Capital (Gone Concern Capital)

*...cont'd*

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- > These criteria will also apply to instruments which appear in the consolidated accounts as minority interest
  - This element of capital will be net of the appropriate corresponding deductions related to holding of non-common equity capital instruments in other financial institutions

- > Banks will be required to disclose the following:
  - a full reconciliation of all regulatory capital elements back to the balance sheet in the audited financial statements;
  - separate disclosure of all regulatory adjustments;
  - a description of all limits and minima, identifying the positive and negative elements of capital to which the limits and minima apply;
  - a description of the main features of capital instruments issued;

# Disclosure Requirements

...cont'd

- banks which disclose ratios involving components of regulatory capital (e.g., “Equity Tier 1”, “Core Tier 1” or “Tangible Common Equity” ratios) to accompany these with a comprehensive explanation of how these ratios are calculated
- > In addition to the above, banks will be required to make available on their websites the full terms and conditions of all instruments included in regulatory capital

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**Toronto**  
**New York**

416.865.0040  
212.880.6000