The New Basel III Framework: Implications for Banking Organizations

The Basel Committee on Banking Supervision (the “Basel Committee”) released a near final version of its new bank capital and liquidity standards, referred to as “Basel III”, in December 2010. Subsequent guidance was issued in January 2011 regarding minimum requirements for regulatory capital instruments. The United States and the European Union have publicly endorsed the Basel III standards and are considering how to implement them into law in their respective jurisdictions. Legal and compliance personnel at impacted financial institutions will need to work alongside risk management staff to ensure their institution is able to comply with the new standards.

Basel III is a series of amendments to the existing Basel II framework. The core aspects of Basel III are scheduled to be implemented into national law by January 1, 2013; certain aspects of the new standards are slated to become effective upon implementation while others will be phased in over several years. Well before 2013, however, it will become essential for legal and compliance professionals at many institutions to have a working understanding of the new Basel III standards in order to be able to assist in the development of a bank capital plan that meets supervisory expectations. In the U.S., for example, large banking groups are required to demonstrate their ability to comply with Basel III standards both as a formal part of their capital plans and as a condition for regulatory approval of actions that could diminish their capital bases, such as paying dividends.1

While the broad outline of Basel III was introduced more than a year ago, the Basel Committee continued to refine the new capital and liquidity standards during 2010.2 As described in further detail below, the Committee continues to work on certain aspects of the framework which may lead to additional changes in Basel III.

---

1 The requirements apply to the 19 large U.S. bank holding companies that participated in the Supervisory Capital Assessment Program “stress tests” conducted in the spring of 2009. See “Comprehensive Capital Analysis and Review: Objectives and Overview” (March 18, 2011, Federal Reserve Board) and “Revised Temporary Addendum to SR Letter 09-4: Dividend Increases and Other Capital Distributions for the 19 Supervisory Capital Assessment Program Bank Holding Companies” (Nov. 17, 2010, Federal Reserve Board press release).

2 The Basel Committee is an international supervisory group in which banking supervisors from the U.S., the U.K. and twenty-five other nations participate. Basel III was endorsed in principle by the leaders of the G20 Nations at the G20 Summit held in Seoul on November 11 and 12, 2010. See “The G20 Seoul Summit Leaders’ Declaration November 11-12, 2010”. The G20 nations include: Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the U.K and the U.S.
The principal objective of this Client Alert is to summarize the key elements of Basel III and their implications in the U.S. and European Union. There remain several uncertainties relating to the Basel III framework which are also addressed.

Table of Contents

- Background to Basel III ........................................................................................................ 2
- Key Elements of the Basel III Framework ........................................................................... 3
- Scope and National Implementation of Basel III ................................................................. 5
- Capital Ratios ..................................................................................................................... 8
- Constituents of Capital ....................................................................................................... 9
- Risk-Weighting of Assets ................................................................................................. 11
- New Leverage Ratio Requirement ..................................................................................... 12
- New Liquidity Requirements .............................................................................................. 13
- Possible Future Refinements to Basel III ......................................................................... 14
- Basel III and the Dodd-Frank Act ..................................................................................... 15
- Impact of Basel III on Financial Institutions .................................................................... 16
- Annex: Timeline for New Minimum Capital Standards ..................................................... 19

Background to Basel III

The existing approach to capital regulation in the U.S. and E.U. – based on so-called “Basel I” and “Basel II” – was identified by many regulators and commentators as one of the key factors contributing to the financial crisis.\(^3\) Under the pre-crisis capital adequacy rules, the minimum regulatory capital levels of banks were insufficient in relation to the exposures and actual losses of the banks suffered during the financial crisis. Also the quality of regulatory capital appeared often insufficient to absorb bank losses effectively. The capital adequacy rules of Basel I and Basel II did not adequately capture risks posed by bank exposures to transactions such as securitizations, derivatives and repurchase agreements or take into account the systemic risks associated with the build-up of leverage in the financial system. Moreover, Basel I and II focused on capital only, with no internationally agreed quantitative standards for liquidity.\(^4\) This is often perceived to have been a serious shortcoming when the financial crisis unfolded in 2007 and liquidity evaporated in the key funding markets used by many banks and bank-sponsored vehicles.

---

\(^3\) A composite version of Basel II was issued by the Basel Committee in 2006 as an update to Basel I. Since 2008, many European banks have been required to compute their risk-based capital requirements using regulatory capital guidelines based on Basel II. In many cases, these banks have been operating subject to capital floors based on Basel I standards. The U.S. only partially adopted Basel II; large, internationally active banks are required to adopt the so-called “advanced approach” of Basel II which relies on sophisticated risk modeling. Implementation, however, was delayed and to date all U.S. banking organizations are still required to compute their risk-based capital requirements using rules linked to Basel I.

\(^4\) The Basel Committee has previously issued statements relating to principles of liquidity management such as the importance of establishing a liquidity risk tolerance and a robust and operational contingency funding plan (see, e.g., Principles for Sound Liquidity Risk Management and Supervision (Basel Committee, 2008) updating Sound Practices for Managing Liquidity in Banking Organizations (Basel Committee, 2000)).
In response to the financial crisis, the Basel Committee undertook to develop standards to supplement and, in certain respects, replace, the existing standards of Basel I and Basel II. In July 2009, the Basel Committee released proposed revisions principally addressing risk-based capital and disclosure requirements for a bank’s “trading book” (the “July 2009 Release”). Proposals regarding revised risk-based capital requirements, the introduction of a leverage ratio requirement and new liquidity standards followed in December 2009 (the “December 2009 Release”). In September 2010, the Basel Committee formally adopted the name “Basel III” for the reforms that developed from these releases and in December 2010 the Basel Committee issued the finalized text for the core elements of the Basel III framework.

While the basic building blocks of the existing framework would remain largely in place, there are several important new elements, relating in particular to minimum capital ratios, rules which define eligibility of regulatory capital, leverage and liquidity requirements, as summarized below.

Key Elements of the Basel III Framework

A. Capital Ratios

• Core solvency ratio retained at 8% of risk weighted assets (“RWAs”).

• Minimum “common equity” component will be 4.5% when fully phased in by 2015, increased from the current 2% minimum.

• Overall Tier 1 element of the capital base (including common equity) will be 6% when fully phased in by 2015, increased from the current 4% minimum.

• In addition, there will be a “capital conservation buffer” made up of common equity and amounting to 2.5% of RWAs when fully phased in by 2019; an institution with capital falling within the buffer range (i.e., with common equity of between 4.5% and 7%) will be subject to restrictions on dividend payouts, share buybacks and bonuses. In effect, most banks will be required, or otherwise seek, to maintain a ratio of 7% of RWAs in common equity (4.5% minimum plus a 2.5% capital conservation buffer).

• A further “countercyclical capital buffer” (see further below) may be imposed. Where required, it would be made up of common equity of up to an additional 2.5% of RWAs. This buffer is expected to be imposed at a national level only during times of excessive credit growth, and will be allowed to be released during times of credit contraction.

---

5 Revisions to the Basel II Market Risk Framework (BCBS 148).
6 Strengthening the Resilience of the Banking Sector (Basel Committee 189) and International Framework for Liquidity Risk Measurements, Standards and Monitoring (Basel Committee 188).
8 Basel III does not supplant the basic “three pillar” approach introduced by Basel II: Pillar 1 – minimum capital requirements, including separate capital charges for credit risk, market risk and operational risk; Pillar 2 – supervisory review of banks allowing for adjustments of an individual bank’s capital requirement above the minimum; and Pillar 3 – disclosure of details regarding capital calculations and related practices.
B. Constituents of Capital

- The common equity component of Tier 1 will be comprised of ordinary share capital and retained profits.

- Non-common equity Tier 1 ("Additional Tier 1") will be principally made up of perpetual non-cumulative preference shares and other qualifying instruments. Mandatory write-down or conversion into common equity will apply to all Additional Tier 1 instruments in the event of the institution becoming non-viable without a bail-out.

- Tier 2 capital will no longer be divided into lower Tier 2 (principally, dated term preference shares and subordinated debt) and upper Tier 2 (including certain perpetual preferred instruments and subordinated debt). Instead, a single set of criteria will apply to Tier 2 capital. All Tier 2 instruments will be required to be either convertible into common equity or written down in the event of the institution becoming non-viable without a bail-out.

- Tier 3 capital will be abolished. Generally speaking, Tier 3 capital was unsecured subordinated debt that is fully paid up, cannot be repaid before maturity without prior regulatory approval and with an original maturity of at least two years.

- Deductions from capital (or regulatory adjustments) will be applied to the common equity Tier 1 component and not to overall capital.

C. Leverage Ratio

- A backstop 3% ratio of Tier 1 capital as against all of a bank’s assets and certain off-balance sheet exposures will be introduced. The assets will be treated on a non-risk adjusted basis with limited or no recognition of collateralization or credit risk mitigation associated with assets. Effectively, this would amount to a leverage ratio of 33:1.

---

**Key**

- SIFI Surcharge (TBD in 2011)
- Countercyclical Capital Buffer (made up of “common equity”)
- Capital Conservation Buffer (made up of “common equity”)
- Tier 2 and Tier 3*
- Tier 2*
- Tier 1 – non-common equity*
- Tier 1 – common equity

* Requirements could be met by a higher form of capital.
D. **Liquidity Ratios**

- Short term liquidity – Liquidity Coverage Ratio ("LCR") – banks will be required from 2015 to maintain a liquid assets buffer calibrated by reference to net cash outflow over a 30 day stressed period.

- Longer Term liquidity – Net Stable Funding Ratio ("NSFR") – banks will be required to have stable funding in place to address funding needs over a stressed one year period. Implementation is scheduled for 2018.

E. **Other Elements of the Basel III Framework**

- Systemically important financial institutions ("SIFIs") are likely to be subject to additional capital requirement and liquidity surcharges, to be determined in 2011.

- Provisions on Pillar 2 (supervisory evaluation) and Pillar 3 (disclosure, market discipline) will be set out in further detail in 2011, building on the existing enhancements to the Basel II framework.

- More stringent standards for the treatment of securitizations and CDOs were issued in the July 2009 release.

- The treatment of trading positions will be subject to a more comprehensive review in 2011. Banks applying “Value-at-risk” ("VaR") models to trading positions are required to calculate a stressed-VaR charge based on a historical period of recent stressed market conditions. Further, credit conversion factors have been adjusted under Basel III to reflect the 2007-2008 experience that some off-balance sheet items are more likely than previously thought to be brought on-balance sheet.

**Scope and National Implementation of Basel III**

**Legal status of the Basel III standards:** Like Basel I and Basel II, Basel III is not a legally binding framework in any jurisdiction. The U.S.’s selective implementation of Basel II exemplifies how a Basel Committee member country may implement only certain aspects of Basel III and/or impose the requirements on only certain institutions. Accordingly, the U.S. and/or the E.U. may choose to modify certain of the Basel III provisions when they finalize and adopt rules. However, it is likely that, over time, the Basel Committee will focus its efforts on ensuring consistent implementation of the new regime, with the result that there is likely to be convergence in implementation among the major jurisdictions.

**Financial institutions subject to the Basel III reforms:** Basel III (like Basel II) is intended to apply to:

- Holding companies for corporate groups that engage primarily in banking activities (Basel III would be applied on a consolidated basis);

- Internationally active banks and their subsidiaries (Basel III would be applied on a consolidated basis); and

- Internationally active banks on an individual basis.

The requirements are designed to apply to all of a group’s banking and other financial activities (e.g., financial leasing, issuing credit cards, portfolio management, investment advisory and custodial and safekeeping services).
United States Institutions: The U.S. has pledged to implement Basel III into U.S. law through agency rulemakings. Nonetheless, the U.S. may determine not to apply the standards to all U.S. banks or may otherwise determine to apply the standards selectively.

Rules relating to the implementation of the revised risk-based capital requirements, capital buffers, the introduction of the leverage ratio requirement and the new liquidity standards originally introduced in the December 2009 Release (generally considered to be the core components of Basel III) have yet to be proposed. According to the acting Comptroller of the Currency (in mid-January), work on a U.S. notice of proposed rulemaking to implement the standards is getting underway but final rules are still some time away from being formulated.

The U.S. could take a number of different approaches to implementation of the core components of Basel III, including drawing a distinction between (i) community banks, (ii) banks with $50 billion assets and above (which, under U.S. law, must be subject to capital requirements above those that generally apply to other banks), and (iii) the largest and most complex banks. In this regard, it is almost certain that virtually all of the key reforms will be imposed on large and internationally active U.S. banking groups. Moreover, it is generally expected that these institutions (and, possibly, any institution with greater than $50 billion in assets) will be required to comply with capital requirements quantitatively above the minima established by Basel III. On the other hand, it is less certain whether smaller institutions will be compelled to adopt reforms such as maintaining capital buffers and employing the stricter definition of capital. It is quite possible that certain of the Basel III reforms will apply to community banks while others (e.g., perhaps, the liquidity requirements and other Basel III requirements that impose higher compliance burdens and costs) will not be “pushed down” to those institutions.

U.S. law creates capital categories which are used for various purposes, including delineating the types of activities and transactions in which a banking group may engage. In connection with the implementation of Basel III, the U.S. federal banking agencies will also need to determine whether compliance with Basel III minimum capital requirements will equate to “well capitalized” or only “adequately capitalized” status. Currently, the minimum capital ratios set under Basel I and II generally equate to “adequately capitalized” status, with the thresholds for “well capitalized” status set higher.

The U.S. federal banking agencies jointly issued a proposed rule on January 11, 2011 that would incorporate improvements to the current trading book regime in a manner broadly consistent with those proposed by the Basel Committee in the July 2009 Release. The proposed rule generally applies to U.S. banks with aggregate trading assets and liabilities equal to 10% or more of quarter-end total assets, or aggregate trading assets and liabilities equal to $1 billion or more. The proposed rule offers a number of technical changes. For example, it (i) establishes more explicit eligibility criteria for trading positions subject to market risk capital treatment, (ii) sets requirements for prudent valuation, robust stress testing and the control, oversight and validation mechanisms for models, (iii) introduces a Stressed VaR requirement, which better captures market risk during periods of stress, and (iv) changes risk-weighting and modeling requirements (and introduces new diligence requirements) for securitizations and re-securitizations.

9 Implementation would be carried out through formal rulemaking by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.
11 See section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).
12 There is, however, some question over how the proposed Basel III leverage ratio would be implemented in the U.S. even for the largest institutions given the existing U.S. leverage ratio requirement applied to U.S. banks and bank holding companies.
13 See Office of the Comptroller of the Currency RIN 1557-AC99; Federal Reserve System RIN No. 7100-AD61; Federal Deposit Insurance Corporation RIN 3064-AD70. The comments on the proposed rule are due April 11, 2011.
U.K. and E.U. Institutions: The E.U. will implement the Basel III framework in an amendment to the Capital Requirements Directive ("CRD"), which consists of two separate directives: (i) the Banking Consolidation Directive,\textsuperscript{14} which applies Basel II to all banks, and (ii) the Capital Adequacy Directive,\textsuperscript{15} which applies Basel II to investment firms. To implement Basel III, the European Commission is currently consulting on proposals for a new directive (known as “CRD IV”) to amend the CRD. The European Commission is also currently consulting on the mechanics of how a countercyclical capital buffer would operate in the E.U.

The E.U. has already effected changes to the regulatory capital treatment applicable to all E.U. banks and investment firms. Some, but not all, of these changes follow on from the Basel Committee’s enhancements to the Basel II framework. The CRD has been amended (in an amending directive known as “CRD II")\textsuperscript{16} to include new rules on hybrid capital instruments required for non-core Tier 1 capital, large exposures and the treatment of securitizations. This has already been implemented in the U.K. by the FSA and other member states of the E.U. were required to implement the amendments by December 31, 2010. Further amendments to the CRD (in a directive known as “CRD III")\textsuperscript{17} have brought about the following changes: higher capital requirements for re-securitizations compared to ordinary securitizations, remuneration requirements, a new charge for firms using VaR risk modeling, to be based on a historical period of stressed market conditions, and an incremental risk charge (“IRC") to apply to firms using a VaR model which imposes a new capital charge intended to cover not only losses from defaults but losses resulting from a downgrading in credit quality of instruments in a bank’s trading book (this replaces the existing incremental default risk charge that was applied pursuant to the CRD).

Implementation timetables: Sovereign countries that have endorsed Basel III are expected to transpose the reforms into national law by January 1, 2013 and the Basel III implementation process is expected to commence on that date (see the Annex for Basel III implementation deadlines). Each country may decide independently how and when to implement Basel III, including whether to adhere to the transitional timeline set out in Basel III or to proceed with implementation on a different schedule. For example, while the U.S. has committed to the Basel III schedule in principle, it is possible that the U.S. may proceed more quickly (or more slowly) with certain reforms than envisaged by the Basel III timetable.

As mentioned previously, U.S. regulators are already taking into account the ability of the largest banks to meet the new standards when determining whether or not the bank can increase dividends, implement common stock repurchase programs, or redeem or repurchase capital instruments. Banks may also encounter market pressure to comply with Basel III’s capital, leverage and liquidity ratios before the deadlines set out in Basel III. Given the possibility of early national compliance deadlines and market pressure, some banks may be unable to build up capital slowly and organically, as the Basel Committee intended.

Divergent approaches to implementation: Some countries view the Basel Committee’s standards as “best practices” for dealing with capital adequacy issues even for the most complex organizations. Others, however, believe that the standards should serve as a universal floor for all banks. For example, the Bank of England has expressed the view that Basel III should be seen as a minimum standard, on which individual nations can build more stringent requirements. Similarly, Switzerland has proposed capital requirements for its largest banks that would be more onerous than the requirements of Basel III in its current form (UBS and Credit Suisse would need to lift their ratio of Tier 1 common equity to 10% of RWAs, and have an additional 9% of capital to RWAs, which extra 9% may comprise contingent capital instruments). Capital adequacy regimes

\textsuperscript{14} Directive 2006/48/EC.
\textsuperscript{15} Directive 2006/49/EC.
\textsuperscript{16} Directive 2009/111/EC.
\textsuperscript{17} Directive 2010/76/EU.
that vary from country to country could provide opportunities for geographical arbitrage, and differences in national implementation of Basel III may affect international competitiveness.

**Capital Ratios**

By January 1, 2019, banking institutions subject to Basel III will be required to maintain:

- A minimum ratio of Tier 1 common equity to RWAs of 4.5% (increased from the existing requirement of 2%);
- A minimum ratio of Tier 1 capital to RWAs of 6% (increased from the existing requirement of 4%); and
- A minimum ratio of total capital to RWAs of 8% (unchanged from the existing requirements).

These ratios will be phased in from January 1, 2013 onwards (see the Annex).

<table>
<thead>
<tr>
<th>Capital Base</th>
<th>Minimum Capital to RWAs Ratio</th>
<th>BASEL III</th>
<th>BASEL II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1 Common equity</td>
<td></td>
<td>4.5%</td>
<td>2%</td>
</tr>
<tr>
<td>Non-core</td>
<td></td>
<td>1.5%</td>
<td>2%</td>
</tr>
<tr>
<td></td>
<td>Innovative Tier 1 – max 15%</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>of overall Tier 1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tier 2</td>
<td></td>
<td>2%</td>
<td>4% (of both upper and lower Tier 2 instruments)</td>
</tr>
<tr>
<td>Tier 3</td>
<td></td>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Capital Conservation Buffer</td>
<td></td>
<td>2.5%</td>
<td>--</td>
</tr>
<tr>
<td>Countercyclical Capital Buffer</td>
<td></td>
<td>0 – 2.5%</td>
<td>--</td>
</tr>
<tr>
<td>SIFI Requirement</td>
<td>To follow</td>
<td></td>
<td>--</td>
</tr>
</tbody>
</table>

As shown above, the overall required Tier 1 and common equity (or “core”) Tier 1 ratios will be much higher under Basel III. Moreover, the full extent of the change is not reflected in the numerical increase given both (i) tighter minimum requirements for inclusion in the capital base (which may decrease the numerator of a bank’s capital ratio), and (ii) greater risk weightings of assets (which may increase the denominator of a bank’s capital ratio).

**Capital conservation buffer:** Basel III introduces an extra buffer of 2.5% of common equity above the minimum requirement for Tier 1 common equity for the top-tier holding company of the banking group. It is intended to ensure that financial institutions have a cushion during times of financial and economic stress. Where a financial institution’s common equity in excess of the regulatory minimum amount falls within the buffer range, the institution will be restricted in the distributions (such as dividends, share buy-backs and staff bonuses) that it can make, although its operations will not be restricted (meaning that extensions of new credit, etc. will continue to be permitted). The constraints on distributions will increase as the capital conservation buffer decreases further below the required amount.
The capital conservation buffer requirement will apply as of January 1, 2016 at 0.625%, moving to 1.25% as of January 1, 2017, then 1.875% as of January 1, 2018 and will rise to the full 2.5% level by January 1, 2019 (at which point the total Tier 1 common equity target would effectively be 7%, i.e., a 4.5% minimum and a 2.5% conservation buffer). Under Basel III, institutions that meet the minimum ratio requirement but remain below 7% Tier 1 common equity target (i.e., the minimum plus a conservation buffer) would be expected to maintain prudent earnings retention policies with a view to meeting the conservation buffer as soon as reasonably possible. The Basel Committee has suggested that a quicker implementation may be appropriate in countries that are experiencing excessive credit growth.

**Countercyclical capital buffer**: A second buffer, comprising between 0% to 2.5% of Tier 1 common equity to RWAs, may be imposed by a national authority in times of excessive credit growth. The buffer is “countercyclical” in the sense that its introduction is intended to raise the cost of credit during periods of rapid credit growth and its “release” is intended to reduce its cost during a downturn.\(^{18}\) The countercyclical capital regime will be phased in together with the capital conservation buffer requirement on January 1, 2016, becoming fully effective on January 1, 2019.\(^{19}\)

A national regulator may institute – and permit the release of – a buffer of any size and at any time to the extent deemed warranted to achieve the buffer’s objective. The Basel Committee suggests that the use of a buffer is particularly appropriate when the stock of national credit is excessive relative to historical trends.\(^{20}\) Individual countries are free to consider other factors in making buffer decisions and may well exercise their discretion in very different ways. As a consequence, precisely when, how and the extent to which the buffer will be used in practice will remain uncertain for some time.\(^{21}\)

Where a banking group has operations in more than one country, it is required to calculate its own countercyclical buffer based on a weighted average of all of the countercyclical capital buffers in force in each Basel III country to which the group has any credit exposure.\(^{22}\) This unique aspect of the countercyclical capital buffer – which the Basel Committee refers to as “jurisdictional reciprocity” – is intended to create a level playing field for all institutions (whether incorporated in the jurisdiction or not) providing credit in a given jurisdiction. In practice it would seem to (i) create an economic incentive for banks to increase their exposures to countries with no (or a relatively smaller) capital buffer requirement in place and to reduce their exposures to countries that have imposed a relatively larger buffer, and (ii) add to the complexity (and compliance burden) associated with the calculation of the buffer.

**Constituents of Capital**

Basel III further restricts the types of instruments that qualify as bank regulatory capital through the introduction of new requirements. The classes or “tiers” of regulatory capital under Basel III are summarized below.

**Tier 1 “common equity”**: Includes common shares (including share premium resulting from the issue of such instruments), retained earnings, certain accumulated other comprehensive income (including interim profit and loss) and disclosed

---

\(^{18}\) The existing Basel I and II regimes arguably make it more expensive and difficult for institutions to lend during a time of market turbulence. Without a required buffer of bank capital that would be available to absorb higher losses, many banks need to curtail their lending activities in order to preserve sufficient capital during downturns to ensure that they are operating above minimum required capital levels.


\(^{20}\) The Basel Committee has directed each national authority to calculate its current aggregate private sector credit to GDP ratio and compare it to the corresponding historical value.

\(^{21}\) In order to provide banking groups with time to raise additional capital, Basel III directs countries to preannounce any introductions of, or increases to, the countercyclical buffer by up to 12 months.

\(^{22}\) An international bank would not be required to apply any buffer amount instituted in a “host country” in excess of 2.5% of RWAs. Accordingly, a buffer above 2.5% would only apply only to domestic institutions.
reserves, and a limited amount of common shares issued by consolidated bank subsidiaries and held by third parties. Certain assets are deducted from Tier 1 “common equity.”

**Additional Tier 1 instruments:** In addition to common equity, Tier 1 capital includes certain non-common subordinated instruments with fully discretionary non-cumulative dividends or coupons. So-called Additional Tier 1 instruments must be perpetual, i.e., without a maturity date and precluding any incentives to redeem. In January, the Basel Committee pronounced that Additional Tier 1 instruments, if issued by internationally active banks, must be convertible to common equity or be written off at the point that an institution would become non-viable without state support. In addition, any Tier 1 instruments that are classified as liabilities for accounting purposes must include a similar conversion or write-off feature.

**Tier 2 capital:** Basel III abolishes the existing categories of upper and lower Tier 2 capital. Under Basel III, there will be one unified category of Tier 2 capital, consisting of instruments capable of absorbing losses in the event a bank is insolvent (“gone concern capital”). Tier 2 capital mainly consists of subordinated debt with a minimum original maturity of at least five years. Like Additional Tier 1 instruments, Tier 2 instruments must incorporate a mandatory write-down or conversion feature if issued by an internationally active bank and satisfy several other specific criteria.

**Tier 3 capital abolished:** Under Basel II, there is a category of Tier 3 capital that includes some short-term subordinated debt and net interim trading book profits. Under the existing framework, Tier 3 capital can satisfy a part of the capital requirement for market risk. The concept of Tier 3 capital has been abolished, and so these instruments will no longer be included in calculations of the total risk-based capital ratio. This means that the same quality of capital must now be used to meet capital requirements for both the trading book and the banking book.

**U.S. and E.U. differences:** The U.S. and the E.U. took slightly different approaches to determine regulatory capital when Basel I and II were implemented into national law. Approaches could likewise differ under Basel III.

**Application of criteria to non joint stock companies:** The criteria developed for inclusion as common equity will also apply to banks that are not organized as joint stock companies, such as mutuals, cooperatives or savings institutions taking into account their specific constitution and legal structure. Capital instruments representing interests in these organizations will satisfy the common equity component if 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.

**Phase-out of ineligible capital instruments:** Capital instruments that no longer qualify as Additional Tier 1 capital or Tier 2 capital will be phased out over a 10 year period, with 90% recognition of such instruments commencing January 1, 2013, 80% recognition commencing January 1, 2014, 70% recognition commencing January 1, 2015, and so on. Only instruments issued prior to September 12, 2010 will qualify for these transitional arrangements. Capital instruments that no longer qualify as common equity will be excluded from Tier 1 common equity capital as of January 1, 2013 (subject to certain narrow exceptions for some capital instruments that will be phased-out over a ten-year period).

**Deductions from Capital:** Certain assets will be deducted from the calculation of common equity Tier 1 capital (rather than such adjustments being applied to the overall regulatory capital of a bank).

The deductions from a bank’s common equity include goodwill and other intangible assets (excluding mortgage servicing rights), reciprocal cross-holdings in other financial institutions, any shortfall in provisions by reference to expected losses

---

calculated under its own internal models, defined benefit pension fund assets, investment in the bank’s own shares (unless already derecognized under relevant accounting standards), and some deferred tax assets which must be entirely deducted from common equity. Items that are required to be derecognized in relation to common equity include unrealized gains and losses recognized on a bank’s balance sheet because of a change in such bank’s credit risk (e.g., gains and losses with respect to debt instruments, equities, loans and receivables), cash flow hedge reserves, and gains, on sales related to securitization transactions.

Certain assets are subject to partial deduction from Tier 1 common equity. These assets include significant investments (being more than 10% of the issued share capital) in the common shares of unconsolidated financial institutions, mortgage servicing rights and certain deferred tax assets. Such assets can be included as Tier 1 common equity so long as (i) each of these items is capped at 10% of a bank’s common equity, and (ii) in the aggregate, all three of these items do not exceed 15% of a bank’s common equity. These adjustments to capital will be fully deducted by January 1, 2018.

**Risk-Weighting of Assets**

Existing approaches to assessing credit risk associated with a bank’s assets, namely (i) the standardized approach, (ii) the foundation internal ratings based approach, and (iii) the advanced internal ratings based approach remain intact under Basel III. The standardized approach focuses on a counterparty’s credit rating to determine the credit risk of that counterparty. The second and third approaches determine the mechanism for calculating the three variables which are used in computing the credit risk component of capital requirement for institutions, namely: probability of default (“PD”), loss given default (“LGD”) and exposure at default (“EAD”). Under the standardized approach, PD and LGD are incorporated into the weightings prescribed by Basel II, whereas prescribed credit conversion factors are used to calculate the EAD. The foundation internal ratings based approach permits the bank to use internal rating models to calculate PD, whereas LGD and EAD inputs are provided by the bank’s regulator. The advanced internal ratings based approach allows a bank to calculate all three variables using internal models, although the formulae used in the model must be agreed with the regulator.

The Basel Committee found that mark-to-market losses occasioned by the deterioration of creditworthiness, short of default, of a counterparty were not accurately reflected. Accordingly, Basel III now requires (i) the use of stressed inputs in assessing credit risk, (ii) more capital to be held to reflect mark-to-market losses (i.e. the credit valuation adjustment risk) associated with deterioration in a counterparty’s credit quality in relation to OTC derivatives, (iii) strengthened standards for collateral management and margining for OTC derivatives and securities financing transactions, (iv) applying a multiplier of 1.25 to the asset value correlation of exposures to regulated financial firms (with assets of at least $100 billion) and to all exposures to unregulated financial firms regardless of size; and (v) applying a proposed risk weighting of 2% to exposures to a central counterparty (where currently such exposures are treated as risk-free).

In addition, banks will be required to identify instances of “wrong-way” risk where the future exposure to a counterparty is highly correlated to the counterparty’s probability of default. For example, a company writing put options on its own stock creates wrong way exposures for the option buyer. Similarly, in the case of a single name CDS written by a counterparty affiliated with the underlying issuer. The EAD in respect of such a counterparty is equal to the full expected loss in the remaining fair value of the underlying instrument assuming the underlying issuer is in liquidation.

**Risk-weightings for trading book activities:** Banks that are permitted to use their own internal “value-at-risk” (VaR) models for assessing market risk associated with their trading positions will now be required to incorporate stressed inputs in their VaR modeling. This is to address the inherent procyclicality of normal VaR modeling where capital requirements were greater in downswings but reduced in upswings, which was a particular problem where the trading book included illiquid

---

24 As noted previously, thus far only the advanced internal ratings based approach has been adopted in the United States. See note 3 above.
positions and VaR modeling used stressed inputs calibrated only by reference to a historical 12 month period. A stressed VaR measurement will now take into account a 12 month period of significant financial stress and losses and this 12 month period would be equated with the losses suffered in the 2007/8 period of the financial crisis. In addition, there will also be a new “incremental risk charge” applied to trading positions where losses occasioned by, typically, a ratings downgrade of an issuer would be captured. This replaces the current “incremental default risk charge” which captured default risk of the underlying obligor. Risk-weighting for exposures to counterparties who are financial institutions will be higher than risk-weighting for other types of corporations.

It is estimated that these changes (and the introduction of the new liquidity ratios) will require banks to hold on average three to four times the old capital requirements for trading positions. It has been argued that, given the one-off nature of the financial crisis, risk weightings based on stresses occurring in the crisis would be overly conservative, unduly constraining bank activities.

Under Basel III, risk-weightings need only be applied to the “loan equivalent amount” of a bank’s derivative exposure to a counterparty, which is determined by netting out the parties’ derivatives exposure to each other. This incentivizes increased netting by banks, which encourages them to ensure their bilateral OTC derivatives are centrally cleared.

Risk-weightings for securitizations: Concern about arbitrage between the banking book and the trading book, particularly in relation to securitization exposures, was the basis for the realignment of capital charges for such exposures whether held in the banking book or the trading book. Increased capital charges will be required for re-securitizations (or CDOs). Banks will also be incentivized to reduce reliance on external ratings of securitization exposures and to conduct their own due diligence.

Timeline for implementation: Banks subject to the trading book capital regime are expected to comply with changes to the risk-weighting of trading book assets by the end of 2011. Other changes to risk weightings are due to become effective on January 1, 2013. The Basel Committee will continue to work through 2011 on reviewing regulatory capital requirements for market risk and trading activities.

New Leverage Ratio Requirement

The leverage ratio is a “simple, transparent, non-risk based measure” intended to reduce the amount of risk in the financial system and to backstop the risk-based capital requirements. The leverage ratio restricts the absolute level of indebtedness of a bank for a given amount of capital. As such it is intended to act as a safeguard against attempts to game the risk-based capital requirements and it also serves to mitigate discrepancies and/or misjudgments in risk attribution to assets. Basel III provides for a trial period a minimum leverage ratio requiring 3% of Tier 1 capital measured against gross exposures without risk adjustments. The leverage ratio will be required to be calculated as an average over each month.

Like the leverage requirement currently in effect in the United States for banks and bank holding companies, the numerator of the ratio of the Basel III requirement is Tier 1 capital (see page 12 for further detail). The denominator of the ratio, the “total exposure”, is based on non-risk weighted assets and off-balance sheet exposures. The denominator is to be calculated in accordance with financial accounting principles that apply to the bank but with a consistent application of regulatory netting principles to gross assets. This is to prevent the application of netting rules of differing accounting regimes which could result in the divergent calculation of total exposures. In calculating total exposures, netting of loans and deposits is not permitted. Derivatives exposures can be netted out, but the “loan equivalent amount” of an exposure to a derivative counterparty after netting must be included in total exposures. Repo and off-balance sheet commitments must also be included (with a 100% credit conversion factor, unless the off-balance sheet commitments are unconditionally cancellable, in which case a 10% credit conversion factor will apply). Securitized assets will be treated according to the accounting treatment for such assets.
Implementation: The transition to the leverage ratio will be marked by the following “milestones”:

- A supervisory monitoring period from January 1, 2011 through December 31, 2012 will focus on developing templates to consistently track the components of the ratio and the resulting ratio.

- A parallel run period from January 1, 2013 through December 31, 2016 during which the leverage ratio and its components will be tracked, including the ratio’s relation to the risk-based requirements.

- Bank disclosure of the leverage ratio will start on January 1, 2015.

- Based upon the results of the parallel run period, any final adjustments will be made in the first half of 2017, with a view to full applicability from January 1, 2018.

Notwithstanding that full compliance is not required until January 1, 2018, market pressure could effectively require compliance at an earlier date (especially once banks are required to start disclosing their leverage ratios from January 2015).

Impact: The new leverage ratio could constrain balance sheet growth for some institutions (or even possibly lead to balance sheet contraction) where raising additional capital is not a viable option. It may also push banks to favor fee-based activities that do not create any exposures included in the denominator of the leverage ratio. In cases where the leverage ratio requirement (rather than the risk-weighted capital requirements) acts as the effective minimum capital floor for a particular bank, the bank may perversely have incentive to acquire riskier higher yielding assets.

New Liquidity Requirements

Basel III introduces two new liquidity standards as follows:

**The Liquidity Coverage Ratio (“LCR”):** The LCR is intended to measure a bank’s ability to access funding for a 30 day period of acute market stress. Banks will be required to have a segregated stock of highly liquid and unencumbered assets that are at least equal to its estimated “net cash outflows” for a thirty day period during a time of acute liquidity stress. The 30 day stressed period assumes certain institution-specific and system wide liquidity shocks including a credit rating downgrade of the bank of three notches, partial loss of unsecured wholesale funding, withdrawal of some retail deposits, some committed but unfunded credit and liquidity lines provided by the bank being drawn down and general market volatility.

**High quality liquid assets:** Qualifying high quality liquid assets (i.e., the numerator of the LCR) are generally unencumbered, easily and immediately convertible to cash with little or no loss of value even during times of stress, and central bank eligible. Qualifying assets fall into one of two categories: Level 1 and Level 2. Only cash, central bank reserves and certain securities issued by governments, central banks and some international finance agencies constitute Level 1 assets. Other qualifying liquid assets will be treated as Level 2 assets. A 15% haircut is applied to all Level 2 assets and, after applying this haircut, Level 2 assets cannot make up more than 40% of the total liquid assets used to calculate the LCR.

**Net cash outflows:** Basel III sets out complex formulae for determining “net cash outflows” (i.e. the denominator of the LCR), which involve the weighting of cash inflows and outflows to determine net cash outflows. While the term “net cash outflow” suggests otherwise, a bank cannot completely net cash inflows and outflows for the purpose of calculating the denominator of the LCR. The formula is designed to ensure that there will be enough high quality liquid assets to service at least 25% of un-netted cash outflows, in addition to having liquid assets sufficient to service 100% of net cash outflows. The Basel Committee also adopts a conservative approach to the treatment of credit facilities. Banks will not be able to include as a cash inflow their ability to draw down on any credit or liquidity facility lines granted by another bank, yet banks are required to assume a 100% drawdown of committed credit and liquidity facilities granted to other banks for the purpose of calculating cash outflows.
The Net Stable Funding Ratio ("NSFR"): The purpose of the NSFR is to limit short-term liquidity mismatches and encourage the use of longer term funding. A bank is required to have stable funding sources in excess of the amount of stable funding it would likely need over a one-year period of extended market stress. This is a longer term structural ratio that covers a bank’s entire balance sheet as well as certain off-balance sheet commitments. Essentially a sufficient amount of stable funding is required to finance those assets which are regarded as not being capable of being monetized through sale or use as collateral in secured borrowings during a liquidity event lasting one year.

Available stable funding: These are the available reliable sources of funds over a one-year period under conditions of extended stress. Stable funding sources include Tier 1 and Tier 2 capital, preferred stock (that does not otherwise qualify as Tier 2 capital) with maturity greater than one year, liabilities with maturities greater than one year, and deposits and funding with maturities less than one year which would be expected to stay with the bank even during stress events. Basel III gives various stable funding sources different weightings, to be used in calculating the available amount of stable funding. These weightings reflect the perceived availability and stability of the various sources.

Required funding: The amount of stable funding that is required is the sum of the various types of asset held and funded by a bank and off-balance sheet contingent exposures incurred and other activities of the bank that could expose it to liquidity risk - in effect the illiquid portion of a bank’s asset book. Determining the required amount of stable funding is again a complex calculation that requires a bank’s assets and activities to be weighted in accordance with various weighting factors. For example, encumbered (e.g., pledged) assets have a weighting of 100% unless the encumbrance expires within a year. Interestingly, loans to corporates would be assigned a higher weighting than equivalent borrowings by such corporates through bond issues.

Implementation of the LCR and NSFR: The observation period for both the LCR and the NSFR begins on January 1, 2012. The minimum standard for the LCR is intended to be introduced on January 1, 2015, and the NSFR minimum standard is intended to be introduced on January 1, 2018. It should be noted that the Basel Committee has already indicated that some refinements to the calculation of the LCR and the NSFR may be necessary.

Impact: Compliance with the new liquidity ratios is likely to be the most challenging aspect of Basel III implementation for many banks. To ensure compliance, the Basel Committee recommends that banks and their supervisors regularly assess each bank’s contractual maturity mismatch, concentration of funding, available unencumbered assets, and ability to satisfy liquidity ratios in all relevant currencies. Despite the fact that Basel III provides for long implementation periods for these ratios, banks will need to be in a position to report data regarding liquidity by the beginning of the relevant observation period (which is January 1, 2012 for both the LCR and the NSFR). Banks may also be subject to market pressure to comply with the liquidity ratios even before the deadlines set out in Basel III.

Possible Future Refinements to Basel III

The above proposals are expressed to be the final statement of the Basel Committee on certain issues (such as the new risk-weighted capital ratios). However, the Basel Committee has not yet completed its work on Basel III, and has identified trading activities, the use of external credit ratings, and large exposures as areas that warrant further consideration. These areas are not fully covered in the Basel III framework. Additional work will also be done on contingent capital and SIFIs (see below). Furthermore, the new ratios (especially the new liquidity ratios) may be amended based on the results of the observation and monitoring process. Even to the extent that the rules are settled, they will need to be implemented by national regulators. It remains to be seen how this is to be done.

The application of Basel III to SIFIs: The Basel Committee has taken the view that SIFIs should be required to hold more capital than other financial institutions. Later this year, the Basel Committee is expected to release a methodology for assessing which institutions are “systemically important”. The Basel Committee is also expected to complete by the middle
of 2011 a study of the level of additional capital that SIFIs should hold (recently, there has been speculation that this may be
in the form of a requirement to hold additional common equity between 1-3% of RWAs), and whether there should be extra
requirements for contingent capital and bail-in debt. The Basel Committee is also considering what type of resolution
authority is appropriate for SIFIs. The G20 has identified liquidity surcharges, tighter large exposure restrictions, levies and
structural measures as areas for further exploration. It is likely that each country will have some flexibility in implementing
these principles of Basel III, which may lead to unequal treatment of SIFIs in different jurisdictions.

**Basel III and the Dodd-Frank Act**

**Interaction with Dodd-Frank:** Certain provisions of Dodd-Frank that relate to capital adequacy are not entirely consistent
with Basel III, and it is not clear at this point how these inconsistencies will be resolved. For example, Basel III still relies on
external credit ratings in determining capital charges for certain assets and whether assets can be counted towards the LCR
(although the Basel Committee is considering whether such reliance is appropriate). In contrast, section of 939A of Dodd-
Frank requires that any reference to credit ratings in federal agency regulations be removed by July 2011. There are also
inconsistencies between Basel III and the Collins Amendment, which are discussed below.

In some instances where there is consistency between Dodd-Frank and Basel III, the implementation timeframes are
different. For example, both Dodd-Frank and Basel III exclude cumulative preferred securities such as trust preferred
securities (which have been widely used by U.S. bank holding companies) from Tier 1 capital, but Basel III generally gives a
much longer time period to phase out these types of securities than the three years given by Dodd-Frank. Also, under Dodd-
Frank the smallest banks are not subject to the statutory requirement to phase out trust preferred securities from Tier 1
capital, but Basel III does not provide a similar exemption.

Finally, Dodd-Frank mandates the undertaking of a variety of studies, several of which cover areas that are also covered by
Basel III, including the costs, benefits and feasibility of implementing contingent capital requirements. The outcomes and
recommendations set out in such studies will need to be reconciled with the requirements of Basel III.

**Interaction with the Collins Amendment:** Section 171 of Dodd-Frank (known as the “Collins Amendment”) incorporates
into Dodd-Frank minimum leverage capital requirements and minimum risk-based capital requirements which are to be
established by federal banking agencies. These requirements will be set at least as high as the Basel I ratios, but may be set
higher. In a departure from current practice (which defers to home country standards), these standards will be applied to
intermediate U.S. bank holding companies that are subsidiaries of a non-U.S. bank. This may cause difficulties for affected
non-U.S. banks, as home country and U.S. implementations of Basel III may be inconsistent and such banks will have
additional costs associated with maintaining and managing capital at a new entity. In response, certain non-U.S. banks have
already begun reorganizing their U.S. operations. This aspect of the Collins Amendment is set to come into effect in
July 2015.

The Collins Amendment also requires Federal banking agencies to develop special capital adequacy requirements for
systemically risky activities (including significant involvement in derivatives, securitized products, financial guarantees,
securities lending and the repo market). These special requirements may diverge from the Basel III requirements.

**How Dodd-Frank relates to capital requirements:** As noted above, the risk-based capital requirements of Basel II were only
implemented in the U.S. with respect to large, internationally active banking institutions (by what is known as the “advanced

25 “Bail-in” is the concept that holders of a bank’s debt would risk having that debt restructured (which could involve conversion to equity) if the
bank runs into trouble. Regulators, practitioners and academics are still debating how effective bail-in debt would be and how it would be
structured.
approaches” rule). Under certain circumstances, the application of the advanced approaches rule can allow these large, internationally active banking institutions to hold less capital than would otherwise be required under existing rules that apply to other U.S. banks. On December 15, the U.S. banking regulatory agencies jointly proposed a rule that would set a floor for risk-based capital and leverage requirements for such “Basel II banks”.26 This is intended to comply with the requirement of the Collins Amendment that the minimum risk-based capital and leverage requirements not be less than the “generally applicable” capital and leverage requirements in force on the date of the enactment of Dodd-Frank.

Also on December 15, the U.S. banking regulatory agencies jointly proposed a rule that would implement the changes to risk based capital standards for trading activities.27 Notably, the proposed rule does not incorporate the Basel Committee’s methodologies for assignment of charges to securitization positions, because those methodologies rely on external credit ratings and, as discussed above, Dodd-Frank does not allow federal agency rulemakings to refer to external credit ratings.

The Board of Governors of the Federal Reserve System has indicated that, some time between April and June 2011, it will propose rules regarding increased risk-based capital, leverage and liquidity requirements for institutions with assets in excess of $50 billion.28 The Federal Reserve’s rules could potentially diverge from the Basel Committee’s recommendations on additional capital requirements for SIFIs (expected to be released by mid-2011). Final U.S. rules on the enhanced requirements are required to be issued no later than January 2012, pursuant to section 165(b)(1)(A) of Dodd-Frank.

Any inconsistency between the U.S. and international positions could potentially be an issue for non-U.S. banks operating in the U.S. if they are required to comply with both U.S. rules as well as the rules of their “home country”. It is not yet clear whether the new U.S. capital adequacy requirements will apply only at the U.S. level, or whether they may also be applied at the level of a non-U.S. parent bank where, e.g., the non-U.S. bank has “financial holding company” or SIFI status under U.S. law.

Impact of Basel III on Financial Institutions

Basel III is intended to be applied consistently around the world so as to reduce the risk that financial institutions will move their operations to jurisdictions with more lenient regulatory regimes. However, it is by no means clear that Basel III will be implemented uniformly around the world. The timing of implementation will not be identical, and banks with operations in multiple countries may be compelled to comply with the tightest national timeline to which they are subject. Even when fully implemented, the finer details of national capital adequacy regimes are likely to differ and, again, international banks may find themselves compelled to comply with the rules of the host country with the most stringent national capital adequacy requirements.

Basel III’s new requirement for countercyclical capital buffers may also be difficult for banks with international operations. Basel III requires that individual countries consider whether to increase their national capital requirements when there is an unsafe build-up of credit. If a bank has operations in more than one country, the countercyclical buffer that it is required to maintain will be a weighted average of all of the countercyclical buffers in force in countries in which it has credit exposure.

The results of studies by the Basel Committee and Barclays Capital relating to the impact of Basel III have received significant press coverage. According to the Basel Committee’ Quantitative Impact Study (“QIS”, released December 16, 2010), banks would have collectively required an additional €602 billion of Tier 1 common equity capital at the end of 2009 in order to have satisfied new common equity requirements. The Barclays Capital study (released in November 2010) found that the largest 35 U.S. banks are short of meeting the common equity requirements of Basel III by

26 See OCC RIN 1557-AC33; Federal Reserve System RIN No. 7100-AD62; FDIC RIN 3064-AD58.
27 See OCC RIN 1557-AC99; Federal Reserve System RIN No. 7100-AD61; FDIC RIN 3064-AD70.
between $100 billion and $150 billion, with 90% of the shortfall concentrated in the largest six banks. These studies show that the capital shortfalls were much more pronounced for larger, internationally active banks than for smaller banks. In contrast, the new liquidity requirements may prove more difficult for mid-size and smaller banks than for larger banks, and this may cause these smaller banks to exit lines of business that tie up liquid assets, like processing cash payments.\textsuperscript{29} That is not to say that the new liquidity requirements will not be expensive for larger banks as well – the QIS indicates that if the larger banks make no changes to their liquidity profile, they will collectively be €1,730 billion short of liquid assets by the time the requirement becomes effective in 2015. The impact of the Basel III requirements as a whole may encourage certain activities to migrate to the shadow banking or unregulated sectors, albeit the Basel Committee has experienced a desire to address any such trend and opine on the scope of the regulatory perimeter accordingly.

On December 17, 2010, the Basel Committee released a report on the likely macroeconomic impact of Basel III.\textsuperscript{30} It indicated that full compliance with Basel III is likely to result in a small dip in real GDP growth. However, if the U.S. (or any other country) rushes to implement Basel III more quickly than required, or if banks decide (for prudential or competitive reasons) to be even more conservative on capital and liquidity than Basel III requires, the impact on GDP growth would be greater. Where banks have strengthened their capital over the last few years through retained earnings and capital raisings, the implementation of Basel III is likely to have less of an impact on the global economy. To the extent that banks try to comply more quickly with Basel III’s capital and leverage requirements, this may lead to an increase in loan spreads, the tightening of loan terms or a cut-back in lending volumes.

\textsuperscript{29} See, e.g., \textit{Liquidity Rules to Squeeze Smaller Banks}, Financial Times (Dec. 30, 2010).

\textsuperscript{30} \textit{Final Report on the Assessment of the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements} (Basel Committee).
This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

<table>
<thead>
<tr>
<th>Name</th>
<th>City</th>
<th>Country</th>
<th>Contact Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barney Reynolds</td>
<td>London</td>
<td></td>
<td>+44.20.7655.5528 <a href="mailto:barney.reynolds@shearman.com">barney.reynolds@shearman.com</a></td>
</tr>
<tr>
<td>Tobia Croff</td>
<td>Milan</td>
<td></td>
<td>+39.02.0064.1509 <a href="mailto:tcroff@shearman.com">tcroff@shearman.com</a></td>
</tr>
<tr>
<td>Azad Ali</td>
<td>London</td>
<td></td>
<td>+44.20.7655.5659 <a href="mailto:azad.ali@shearman.com">azad.ali@shearman.com</a></td>
</tr>
<tr>
<td>Steven Blau</td>
<td>New York</td>
<td></td>
<td>+1.212.848.8534 <a href="mailto:steven.blau@shearman.com">steven.blau@shearman.com</a></td>
</tr>
<tr>
<td>Hans Diekmann</td>
<td>Dusseldorf</td>
<td></td>
<td>+49.211.1788.8814 <a href="mailto:hdiekmann@shearman.com">hdiekmann@shearman.com</a></td>
</tr>
<tr>
<td>Bradley Sabel</td>
<td>New York</td>
<td></td>
<td>+1.212.848.8410 <a href="mailto:bsabel@shearman.com">bsabel@shearman.com</a></td>
</tr>
<tr>
<td>Donald Lamson</td>
<td>Washington</td>
<td></td>
<td>+1.202.508.8130 <a href="mailto:donald.lamson@shearman.com">donald.lamson@shearman.com</a></td>
</tr>
<tr>
<td>Pierre-Nicolas Ferrand</td>
<td>Paris</td>
<td></td>
<td>+33.15389.7177 <a href="mailto:pferrand@shearman.com">pferrand@shearman.com</a></td>
</tr>
<tr>
<td>Russell Sacks</td>
<td>New York</td>
<td></td>
<td>+1.212.848.7585 <a href="mailto:russell.sacks@shearman.com">russell.sacks@shearman.com</a></td>
</tr>
<tr>
<td>Bertrand Senechal</td>
<td>Paris</td>
<td></td>
<td>+33.15389.7095 <a href="mailto:bsenechal@shearman.com">bsenechal@shearman.com</a></td>
</tr>
<tr>
<td>Gregg Rozansky</td>
<td>New York</td>
<td></td>
<td>+1.212.848.4055 <a href="mailto:gregg.rozansky@shearman.com">gregg.rozansky@shearman.com</a></td>
</tr>
<tr>
<td>Michael Blankenship</td>
<td>New York</td>
<td></td>
<td>+1.212.848.8531 <a href="mailto:michael.blankenship@shearman.com">michael.blankenship@shearman.com</a></td>
</tr>
<tr>
<td>Katja Kaulamo</td>
<td>Frankfurt</td>
<td></td>
<td>+49.69.9711.1719 <a href="mailto:katja.kaulamo@shearman.com">katja.kaulamo@shearman.com</a></td>
</tr>
<tr>
<td>Roger Kiem</td>
<td>Frankfurt</td>
<td></td>
<td>+49.69.9711.1280 <a href="mailto:rkiem@shearman.com">rkiem@shearman.com</a></td>
</tr>
<tr>
<td>Charles Gittleman</td>
<td>New York</td>
<td></td>
<td>+1.212.848.7317 <a href="mailto:cgittleman@shearman.com">cgittleman@shearman.com</a></td>
</tr>
<tr>
<td>Thomas Donegan</td>
<td>London</td>
<td></td>
<td>+44.20.7655.5566 <a href="mailto:thomas.donegan@shearman.com">thomas.donegan@shearman.com</a></td>
</tr>
</tbody>
</table>
## ANNEX
TIMELINE FOR NEW MINIMUM CAPITAL STANDARDS

### PHASE-IN ARRANGEMENTS FOR NEW MINIMUM RISK-BASED CAPITAL RATIOS (ALL DATES AS OF JANUARY 1)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tier 1 Common Equity</strong></td>
<td>2.0%</td>
<td>2.0%</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
</tr>
<tr>
<td><strong>Capital Conservation Buffer</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.625%</td>
<td>1.25%</td>
<td>1.875%</td>
<td>2.50%</td>
</tr>
<tr>
<td><strong>Tier 1 Common Equity plus Capital Conservation Buffer</strong></td>
<td>2.0%</td>
<td>2.0%</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>5.125%</td>
<td>5.75%</td>
<td>6.375%</td>
<td>7%</td>
</tr>
<tr>
<td><strong>Tier 1 Capital</strong></td>
<td>4.0%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>5.5%</td>
<td>6.0%</td>
<td>6.0%</td>
<td>6.0%</td>
<td>6.0%</td>
<td>6.0%</td>
</tr>
<tr>
<td><strong>Total Capital</strong></td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
</tr>
<tr>
<td><strong>Total Capital plus Capital Conservation Buffer</strong></td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>5.0%</td>
<td>8.0%</td>
<td>8.625%</td>
<td>9.25%</td>
<td>9.875%</td>
<td>10.5%</td>
</tr>
</tbody>
</table>

### PHASE-IN ARRANGEMENTS FOR LEVERAGE RATIO

<table>
<thead>
<tr>
<th>Leverage Ratio</th>
<th>Supervisory Monitoring</th>
<th>Parallel Run (3%) (disclosure begins January 1, 2015)</th>
<th>Pillar 1 Migration</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### PHASE-OUT ARRANGEMENTS FOR CAPITAL INSTRUMENTS NO LONGER QUALIFYING AS NON-COMMON EQUITY TIER 1 OR TIER 1 (ALL DATES AS OF JANUARY 1)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>90%</td>
<td>80%</td>
<td>70%</td>
<td>60%</td>
<td>50%</td>
<td>40%</td>
<td>30%</td>
<td>20%</td>
<td>10%</td>
<td>0%</td>
</tr>
</tbody>
</table>

### PHASE-IN ARRANGEMENTS FOR DEDUCTIONS OF REGULATORY ADJUSTMENTS TO COMMON EQUITY

<table>
<thead>
<tr>
<th></th>
<th>0%</th>
<th>20%</th>
<th>40%</th>
<th>60%</th>
<th>80%</th>
<th>100%</th>
</tr>
</thead>
</table>
**IMPORTANT DATES: BASEL III**

- **Dec. 16, 2010**
  - G-20 Summit

- **Nov. 11-12, 2010**
  - Introduction of minimum standard for liquidity coverage ratio
  - Disclosure of leverage ratio commences
  - Full phase-in of minimum common equity requirement (4.5%)

- **Jan. 1, 2013**
  - Implementation of Basel III
  - Exclusion of capital instruments no longer qualifying as common equity
  - Leverage ratio parallel run begins

- **Jan. 1, 2015**
  - Full phase-out of capital instruments no longer qualifying for non-common equity Tier 1 or Tier 2

- **Jan. 1, 2016**
  - Introduction of capital conservation buffer

- **Jan. 1, 2018**
  - End of "grandfather" period for public sector capital injections
  - Introduction of minimum standard for net stable funding ratio
  - Migration of leverage ratio to Pillar 1

- **Jan. 1, 2019**
  - Full phase-in of capital conservation buffer (2.5%)

- **Jan. 1, 2022**
  - Basel III Rules issued
  - Full phase-in of capital conservation buffer (2.5%)