

## Basel Committee Proposes Significant Reforms to Regulatory Capital Framework

On December 17, 2009, the Basel Committee on Banking Supervision (the “Committee”) released for public comment a series of detailed and far-reaching proposals designed to strengthen the Basel II capital framework and improve the banking industry’s ability to withstand future financial and economic stress. The proposal, *Strengthening the resilience of the banking sector* (the “Capital Reform Proposal” or “Proposal”), constitutes a key element of the Committee’s effort to apply lessons learned from the recent financial crisis.<sup>1</sup>

Unlike earlier Basel II actions, the Proposal contains important changes to the components of capital and as-yet unspecified increases to the basic minimum tier 1 and total risk-based capital ratios. In addition, the Proposal contains a “capital buffer” concept that would impose a sliding scale of enhanced regulatory restrictions on the ability of banking organizations to pay dividends and employee bonuses if regulatory capital levels are not maintained at particular levels above the “normal” minimum requirements. These and other aspects of the Proposal suggest that the Proposal will likely have significant implications not just for those banking organizations currently subject to the Basel II regime, but also for the vast majority of US banks that remain outside the Basel II regime.<sup>2</sup> In fact, the US bank regulatory agencies have formally urged US banks to submit comments to the Committee on the Proposal and may well consider issuing their own version of the Proposal for public comment later this year.<sup>3</sup>

The Proposal consists of four main components:<sup>4</sup>

- A package of measures to *strengthen the quality, consistency and transparency of the capital base* including: a greater emphasis on the common equity component of tier 1 capital; stricter eligibility requirements for tier 1 treatment; standardized rules for deductions and other regulatory adjustments to capital; simplification of tier 2 capital and the elimination of tier 2 sub-categories; elimination of tier 3 capital; and detailed regulatory capital disclosure requirements;
- Enhancement of risk coverage through *increased capital requirements for counterparty credit risk* arising from derivatives, repurchase agreement and securities financing activities;
- Introduction of a *non-risk adjusted leverage ratio* as a supplementary measure to the Basel II risk-based capital framework; and
- A package of measures to promote a more *countercyclical capital framework*, including the build-up of capital buffers and incentives to promote more forward-looking loan loss provisioning based on expected, rather than incurred, losses.

### Strengthening the Quality, Consistency and Transparency of the Capital Base

#### TIER 1 CAPITAL

The Capital Reform Proposal would amend the definition of tier 1 capital to bring it into closer alignment with “tangible common equity,” a measure of capital that gained increased support among investors, analysts and many regulators as a more reliable measure of regulatory capital strength than tier 1 capital — which often included items such as trust preferred and other “hybrid” elements that, as evidenced during the financial crisis, demonstrated less ability to absorb losses on an operating basis.

- **Common Equity Component of Tier 1 Capital.** The Proposal would require that tier 1, or “going concern” capital, consist predominantly of

“common equity,” generally defined as common shares (or instruments of equivalent quality for non-joint stock companies) plus retained earnings, net of any regulatory adjustments including deductions of intangible assets. In addition, the Proposal calls for an explicit minimum ratio of common equity to risk-weighted assets, although it does not specify a ratio. Rather, the ratio of common equity to risk-weighted assets (like other minimum ratios called for in the Proposal) will be developed through an extensive impact assessment and calibration process to occur throughout 2010 (discussed further below).

- **Eligibility Criteria for Common Equity.** The Proposal includes an extensive list of 14 criteria that would have to be satisfied in order for common shares to be included as common equity. Generally speaking, these criteria would exclude any common stock with features that could increase leverage or cause the condition of a bank to be weakened during periods of financial stress. Among other things, the Proposal would require that common stock be fully subordinated to all other claims in liquidation with no fixed or capped claim upon liquidation; have principal that is perpetual and could never be repaid outside of liquidation except at the discretion of the issuing bank; carry no obligation or expectation as to repurchase or redemption; avoid non-discretionary or mandatory dividend or other distribution requirements; be issued with the approval of the owners of the issuing bank or, if permitted, its board of directors; and the paid in amount must be recognized as equity capital under applicable accounting principles and for purposes of determining balance sheet solvency.<sup>5</sup> The Proposal would permit non-voting common shares to be included as common equity, but only if such shares are identical to voting common shares in all respects except the absence of voting rights.

Instruments other than common equity would be includable in tier 1 capital subject to two general conditions. First, as noted above, common equity would always have to comprise the “predominant” form of tier 1 capital. Second, non-common equity instruments would be required to satisfy criteria set forth in the Proposal intended to ensure that those

instruments constitute high-quality capital capable of absorbing losses.

The Proposal includes another extensive list of 14 specific eligibility criteria for tier 1 capital, several of which (e.g., issued and paid in, perpetual with no maturity date or incentive to redeem, dividends/coupons may be paid only out of distributable items) overlap with the common equity criteria. However, non-common equity instruments includable in tier 1 capital may be callable after a minimum of five years (subject to numerous restrictions); need not represent the most subordinated claim in liquidation (i.e., must be subordinated to depositors, general creditors and subordinated debt, but may be senior to common stock); and may have a distribution preference in relation to common stock. Any repayment of principal must be subject to supervisory approval, and the issuer must retain discretion over payment of dividends and “full access” to cancelled payments. Thus, some types of perpetual preferred stock would continue to be includable as tier 1 capital. However, based on the proposed criteria, several innovative tax-advantaged hybrid capital instruments currently eligible, under certain circumstances, for tier 1 treatment will be phased out.

- **Instruments with Step-Up Clauses.** Based on the Proposal’s blanket exclusion from tier 1 of any instrument with a redemption incentive, instruments with “step-up” clauses (i.e., rate increases triggered if an instrument is not redeemed or converted by a particular date), which may currently comprise up to 15 percent of tier 1 capital under the existing Basel II framework as implemented in some jurisdictions, will no longer be eligible for tier 1 treatment.<sup>6</sup>
- **Cumulative Preferred Stock.** Based on the requirement of “full access” to cancelled dividends, it appears that the tier 1 criteria would exclude the use of cumulative preferred stock as tier 1 capital. This would represent a change from the current US capital requirements, which permit inclusion of cumulative preferred in tier 1 for bank holding companies (though not for banks).
- **Trust Preferred Securities.** This currently popular form of tax-advantaged tier 1 capital, as typically structured, would appear to be excluded

from tier 1 capital treatment under the proposal based on some of its features, including the existence of a maturity date.

- **Contingent Capital; Convertible Instruments.** According to the Proposal, the Committee is continuing to review the appropriate regulatory treatment of contingent capital, convertible capital instruments and instruments with write-down features, including their use to satisfy requirements for additional “capital buffers” (discussed below), and will consider these issues in more detail at its July 2010 meeting.

In addition to narrowing the scope of instruments eligible for tier 1 treatment, the Capital Reform Proposal also provides for regulatory adjustments (i.e., deductions from capital) to be harmonized on a global basis and applied generally to the common equity component of tier 1, rather than to total tier 1 capital or a combination of tier 1 and tier 2 as under the current framework. While a full review of the regulatory adjustments set forth in the Proposal is beyond the scope of this Update, several of the most noteworthy “harmonized adjustments” are described below.

- **Minority Interest.** Minority interests in the equity of consolidated subsidiaries, which currently are included in tier 1 capital, would be expressly excluded from the new common equity component of tier 1 capital. However, they could continue to be treated as other tier 1 capital, provided that the criteria for tier 1 treatment are satisfied.
- **Deferred Tax Assets.** Any deferred tax asset that relies on future profitability in order to be realized would be deducted from the common equity component of tier 1 capital. This would represent a significant change from the existing Basel II framework, which does not require deduction of any deferred tax assets. It also would be stricter than the existing US capital requirements, which permit inclusion of deferred tax assets based on future profitability up to an amount that does not exceed the lesser of 10 percent of tier 1 capital or the amount that can be realized over the next 12 months.
- **Shortfall in Reserves.** Any shortfall in reserves (as compared to expected losses as determined

under the internal ratings-based approach to the Basel II framework) would be deducted entirely from the common equity component of tier 1 capital. This represents a change from the current Basel II framework, in which a shortfall of reserves results in a capital deduction taken 50 percent from tier 1 and 50 percent from tier 2 capital. Thus, the Proposal seeks to eliminate an existing capital incentive to under-provision, as, currently, the full amount of provisions, in the form of reduced earnings, effectively represents a deduction from tier 1 capital, whereas the capital penalty for a shortfall in the actual loan loss reserve is allocated between tier 1 and tier 2 capital.

- **Goodwill and Other Intangibles.** Goodwill (net of any associated deferred tax liability), which currently is deducted from total tier 1 capital, would be deducted instead from the common equity component of tier 1 capital. Other intangibles – including assets such as mortgage-servicing rights, which are not subject to explicit deduction under the existing Basel II framework and are included (subject to restrictions) in tier 1 capital under the current US framework – would also be deducted from common equity.
- **Unrealized Gain and Losses.** No adjustment would be applied to remove from the common equity component of tier 1 capital unrealized gains or losses on debt instruments, loans and receivables, equities or certain other assets (including bank premises) that are recognized on the balance sheet. In other words, at least for common equity purposes, the regulatory capital treatment of unrealized gains and losses would follow the accounting treatment. This is true under the existing Basel II framework, although some countries have permitted the exclusion from regulatory capital of unrealized losses in implementing the existing framework. In recognition that the current Basel II framework (and some jurisdictions including the United States) currently permit inclusion of a portion of unrealized gains on equity securities as tier 2 capital, the Proposal indicates that the Committee will “continue to review” the appropriate regulatory capital treatment of unrealized gains.
- **Investments in Other Financial Institutions.** Banks would be required to apply a “corresponding

deduction approach” to certain reciprocal or large investments (including both banking book and trading book investments) in the capital of other unconsolidated banks, financial institutions and insurance companies. Under this approach, a capital deduction would be applied for these investments to the same component of capital for which the instrument would qualify if issued by the investing bank.

- **Gains and Losses Due to Changes in Own Credit Risk.** The Proposal would broaden the existing exclusion from tier 1 capital for any gain or loss resulting from a change in the fair value of a bank’s own liabilities and would make that exclusion applicable to the common equity portion of tier 1 capital. This change is intended to make clear that a bank’s regulatory capital should not increase as a result, for example, of accounting rules that may permit recognition of a gain resulting from a write-down of the bank’s outstanding subordinated debt held by third parties due to a decline in the bank’s own financial condition.
- **Defined Benefit Fund Assets and Liabilities.** Liabilities arising from defined benefit pension funds would be fully recognized in the calculation of the common equity component of tier 1 capital, and the value of any defined benefit plan asset would be deducted from common equity. However, the Proposal would permit banks (with supervisory approval) to offset the deduction by the risk-weighted amount of any assets in the fund to which the bank has “unrestricted and unfettered access.”

## TIER 2 AND TIER 3 CAPITAL

The Proposal also would simplify tier 2 or, in the Basel Committee’s language, “gone concern” capital, by establishing a single set of eligibility criteria and eliminating all tier 2 sub-categories, apparently including allowances for loan and lease losses, which under the existing Basel II and US regimes are includible in tier 2 capital up to 1.25 percent of risk-weighted assets.

- **Tier 2 Capital Criteria; Limit.** The Proposal would eliminate the tier 2 sub-categories that exist under the existing capital framework for items such as hybrid capital instruments and subordinated term debt, in favor of a single set

of eligibility criteria. Among other things, the Proposal would require that tier 2 capital be subordinated to depositors and general creditors; be neither secured nor covered by a guarantee of the issuer or a related entity; have an original maturity of at least five years; be callable at the initiative of the issuer only after a minimum of five years; and not carry any investor rights to accelerate repayment or credit sensitive dividend features. The Proposal also would eliminate the restriction under the current framework that tier 2 capital may not exceed tier 1 capital.

- **Elimination of Tier 3 Capital.** The element of Tier 3 capital (currently used to cover market risk as part of the trading book) would be eliminated completely to ensure that market risk is backed by the same quality of capital as credit and operational risk.

## TRANSPARENCY

The Capital Reform Proposal would require disclosure of detailed regulatory capital information, including a full reconciliation of all regulatory capital elements with audited financial statements. It would also require separate disclosure of all regulatory adjustments, a description of the main features of outstanding capital instruments and publication of regulatory capital ratios. In addition, the Proposal calls for the terms and conditions of all instruments included in regulatory capital to be made publicly available through bank web sites.

Generally speaking, for US banking institutions, much of the information covered by the Proposal is already prepared and disclosed publicly through quarterly “call reports” and similar regulatory filings, and/or pursuant to disclosure obligations under the US securities laws.

## Increased Capital Requirements for Counterparty Credit Risk<sup>7</sup>

More than one-third of the 72-page Proposal is devoted to issues relating to the regulatory capital treatment of counterparty credit risk (CCR) arising from a bank’s derivatives, repurchase agreement and securities financing activities. In addition to significantly increasing the capital requirements for these activities, the Proposal would add “capital buffers”

(i.e., amounts of capital in excess of the basic regulatory minimums) backing these exposures, attempt to reduce procyclicality (discussed below) and, consistent with recent legislative and regulatory initiatives in key jurisdictions, contain systemic risk by introducing new incentives to move OTC derivatives contracts to central counterparties and exchanges.

Specific measures to strengthen risk coverage outlined in the Proposal include:

- A requirement that banks determine capital charges for CCR using stressed inputs;
- A capital charge for mark-to-market losses associated with a deterioration in the creditworthiness of a counterparty;
- Stronger collateral and margin requirements for banks with large illiquid derivatives exposures;
- Enhanced counterparty credit risk management requirements;
- Increased risk-weights for exposures to financial institutions relative to non-financial entities; and
- A zero percent risk weight for counterparty credit exposures to qualified central counterparties and exchanges.<sup>8</sup>

#### DECREASING RELIANCE ON RATING AGENCIES

In connection with the enhancement of risk coverage related to CCR, the Proposal also includes a package of measures designed to eliminate excessive reliance on external credit ratings. Among other things, the Proposal would (i) require banks to perform their own internal assessments of externally rated securitization exposures, (ii) eliminate certain “cliff effects” associated with credit risk mitigation practices<sup>9</sup> and (iii) incorporate key elements of the *IOSCO Code of Conduct Fundamentals for Credit Rating Agencies* into the eligibility criteria for external credit assessment institutions under the Basel II framework.

#### FUNDAMENTAL REVIEW OF SECURITIZATION FRAMEWORK

The Capital Reform Proposal notes that the Committee is undertaking a “more fundamental review” of the entire securitization framework under Basel II, which may lead to revised capital charges for securitization exposures, as well as to a reconsideration of the

hierarchy rule requiring the use of the Ratings-Based Approach to risk-weight a securitization exposure if an external rating exists.

#### Leverage Ratio

A third significant component of the Capital Reform Proposal is the proposed introduction of a leverage ratio as a supplementary measure to the Basel risk-based capital framework. The leverage ratio would require generally that banks maintain some minimum level of capital relative to total assets, on a non-risk adjusted basis that is more closely aligned with applicable accounting principles.<sup>10</sup> Unlike in most other jurisdictions,<sup>11</sup> a leverage ratio has long been a key component of the US regulatory capital regime, although several elements of the Committee’s Proposal differ significantly from the existing US requirements.

- **Capital Measure.** The numerator of the leverage ratio (capital) would consist only of high-quality capital that is generally consistent with the revised definition of tier 1 capital set forth in the Proposal. However, the Proposal indicates that during the risk assessment and calibration process, the Committee intends to consider whether the more appropriate measure would be total tier 1 capital (as revised) or only the common equity component.
- **Total Exposures Measure.** Generally, the Proposal indicates that the denominator of the leverage ratio (total exposures) would be determined in accordance with applicable accounting rules. The amount would be net of loan loss provisions and valuation adjustments, but would not be reduced by physical or financial collateral. Although proposing particular approaches to different exposures, in most cases the Committee has indicated that it will also consider alternatives through the public comment and impact assessment process. A few key highlights of the proposed treatment of the exposure measure include:
  - » *High Quality Liquid Assets.* The Proposal would include all assets, including cash and cash-like instruments, in the measure of exposure for leverage ratio purposes.
  - » *Repurchase Agreements and Securities Finance.* Repo-style transactions would be included and,

consistent with the approach under IFRS, but unlike US GAAP, netting would not be allowed. However, the Committee plans to assess the impact of applying regulatory netting rules based on the Basel II framework as an alternative to the no-netting approach.

- » *Securitizations.* Under the Proposal, securitization exposures would be counted in a manner generally consistent with accounting treatment (which, in the United States, would include the recent fundamental changes to the consolidation and sale accounting rules applicable to securitizations). For funded securitizations that meet the applicable accounting criteria for de-recognition of the securitized assets, any retained position or other form of credit enhancement provided by the originator would be included in the denominator when calculating the leverage ratio. For securitizations that do not achieve accounting de-recognition, the underlying securitized assets would be fully included in the denominator. Synthetic securitizations would not be recognized for leverage ratio purposes. Due to continuing concerns about implicit recourse and differing accounting regimes, the Committee also will consider a more restrictive approach that would, for leverage ratio purposes, simply mandate inclusion in the denominator of all securitized assets
- » *Derivatives.* The Proposal indicates that the Committee will decide between two approaches for most derivatives: either following the accounting treatment (which generally produces a very low on-balance sheet fair value asset and does not reflect potential exposure), or using the current exposure method under existing Basel II. In either case, netting would not be permitted. With respect to credit derivatives, the Proposal would include the full notional amount (i.e., a 100 percent credit conversion factor) in the measure of exposure for leverage ratio purposes. Moreover, purchased credit protection would not be permitted to be netted against credit protection sold.
- » *Other Off-Balance Sheet Items.* Under the Proposal, off-balance sheet items such as

commitments (including liquidity facilities), unconditionally cancellable commitments, direct credit substitutes, acceptances, standby letters of credit, commercial letters of credit and other off-balance sheet items would be included using a 100 percent credit conversion factor.

## Cyclicality: Capital Buffers and Provisioning

The Committee has identified the “procyclical amplification”<sup>12</sup> of financial shocks through the banking sector, financial markets and broader economy as another significant destabilizing element underlying the financial crisis. In response, the Capital Reform Proposal includes a package of measures designed to increase the resilience of the banking sector in the face of such stress and position the banking sector to absorb financial shocks rather than amplify and transmit those shocks through the broader economy.

- **Excess Cyclicality of the Minimum Capital Requirement.** While reserving judgment regarding the extent to which the minimum capital requirement proved unduly procyclical during the financial crisis, the Committee has undertaken an impact study to assess various mechanisms by which any excess cyclicality of the minimum capital requirement could be reduced or eliminated. For example, the Proposal indicates that the Committee is considering various ways to employ Probabilities of Default based on “downturn conditions” to calculate capital requirements during more benign periods.
- **Forward-Looking Provisioning.** As set forth in the Proposal, the Committee is promoting stronger loan-loss provisioning through three related initiatives, including (i) supporting the International Accounting Standards Board initiative to move to an expected loss approach to loan loss reserves; (ii) revising its supervisory guidance on loan loss reserves to be consistent with the desired expected loss approach and (iii) reviewing the treatment of loan loss provisions under the Basel II framework with the goal of eliminating various disincentives to adequate provisioning. For example, as discussed above, the Proposal calls for any shortfall between reserves and actual loss to be deducted entirely from the

common equity component of tier 1 capital, rather than 50 percent from tier 1 and 50 percent from tier 2 as under the current framework.

- **Stress-tested Capital Buffers and Capital Distribution Limits.** The Proposal would require banks to hold capital buffers above the regulatory minimum capital requirements and establish “capital conservation standards” that include potentially much tighter standard regulatory restrictions on the discretion of banks with insufficient capital buffers to declare dividends or make other distributions out of earnings. Although key details are not provided, the Proposal makes clear that capital buffers in excess of minimum

requirements should be built up during favorable periods and should be of sufficient size and quality to permit a bank to maintain capital above the regulatory minimum throughout a “significant sector-wide downturn.” A specific “buffer range” above the regulatory minimum would be established, and a bank with tier 1 capital in that buffer range (but still above the minimum requirement) would be subject to restrictions on dividend and other capital distributions, as well as bonus payments to employees. Those constraints would become more restrictive as capital drops closer to the minimum capital requirement. An illustrative chart of this “sliding scale” regime is provided below.

### Individual bank minimum capital conservation standards (Numbers are illustrative and do not represent a proposed calibration level)

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%]

- **Excessive Credit Growth.** The Proposal contemplates in general terms a separate regime that could be used by supervisors to increase the capital buffer requirements of the banking sector as a whole when there are signs that credit has grown to excessive levels. While a fully fleshed-out proposal regarding this “second” capital buffer is not expected until the Committee’s July 2010 meeting, the Proposal generally contemplates identification of a pre-defined threshold based on one or more macroeconomic factors; if that threshold were breached, a separate additional capital buffer requirement would take effect to moderate further credit growth and absorb losses.

### Implementation Schedule and Transitional Relief

Comments on the Capital Reform Proposal should be submitted to the Basel Committee by April 16, 2010. The Proposal indicates that a comprehensive impact assessment of its provisions will be carried out during the first half of 2010, and that a fully calibrated set of standards should be released by year-end 2010. The Committee currently expects that banking organizations will be required to comply with the new requirements by year-end 2012.

The Committee appears to recognize that the proposed capital framework enhancements would significantly

impact the capital structure and business model of many banks. In addition, the Committee is sensitive to the adverse impact that suddenly increased regulatory capital requirements could have on the emerging economic recovery. Accordingly, the Proposal expresses the Committee's intention to grandfather instruments in existence as of the issue date of the Proposal and contemplates additional as yet unidentified "transitional provisions." That said, the Proposal provides little detail on specific transitional arrangements, and the proposed grandfather date of December 17, 2009, could further constrain the capital enhancement strategies of some institutions at a still fragile time for much of the banking industry.

## Conclusion

The Capital Reform Proposal represents a significant step in the response of global financial regulators to the recent financial crisis. Key details concerning implementation and calibration remain to be determined. Nevertheless, the changes set forth in the Proposal suggest that financial institutions in the United States and elsewhere should expect an increase in the burdens and costs associated with regulatory capital compliance, including a greater regulatory emphasis on tangible common equity and an increased reluctance to permit institutions to rely on hybrid instruments. Stricter deductions from capital for items like deferred tax assets also would be likely to have a significant impact on many institutions. The introduction of a non-risk adjusted leverage ratio, while less significant from a US perspective, is likely to be among the most controversial aspects of the Proposal and contains several key differences from the existing US version. Finally, the capital buffer concept set forth in the Proposal appears to signal a willingness on the part of international regulators to use regulatory capital requirements as a means of implementing tighter prudential limitations on capital distributions and bonus payments.

The implications and practical effect of these and other aspects of the Proposal deserve careful review and commentary by the banking industry. Moreover, even after the Basel Committee adopts a final version, key issues and challenges will remain with respect to

how any final framework would be adapted and applied by particular regulators, and the degree to which the Committee can achieve its objective of "harmonization" across different jurisdictions.

## Endnotes

<sup>1</sup> The Capital Reform Proposal is available at: <http://www.bis.org/publ/bcbs164.pdf?noframes=1>. Other aspects of Committee's response to the financial crisis include its July 2009 package of final amendments to the Basel II "banking book" securitization framework and market risk or "trading book" requirements (for more information, see <http://www.mayerbrown.com/publications/article.asp?id=7294>), as well as a second set of proposals focused on liquidity requirements that was released at the same time as the Capital Reform Proposal.

The latter document, *International framework for liquidity risk measurement, standards and monitoring*, available at <http://www.bis.org/publ/bcbs165.pdf?noframes=1>, builds and expands upon the principles for sound liquidity risk management issued by the Committee in September 2008. Among other things, this new liquidity proposal would establish two new detailed regulatory standards for liquidity risk: a Liquidity Coverage Ratio mandating that an institution maintain at least enough high-quality liquid assets to meet its net cash needs over a 30-day period under a specified acute stress scenario, and a Net Stable Funding Ratio requiring a minimum amount of specified longer-term, stable sources of funding to be maintained against its anticipated and liquidity risk-adjusted assets and off-balance sheet obligations using a one-year time horizon.

<sup>2</sup> Actions of the Committee do not have direct legal effect in participating countries, but rather must be implemented through a domestic rulemaking process (in the case of European Union countries, this requires action at both the EU level and in EU member states). According to the Committee, 95 countries have implemented or plan to implement the Basel II framework.

In the United States, the Basel II advanced approach has been adopted but applies only to a small group of large, internationally active "core banks" that are currently proceeding through a multi-year transition period. Other US banks, which currently remain subject to the Basel I capital framework, are expected ultimately to have the option of remaining within a modified Basel I regime, opting in to the Basel II advanced approach (with supervisory approval) or opting in to a yet-to-be-finalized Basel II "standardized approach." The US version of the Basel II standardized framework was proposed for public comment in July 2008, but no further action has yet been taken. For more information on the proposed standardized framework, see <http://www.mayerbrown.com/publications/article.asp?id=5681&nid=6>.

In the European Union, Basel II was adopted via the Capital Requirements Directive, which actually consists of two Directives, the Banking Consolidation Directive, 2006/48/EC, and the Capital Adequacy Directive, 2006/49/EC, and then by national legislation or rulemaking in the member states. In the United Kingdom, the Basel II rules and guidelines are included in the Financial Services

Authority's Prudential Sourcebook for Banks, Building Societies and Investment Firms. Basel II is in effect for all UK banks, though some Basel I capital floors still apply.

<sup>3</sup> See <http://www.fdic.gov/news/news/press/2009/pr09232.html>.

<sup>4</sup> In addition to these four components, the Proposal indicates that the Committee also is in the process of developing measures to reduce the probability and impact of the failure of "systemically important" institutions. Although this aspect of the Proposal is not as thoroughly developed as the other components, the Committee does identify several measures set forth in the Proposal (e.g., increased risk-weights for exposures to large financial institutions relative to non-financial corporate exposures and incentives to move OTC derivatives exposures to a central counterparty) as designed to address systemic risk. In addition, the Proposal states that the Committee is reviewing the potential advantages of certain other measures, including capital and liquidity surcharges for systemically important banks.

<sup>5</sup> The criteria for inclusion of common shares in the common equity component would be used to identify instruments of equivalent quality that may be included in the predominant form of tier 1 capital by non-joint stock companies, such as mutual associations and cooperatives, which are unable to issue common stock.

<sup>6</sup> Under the existing US capital frameworks, instruments with dividend rate step-up provisions generally are already excluded from tier 1 capital. However, notwithstanding this general restriction, US institutions were allowed to include in tier 1 capital senior perpetual preferred stock with rate step-ups issued to the United States Department of the Treasury under the Troubled Asset Relief Program.

<sup>7</sup> The measures described in this section build upon the Basel Committee's July 2009 *Enhancements to the Basel II framework* and *Revisions to the Basel II market risk framework*, which significantly increased capital requirements for trading book and complex securitization exposures, and liquidity lines to asset-backed commercial paper vehicles. The July 2009 enhancements are scheduled to take effect at year-end 2010. For a more detailed discussion of these actions, please see our July 23, 2009, *Securitization Update*, available at <http://www.mayerbrown.com/publications/article.asp?id=7294>.

<sup>8</sup> The Proposal provides that collateral and mark-to-market exposures to central counterparties would be eligible for the zero percent risk-weight only if the counterparty complies with enhanced standards for central counterparties currently being developed by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions.

<sup>9</sup> "Cliff effects" in this context refers to the disincentive banks have under the existing Basel II framework to obtain credit ratings on exposures believed to be just below a particular rating threshold beyond which capital requirements significantly increase, as well as the incentive to rely unduly on ratings just above such a threshold.

<sup>10</sup> The Committee recognizes the need for internationally consistent accounting rules for a leverage ratio to be effective across jurisdictions and institutions, and notes that it will continue to monitor closely those accounting standards, and address any differences that would materially impact calculation of the leverage ratio.

<sup>11</sup> Among Organization for Economic Cooperation and Development countries, only the United States, Canada and Switzerland have established a minimum leverage ratio requirement. The Swiss leverage ratio, implemented in 2008, currently applies only to that country's two largest banks.

<sup>12</sup> Procyclicality in this context generally refers to the fact that banks typically are required to increase their capital and loan loss reserves at times of economic stress, which may in turn constrain bank lending and exacerbate the economic downturn.

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