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Legal Update
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Basel III Capital Ratios and Transition Periods Set, but Key Questions Remain

On September 12, 2010, the Group of Governors and Heads of Supervision (Governors)—the oversight body of the Basel Committee on Banking Supervision (Committee)—announced the much-anticipated minimum capital ratios and transition periods that will apply under the "Basel III" package of capital reforms that were proposed in December 2009 and approved by the Governors, with several modifications, in July 2010.[1] This latest announcement represents another key step toward eventual global adoption of these far-reaching changes, which, even after the Committee completes its actions, will still require implementation by participating jurisdictions over an extended time period. However, several key issues remain unresolved even at the Committee level, including the amount and form of additional capital that will be required for systemically important institutions. Additionally, many of the details of the new framework will remain unclear until the Committee's release of specific regulatory language later this year.

The September 12 announcement includes a minimum 4.5 percent common equity risk-based capital requirement, a 6 percent tier 1 risk-based capital requirement, an 8 percent total risk-based capital requirement, and an additional 2.5 percent common equity capital conservation buffer, in addition to the new 3 percent leverage ratio announced in July. Significantly, the release also includes a detailed schedule of "transition arrangements," which call for most of the new minimum capital requirements to be phased-in gradually beginning in 2013, over periods of up to six years. Instruments no longer qualifying as tier 1 or tier 2 capital under Basel III also will be phased-out beginning in 2013, but over a 10-year period.

Increased Minimum Capital Requirements

COMMON EQUITY RISK-BASED CAPITAL

The minimum requirement for the common equity component of tier 1 capital will be increased from 2 percent of risk-weighted assets under the current framework,[2] measured *before* the application of capital deductions, to 4.5 percent of risk-weighted assets, measured *after* the application of the stricter capital deductions required under the Basel III framework. However, when combined with the capital conservation buffer (described below), the resulting common equity requirement under Basel III will, as a practical matter, be 7 percent of risk-weighted assets.[3] The new minimum requirement for common equity will be phased-in beginning with a 3.5 percent requirement in January 2013 and increasing to 4.5 percent by January 2015.

TIER 1 RISK-BASED CAPITAL

Over the same transition period (i.e., 2013 to 2015), the minimum tier 1 capital requirement will increase from 4 percent of risk-weighted assets, as under the current framework, to 6 percent of risk-weighted assets using Basel III's narrower definition of tier 1 capital (which, for example, permits mortgage servicing rights, certain deferred tax assets, and minority investments in qualifying financial institutions to be recognized as tier 1 capital only up to an aggregate of 15 percent of common equity, and would entirely exclude trust preferred securities from tier 1 capital). When combined with the capital conservation buffer, this amounts to an effective minimum tier 1 capital requirement of 8.5 percent.[4]

TOTAL RISK-BASED CAPITAL

The minimum requirement for total capital under the Basel III framework remains unchanged at 8 percent of risk-weighted assets. Again, however, the 8 percent requirement must be satisfied using Basel III's more stringent definition of capital. Thus, when combined with the capital conservation buffer, the total capital requirement under Basel III is effectively 10.5 percent.[5]

CAPITAL CONSERVATION BUFFER

The capital conservation buffer, which the Committee has determined must consist of common equity, is a capital cushion to be maintained above the Basel III minimum capital requirements that is intended to be available to absorb losses during times of financial stress. Under the Basel III framework, the capital conservation buffer will be set at 2.5 percent of risk-weighted assets. Although banks will be permitted to draw on the conservation buffer during periods of stress, as regulatory capital levels get closer to the minimum requirements (i.e., as the buffer is depleted), greater constraints on earnings distributions such as dividend payments and discretionary employee bonuses will be triggered.[6] As indicated above, institutions subject to Basel III are likely, as a practical matter, to target levels of capital that exceed not just the regulatory minimums, but rather the regulatory minimums plus the capital conservation buffer.

LEVERAGE RATIO

As announced in July, the minimum risk-based capital requirements under Basel III will be supplemented by a non-risked-based minimum tier 1 leverage ratio, which has been tentatively set at 3 percent. The appropriateness of the 3 percent ratio (and the use in the numerator of tier 1 capital as opposed to total capital or common equity) will be assessed during a parallel run period from 2013-2017, with the leverage ratio requirement not becoming final until 2018.[7]

Transition Arrangements

The phase-in periods for the minimum capital requirements described above, as well as other key components of the Basel III framework, are summarized below in **Table 1**. Basically, the increases to the minimum common equity and tier 1 capital ratios will be phased-in over two years beginning in January 2013, with the full increases taking effect in January 2015. This will be followed by a three-year phase-in beginning in January 2016 of the capital conservation buffer, with the full 2.5 percent buffer requirement taking effect in January 2019. In addition, the deduction from tier 1 capital of excess (i.e, over 15 percent of common equity in the aggregate) minority investments in financial institutions (FIs), mortgage servicing rights (MSRs), and certain deferred tax assets (DTAs) will be phased-in over a five-year period in 20 percent increments beginning in 2014, so that the full deduction will not take effect until January 2018. Public sector equity investments are fully grandfathered until January 1, 2018.

Instruments no longer qualifying as non-common equity tier 1 capital (e.g., trust preferred securities) or tier 2 capital will be phased out over a 10-year period beginning in January 2013, with recognition of those instruments as qualifying capital being reduced by 10 percent each year, using the nominal amount outstanding on January 1, 2013, as a baseline.[8] Capital instruments that no longer qualify as common equity, however, generally will be excluded altogether from common equity as of January 1, 2013.

Table 1

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Leverage Ratio (3.0%)	**Supervisory monitoring**		**Parallel Run Phase (Public Disclosure as of January 2015)**					**Effective January 2018**	
Minimum Common Equity Capital Ratio	2.0%	2.0%	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer	-	-	-	-	-	0.625%	1.25%	1.875%	2.5%
Minimum Common Equity plus Capital Conservation Buffer	2.0%	2.0%	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of Deductions for FI Investments, MSRs and DTAs	-	-	-	20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital	4.0%	4.0%	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus Capital Conversion Buffer	8.0%	8.0%	8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital Instruments Not Qualified for Tier 1 or Tier 2 Capital Treatment			Phased-Out (2013 through 2023)						

Notwithstanding the transition time frames established by the Committee, the Basel III announcement expressly provides that national authorities have the discretion to impose shorter transition periods and encourages them to do so where appropriate.

Outstanding Issues

Although the minimum capital requirements and transition arrangements constitute crucial components of the Basel III package, other important issues have yet to be resolved.

SYSTEMICALLY IMPORTANT INSTITUTIONS

The Basel III release confirms, without providing any further detail, that systemically important banks will be expected to maintain capital beyond the minimum regulatory requirements described above. The announcement simply notes that the Committee, together with the Financial Stability Board, continues to work on a "well-integrated approach" to systemic institutions that could include "combinations of capital surcharges, contingent capital and bail-in debt." Additional details regarding the capital treatment of systemic institutions are expected to be released in connection with the G-20 summit in November.

COUNTERCYCLICAL CAPITAL BUFFER

In addition to the capital conservation buffer described above, the Basel III framework also contemplates a countercyclical capital buffer that would be funded on a jurisdiction-specific basis during periods of excess credit growth resulting in a build-up of systemic risk. According to the announcement, the countercyclical capital buffer would cover a range of 0 percent to 2.5 percent of risk-weighted assets, would need to be composed of common equity "or other fully loss absorbing capital" when funded, and would be implemented "according to national circumstances." The Committee released a detailed proposal for the countercyclical capital buffer for public comment in July 2010.[9] The comment period for the proposal closed on September 10, and final action is expected by November.

NET STABLE FUNDING RATIO

The Basel III release reiterates the Committee's commitment to issue a revised minimum net stable funding ratio (NSFR), which is intended to promote longer-term structural funding of banks' balance sheets, off-balance sheet exposures and capital markets activities. As first announced in July 2010, the NSFR released as part of the December 2009 Basel III proposal is in the process of being revised, and a new NSFR proposal is expected by year-end 2010. The revised NSFR is not scheduled to take effect as a minimum standard until 2018.

Conclusion

With this release, the Committee remains on track to finalize the Basel III reform package in time for the G-20 summit in South Korea scheduled for November 2010, at which point the focus of Basel III activity will shift to the critical phase of national implementation. In the United States, key elements of the Basel III regime are likely to be applied eventually both to large "core" banks subject to the Basel II capital regime as well as to the vast majority of US banks subject to Basel I. However, US regulators will be forced to address a number of important and complex issues during the implementation process, including the impact of the statutory capital-related provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),[10] and whether and how best to implement other recent Basel capital initiatives. These and other complications, together with the delayed implementation schedule for the international Basel III requirements and the substantial amount of US regulatory resources that will already be devoted to implementing the rest of the Dodd-Frank Act, suggest that

implementation of Basel III in the United States is unlikely to occur quickly.

The path toward implementation in the European Union also may be difficult, with some members of the European Parliament already having voiced strong criticism of the Basel III proposal, citing concerns about the lack of a full assessment of how the proposal will impact banks and the broader economy as well as perceived inequities between the EU and the United States in terms of the scope and timing of implementation of the Basel framework.

Endnotes

[1] A copy of the Governors' press release is available at http://www.bis.org/press/p100912.htm For detailed information about the December 2009 capital reform proposal, please see our update, available at http://www.mayerbrown.com/publications/article.asp?id=8416&nid=6. Our update regarding the Governors' July 2010 "broad agreement" on the Basel III reforms, including certain modifications to the December 2009 proposal, is available at http://www.mayerbrown.com/publications/article.asp?id=9420&nid=6.

[2] The 2 percent common equity requirement under the current Basel II framework derives from the requirement that common equity (including disclosed reserves and retained earnings) constitute the "predominant form" of tier 1 capital, which under the existing framework must be at least 4 percent of risk-weighted assets.

[3] By contrast, under the "prompt corrective action" (PCA) regime in the United States, a bank typically can be deemed "well capitalized" (the highest capital category) with a common equity ratio of just over 3 percent.

[4] Under the US PCA regime, an institution typically can be deemed "well capitalized" with a tier 1 risk-based capital ratio of 6 percent. The minimum tier 1 risk-based capital ratio to be "adequately capitalized" under the PCA regime is 4 percent.

[5] Under the PCA regime, an institution can be deemed "well capitalized" with a total risk-based capital ratio of 10 percent, and "adequately capitalized" with a total risk-based capital ratio of 8 percent.

[6] The Committee has yet to release a detailed description of the components of the capital conservation buffer, including the specific restrictions and the capital levels at which they will be triggered.

[7] The implementation schedule for the minimum leverage ratio under Basel III will begin with a "supervisory monitoring period" in January 2011, during which time regulators will develop and refine methods for measuring and tracking the leverage ratio, to be followed by a "parallel run period" beginning in January 2013 and concluding in January 2017. During the parallel run phase, regulators will track the leverage ratio and its components, including the behavior of the leverage ratio relative to the other risk-based capital requirements. Public disclosure of the leverage ratio and its components is scheduled to begin in January 2015 (i.e., during the parallel run period), but banks are not likely to be required, as a regulatory matter, to comply with the leverage ratio until January 2018.

[8] Only instruments issued before the date of the Basel III release, September 12, 2010, will be eligible for this 10-year phase-out arrangement.

[9] For more information on the countercyclical capital buffer proposal, see our July 2010 update available at http://www.mayerbrown.com/publications/article.asp?id=9420&nid=6.

[10] Our detailed analysis of the Dodd-Frank Act is available at http://www.mayerbrown.com/FSRE/article.asp?id=9307&nid=706.

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