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Deductions from Capital and Prudential Filters

Regional Seminar on Basel III and Capital Management by Banks

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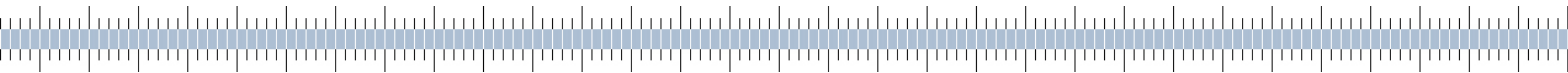

Deductions from capital
- status quo –

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Basel II Framework Part 1: Scope of application

- minority interest
- non consolidated subsidiaries
- significant minority investments in banking, securities and other financial entities
- investments in insurance subsidiaries and significant minority investments in insurance entities
- significant investments in commercial entities

Basel II Framework Part 2, Section Ia: The constituents of capital

- Goodwill
- certain securitisation exposures, which lead to an increase in capital

Deductions from capital
- status quo -

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Where to deduct from?

Holdings in non consolidated financial, insurance and commercial entities

50% → **Tier 1**

50% → **Tier 2**

Goodwill, securitisarion exposures

100% → **Tier 1**

Prudential filters
- status quo -

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BCBS Press release June 8th 2004:

- cash flow hedges
- gains and losses arising from changes in own credit risk as a result of the application of the fair value option to own liabilities

BCBS Press release July 20th 2004:

- no change to existing capital framework in response to certain IFRS with respect to eg:
  - equity/liabilty classification
  - intangibale assets including goodwill
  - deferred tax assets

BCBS Press release December 15th 2004:

- fair value gains and losses on afs instruments
- own use and investment property
- exposure measurment
- use of fair value option

Governors and Heads of Supervision Press Release

September 15th 2009

The Central Bank Governors and Heads of Supervision reached agreement on the following key measures to strengthen the regulation of the banking sector:

- **Raise the quality, consistency and transparency of the Tier 1 capital base. The predominant form of Tier 1 capital must be common shares and retained earnings. Appropriate principles will be developed for non-joint stock companies to ensure they hold comparable levels of high quality Tier 1 capital.**

- **Moreover, deductions and prudential filters will be harmonised internationally and generally applied at the level of common equity or its equivalent in the case of non-joint stock companies.**

- **Finally, all components of the capital base will be fully disclosed.**

Adjustments to regulatory capital
(generally applied to the common equity component)

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- Unrealised gains and losses recognised on the balance sheet
- Capital issued out of consolidated subsidiaries and held by third parties
- Goodwill and other intangibles
- Deferred tax assets
- Investments in own shares (treasury stock)
- Reciprocal cross holdings and investments in the capital of certain banking, financial and insurance entities which are outside the regulatory scope of consolidation
- Shortfall of the stock of provisions to expected losses
- Cash flow hedge reserve
- Cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities
- Defined benefit pension fund assets and liabilities
- Gain on sale related to securitisation transactions
- Threshold deductions
- Former deductions from capital

Unrealised gains and losses

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There is no adjustment applied to remove from Common Equity Tier 1 unrealised gains or losses recognised on the balance sheet. Unrealised losses are subject to the transitional arrangements.

The Committee will continue to review the appropriate treatment of unrealised gains, taking into account the evolution of the accounting framework.

Capital issued out of fully consolidated subsidiaries and held by third parties

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Regulatory concern:
Consolidated supervision suggests, that capital can be transferred within a banking group.

However, capital issued out of consolidated subsidiaries may not be available to aborb losses in other entities belonging to the group without restrictions.

Example:
An attempt to collect the excess by requesting dividend payouts will lead to the excess being paid out to the minority shareholders.

Minority interest example (I)

(Subsidiary Bank overcapitalised relative to Parent Bank)

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Group 1: Parent bank owns 100% of subsidiary

	Parent Bank	Subsidiary Bank	Consolidated Group
Investment in subsidiary	10	-	-
Banking assets	100	-	100
Cash	-	10	10
Deposits	90	-	90
Common stock	20	10	20
Minority interest	-	-	-
Total equity	20	10	20

Group 2: Parent bank owns 70% of subsidiary

	Parent Bank	Subsidiary Bank	Consolidated Group
Investment in subsidiary	7	-	-
Banking assets	100	-	100
Cash	-	10	10
Deposits	90	-	90
Common stock	17	10	17
Minority interest	-	-	3
Total equity	17	10	20

Minority interest example (II)

(Parent Bank overcapitalised relative to Subsidiary Bank)

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Group 1: Parent bank owns 100% of subsidiary

	Parent Bank	Subsidiary Bank	Consolidated Group
Investment in subsidiary	10	-	-
Banking assets	-	100	100
Cash	10	-	10
Deposits	-	90	90
Common stock	20	10	20
Minority interest	-	-	-
Total equity	20	10	20

Group 2: Parent bank owns 70% of subsidiary

	Parent Bank	Subsidiary Bank	Consolidated Group
Investment in subsidiary	7	-	-
Banking assets	-	100	100
Cash	10	-	10
Deposits	-	90	90
Common stock	17	10	17
Minority interest	-	-	3
Total equity	17	10	20

Capital issued out of fully consolidated subsidiaries and held by third parties

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Common shares (minority interest):

- recognition as common equity at group level if issued by fully consolidated bank subsidiaries
- limited to the lower of the minimum common equity requirement of the subsidiary or its contribution to the group's common equity capital requirement (7% of RWA, i.e. including the CCB)

Qualifying Tier 1 capital

- limited to the lower of the minimum Tier 1 requirement of the subsidiary or its contribution to the group's Tier 1 capital requirement (8.5% of RWA, i.e. including the CCB)

Qualifying Tier 1 and Tier 2 capital (total capital)

- limited to the lower of the minimum total capial requirement of the subsidiary or its contribution to the group's total capital requirement (10.5% of RWA, i.e. including the CCB)

Capital issued out of fully consolidated subsidiaries and held by third parties

See: Basel III: A global regulatory framework for more resilient banks and banking systems, Annex 3 for an illustrative example!

Goodwill and other intangibles

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Goodwill and all other intangibles must fully be deducted in the calculation of Common Equity Tier 1

<u>Exception:</u> *Mortgage Servicing Rights* (MSRs) are treated as part of the „threshold deductions“

Subject to prior supervisory approval, banks that report under local GAAP may use the IFRS definition of intangible assets

- **only relevent where definition of intangible assets under local GAAP is wider than under IFRS**
- **especially true for software in some countries**

Deferred tax assets

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Deferred tax assets (DTAs) that rely on future profitability of the bank to be realised are to be deducted in the calculation of Common Equity Tier 1.

Exception: ***DTAs, which relate to temporary differences*** **are treated as part of the „threshold deductions“**

- **netting permitted only where DTAs and DTLs relate to taxes levied by the same taxation authority and offsetting is permitted by the relevant taxation authority**
- **DTLs must be allocated on a pro rata basis between DTAs subject to the threshold deduction treatment and DTAs that are to be deducted in full**

Reciprocal cross holdings in the capital of banking, financial and insurance entities

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Reciprocal cross holdings:
Reciprocal cross holdings of capital that are designed to artificially inflate the capital position of banks will be deducted in full on a corresponding basis.

- **no threshold**

Investments in the capital of financial entities, which are outside the scope of regulatory consolidation

Double gearing example

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Bank A	
Banking assets	= 100
Ordinary liabilities	= 90
Tier 2 liabilities	= 4
Tier 1 (equity)	= 6
Total capital	= 10
Total capital requirement	= 8
Risk Weighted Assets	= 100
Tier 1 ratio	= 6%
Total capital ratio	= 10%

Bank B	
Banking assets	= 100
Ordinary liabilities	= 90
Tier 2 liabilities	= 4
Tier 1 (equity)	= 6
Total capital	= 10
Total capital requirement	= 8
Risk Weighted Assets	= 100
Tier 1 ratio	= 6%
Total capital ratio	= 10%

Bank A (incl. stake in bank B)	
Banking assets	= 100
Investment in Bank B	= 0.9
Ordinary liabilities	= 90
Tier 2 liabilities	= 4
Tier 1 (equity)	= 6.9
Total capital requirement	= ?
Risk Weighted Assets	= ?
Tier 1 ratio	= ?%
Total capital ratio	= ?%

Bank B	
Assets	= 100
Ordinary liabilities	= 90
Tier 2 liabilities	= 4
Tier 1 (equity)	= 6
Total capital	= 10
Total capital requirement	= 8
Risk Weighted Assets	= 100
Tier 1 ratio	= 6%
Total capital ratio	= 10%

Investments in the capital of financial entities, which are outside the scope of regulatory consolidation

Double gearing example

Capital of Bank A after risk weighting investment in Bank B at 100%	
Tier 1	= 6.9
Tier 2	= 4
Total capital	= 10.9
Risk weighted assets	= 100.9
Tier 1 ratio	= 6.8%
Total capital ratio	= 10.8%

Capital of Bank A after deducting the investment in Bank B on a 50:50 basis	
Tier 1 (before deductions)	= 6.9
Tier 1 deductions	= 0.45
Tier 1 after deductions	= 6.45
Tier 2 (before deductions)	= 4
Tier 2 after deductions	= 3.55
Total capital	= 10
Risk weighted assets	= 100
Tier 1 ratio	= 6.45%
Total capital ratio	= 10%

Capital of Bank A after deducting the investment in Bank B 100% from tier 1	
Tier 1 (before deductions)	= 6.9
Tier 1 deductions	= 0.9
Tier 1 after deductions	= 6
Tier 2	= 4
Total capital	= 10
Risk weighted assets	= 100
Tier 1 ratio	= 6%
Total capital ratio	= 10%

Investments in the capital of financial entities, which are outside the scope of regulatory consolidation

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Unconsolidated investments:

- direct, indirect and synthetic holdings
- common stock and all other regulatory capital instruments in both the banking and the trading book
- deduction of net long position for each exposure; netting permitted where short position either has the same maturity as the long position or a residual maturity of at least one year
- exclusion of short term underwriting positions

significant investments

Investments in the capital of financial entities, which are outside the scope of regulatory consolidation

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Non-significant investments:

- **bank does not own more than 10% of the issued common share capital of the entity**
- **deduction of all items which exceed 10% of the bank‘s common equity on a corresponding basis**
- **amounts below the threshold are to be included in the calculation of the bank‘s capital requirements**

Significant investments:

- **bank owns more than 10% of the issued common share capital of the entity**
- **full deduction of all items on a corresponding basis**
- ***invesments that are common shares* are treated as part of the threshold deductions**

Threshold deductions

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- Significant investments in the common shares of unconsolidated financial institutions
- Mortgage servicing rights
- Deferred tax assets that arise from temporary differences

each item: limited to 10% of the bank's common equity

all items together: limited to 15% of the bank's common equity
- **until 31 Dec. 2017: prior to the deduction of these items**
- **from 1 Jan. 2018: after all deductions**

Amounts which are not deducted receive a risk weight of 250%.

Capital issued out of fully consolidated subsidiaries and held by third parties

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See: Basel III: A global regulatory framework for more resilient banks and banking systems, Annex 2 for an illustrative example!

Results from the QIS

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CET1 deductions and minority interest as a percentage of new CET1 capital gross of deductions

	Number of banks	Goodwill	Intangibles	Financials	DTA	MSRs	Excess above 15%	Other*	Total	Minority interest**
Group 1	87	-19.0	-4.6	-4.3	-7.0	-0.4	-2.4	-3.6	-41.3	-2.0
Group 2	136	-9.4	-2.3	-5.5	-2.8	0.0	-1.0	-3.7	-24.7	-2.1

* Other includes deductions related to investments in own shares, shortfall of provision to expected losses, cash flow hedge reserve, cumulative changes in own credit risk, pension fund assets, securitisation gains on sale and deductions from additional Tier 1 capital to the extent they exceed a bank's additional Tier 1 capital and, therefore, have to be taken from CET1 capital. ** Minority interest is not included in CET1 capital gross of deductions and the total deductions.

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