New York Law Journal
WWW.NYLJ.COM
An ALM Publication
VOLUME 248—NO. 7
WEDNESDAY, JULY 11 2012

INTERNATIONAL BANKING

Expert Analysis

New Capital Disclosure Requirements Are Intended to Provide More Clarity

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In my Jan. 12, 2011, column, I discussed the issuance by the Basel Committee of new capital and liquidity requirements and noted, inter alia, that banks would need to provide a full reconciliation of all regulatory capital elements back to the balance sheet in their audited financial statements, list separately all regulatory adjustments and items not deducted from Common Equity Tier 1, and provide information on the main features and full terms and conditions of all instruments included in regulatory capital.[1] On Dec. 19, 2011, the Basel Committee issued a consultative document containing the proposed capital disclosure requirements, noting that the purpose of the requirements was to "aim to improve the transparency and comparability of a bank's capital base" for market participants.[2]

On June 26, 2012, the Basel Committee issued the final capital disclosure requirements.[3] The requirements have been adopted substantially as proposed. This month's column will discuss these final requirements, which will need to be adopted by each country to be effective no later than June 30, 2013. Internationally active banks should be aware of these changes and begin to plan accordingly.

Some Background

In my January 2011 column, I noted that the new Basel III capital and liquidity requirements had to be adopted by countries to be effective on Jan. 1, 2013. The capital disclosure requirements go hand-in-hand with these new substantive requirements. The Basel Committee notes in the issuance on the final capital and liquidity requirements that the economic crisis "revealed the inconsistency in the definition of capital across jurisdictions and the lack of disclosure that would have enabled the market to fully assess and compare the quality of capital across jurisdictions."[4] The new disclosure requirements are intended to provide the clarity and comparability that had been felt to have been lacking at that time.

As finalized, internationally active banks will be required to provide publicly the following:

- A full reconciliation of all regulatory capital elements back to the balance sheet in the audited financial statements;
- Separate disclosure of all regulatory adjustments and the items not deducted from Common Equity Tier 1;
- A description of the main features, and all terms and conditions, of regulatory capital instruments issued by the bank;
- A detailed explanation of how a bank calculated the individual components of its regulatory capital (e.g., "Equity Tier 1," "Core Tier 1" or "Tangible Common Equity" ratios), if it provides disclosure of such components.

Banks also would have to make available on their websites the full terms and conditions of any instruments included in regulatory capital.[5]

The Final Requirements

All internationally active banks will have to provide the required capital disclosures using common templates which should make it easier for market participants to effectively compare the capital adequacy of banks based upon disclosures that are internationally consistent.

There are five sections to the final requirements, and the Basel Committee has provided a form of template or disclosure statement for each requirement.

Section 1: Permanent Common Regulatory Capital Template. Section 1 will be the permanent common regulatory capital template that will be applicable beginning Jan. 1, 2018, when the transition period for deductions for full compliance with Basel III capital requirements ends. If a particular jurisdiction allows full compliance with Basel III prior to Jan. 1, 2018, then it may allow its banks to begin using this template immediately, but the bank must disclose that they are using the template because they have made all the required Basel III deductions.

In order to ensure that the regulatory capital disclosure template is comparable among banks in all jurisdictions, the Basel Committee notes in the final requirements issuance that while there should be no adjustments to the template used to disclose banks' regulatory capital, in recognition of the differences in language among jurisdictions and of the Basel Committee's desire to reduce the reporting of unnecessary information, exceptions will be permitted in order for each country to translate the requirements into that country's national language, and add references to, and explanations of, the statutes or regulations governing the disclosures, including circumstances when a particular country's definition of an element in the template is more conservative than described in the common template.

Section 2: Reconciliation Back to Financial Statement. Section 2 addresses the requirement that all regulatory capital elements be reconciled back to a bank's published financial statements in a manner consistent with other banks. This will not be a common template because the presentation of a bank's balance sheet can vary from country to country due to the use of different accounting standards. However, within a single jurisdiction (for example, the United States), the jurisdiction could develop a common format so that reporting would at least be consistent within that jurisdiction. The final requirement

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was designed to be flexible enough to work under any accounting standard that may be used in a particular jurisdiction.

There is a three-step approach to be taken in preparing this disclosure to show the link between a bank's published financial statements and the bank's regulatory capital disclosures:

• Step 1: Disclose the reported balance sheet under the regulatory scope of consolidation, which often is different than the scope of consolidation for accounting purposes. The bank must list which legal entities (along with disclosure of such entities' balance sheet, balance sheet equity and principal activities) are included within one scope of consolidation that do not appear in the other scope or even if included in both scopes of consolidation, if the consolidation calculation is different within one scope than the other, that also must be disclosed and explained. If the scopes of consolidation are identical, then the bank can just skip this step by noting there is no difference and move onto Step 2.

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• Step 2: Expand the lines of the Section 1 regulatory capital balance sheet template under the regulatory scope of consolidation to display all of the components that are used in the composition of capital disclosure template. The rows in the template should be expanded so that all components used in the composition of capital are included, but only to the extent necessary to disclose all the components of capital. The document provides examples of how this step can be implemented.

• Map each of the components that are disclosed in Step 2 to the composition of the Section 1 capital disclosure template.

Section 3: Features of Regulatory Capital Instruments. Section 3 is a common template that will be used to provide a description of the main features of regulatory capital instruments that have been issued by a bank. The template provided in the document is seen as the minimum level of disclosure that banks must report regarding each capital instrument it issues. Jurisdictions can add additional features that it feels are important to disclose. There is a place for each separate regulatory capital instrument to have its specific features described.

This report must be kept current, so a bank would update the disclosure whenever the bank issues or repays a capital instrument, or there is a redemption, conversion/write down, or other material change. This chart must be included in the bank's published financial statements or accessible on the bank's website via a link in those statements. One new feature of this template is the requirement to identify the governing law of each capital instrument.

Banks should note that this template is designed to be used from the time the Basel III requirements first become effective on Jan. 1, 2013, i.e., during the transitional period to full Basel III compliance, and thus the template covers instruments subject to the transitional requirements (such as the hybrid capital requirements subject to phase-out.)

Section 4: Website Disclosures. Section 4 is a template to be used on a bank's website to describe all the terms and conditions of the regulatory capital instruments it issues and describe the calculation of any ratios involving components of regulatory capital. These disclosures will allow market participants to review in more detail the specific features of each individual capital instrument issued by a bank.

Banks will be required to have a specific section of their websites labeled "Regulatory Disclosures" where all the regulatory capital information would be maintained or links would be available to other documents that contain the required information.

Section 5: Transition Regulatory Capital Template. Section 5 is a form of the Section 1 permanent regulatory capital disclosure template to be used beginning with the first financial statements issued after June 30, 2013, until full implementation of Basel III on Jan. 1, 2018. Section 5 begins with the Section 1 permanent common template, but then makes adjustments for banks to report in a new column the amount of each regulatory adjustment (whether a phasing-in of one requirement or a phasing-out of a previous prudential adjustment) taken during the transition period. As regulatory adjustments may vary from jurisdiction to jurisdiction, the template includes additional rows so that an explanation can be added of how the particular adjustment is part of the calculation of regulatory capital under a particular jurisdiction's laws.

Dates to Remember

As noted above, individual countries must implement these new requirements no later than June 30, 2013, with banks beginning to use the new reporting templates (transitional period regulatory capital disclosure templates are available until Jan. 1, 2018) with the first set of financial statements that include a balance sheet published after that date. The disclosures would be made with each regular publication of financial statements by the bank, although disclosures regarding the features, terms and conditions of a bank's regulatory capital instruments must be updated as material changes occur.

The disclosures may be made in a bank's published financial statements, or the financial statements must provide a link to the full disclosures on the bank's website or other publicly available regulatory reports. No matter where the full disclosures are accessible, they must be set out in the required formats. In addition, banks must maintain archives of templates relating to prior required disclosures.

Finally, under Basel II, certain large banks were required to disclose, on a quarterly basis, their Tier 1 and total capital adequacy ratios, and their components, and information on risk exposure or other information that was prone to rapid change.[6] Basel III will continue to require regular disclosure of this information.

Conclusion

While countries still have one year to adopt these requirements for banks in their individual jurisdictions, banks might consider beginning to review their systems and websites at this time in anticipation of these requirements being adopted in their respective jurisdictions. Banks may need to make substantial changes to their financial reporting systems and framework, as well as their websites, in order to comply with these new requirements, so it may be best to start preparing and budgeting now for those changes.

1. Kathleen A. Scott, "New International Capital and Liquidity Requirements," New York Law Journal, Jan. 12, 2011.

2. Dec. 19, 2011, "Definition of capital disclosure requirements—consultative document," press release and document available through the Bank of International Settlement's Basel Committee website, http://www.bis.org/publ/bcbs212.htm.

3. June 26, 2012, "Composition of capital disclosure requirements—Rules text," press release and document which can be accessed at http://www.bis.org/publ/bcbs221.htm.

4. June 1, 2011, "Basel III: A global regulatory framework for more resilient banks and banking systems—revised version June 2011," p. 12; press release and document are available at http://www.bis.org/publ/bcbs189.htm. The December 2010 final requirements were revised and republished in June 2011 because the Basel Committee had finalized the Basel III capital treatment for counterparty credit risk in bilateral trades, which resulted in a minor modification of the credit valuation adjustment (the risk of loss caused by changes in the credit spread of a counterparty due to changes in its credit quality).

5. Id. at p. 27.

6. June 2006, "International Convergence of Capital Measurement and Capital Standards a Revised Framework Comprehensive Version," p. 228; press release and document are available at http://www.bis.org/publ/bcbs128.htm.