Basel III Capital and Liquidity Framework

Basel Committee Issues Final Revisions to International Regulation of Bank Capital and Liquidity

BACKGROUND AND SUMMARY

On December 16, 2010, the Basel Committee released its final framework for strengthening international capital and liquidity regulation, now officially identified by the Basel Committee as “Basel III”. The Basel III final framework incorporates the Basel Committee’s initial proposals for revision of bank capital and liquidity regulation released in December 2009, as supplemented by (i) the Basel Committee’s proposal for a countercyclical capital buffer released in July 2010, (ii) amendments to the initial proposals announced in July 2010, and (iii) calibrations for the capital proposals announced in September 2010 (collectively, the “Basel III proposals”).

Although the Basel III final framework in broad scope incorporates the core features of the Basel III proposals, it also reflects important clarifications as to many of the calculations under the new standards and some important substantive changes. These include (using in this paragraph terms defined in the more detailed discussion below):

- in the Basel III final capital framework, (i) application of a 250% risk-weighing to the portion of MSRs, DTAs and significant investments in non-consolidated financial entities that are not required to be deducted from CET1, (ii) expanded inclusion of minority interests in the components of regulatory capital, subject to more detailed provisions with respect to the amount that may be included, (iii) revisions to the criteria for Additional Tier 1 capital that will have the consequence of disqualifying many European-style hybrid securities from inclusion in regulatory capital, and (iv) clarification that, for purposes of the denominator in the leverage ratio, a 100% credit conversion factor will be applied to letters of credit, bankers’ acceptances, lending commitments and other off-balance sheet items (other than unconditionally cancellable commitments, which will be subject to a 10% credit conversion factor); and

- in the Basel III final liquidity framework, (i) addition of a new requirement in the LCR under which banks must maintain high-quality liquid assets equal to 25% of cash outflows expected during the
next 30 days even if net cashflows (that is, expected cash outflows minus expected cash inflows) are zero, and (ii) application of an NSFR that, as to concept and basic structure, is essentially identical to the NSFR included in the Basel III proposals, with changes in the calibrations of the ASF factors and RSF factors that will make it easier for banks to achieve a 100% NSFR.

However, the Basel III final framework does not:

- incorporate the Basel Committee’s loss absorbency proposal released in September 2010, although a footnote in the Basel III final framework indicates that the Basel Committee is finalizing additional criteria for Additional Tier 1 capital and Tier 2 capital reflecting that proposal; or
- provide additional guidance concerning “systemically important financial institutions” (“SIFIs”) or “global SIFIs” (“G-SIFIs”), including whether (or the amounts of) any capital and/or liquidity surcharges that may be applied to them, whether (or the amounts of) contingent capital or bail-in debt they may be required to issue and maintain, or how they will be identified.

Basel III Final Capital Framework

The Basel III final capital framework, among other things:

- introduces as a new capital measure “Common Equity Tier 1”, or “CET1”, specifies that Tier 1 capital consists of CET1 and “Additional Tier 1 capital” instruments meeting specified requirements, defines CET1 narrowly by requiring that most adjustments to regulatory capital measures be made to CET1 and not to the other components of capital, and expands the scope of the adjustments as compared to existing regulations;
- when fully phased in on January 1, 2019, requires banks to maintain:
  - as a newly adopted international standard, a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% “capital conservation buffer” (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7%);
  - a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation);
  - a minimum ratio of Total (that is, Tier 1 plus Tier 2) capital to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation); and
  - as a newly adopted international standard, a minimum leverage ratio of 3%, calculated as the ratio of Tier 1 capital to balance sheet exposures plus certain off-balance sheet exposures (as the average for each quarter of the month-end ratios for the quarter); and
- provides for a “countercyclical capital buffer”, generally to be imposed when national regulators determine that excess aggregate credit growth becomes associated with a buildup of systemic risk, that would be a CET1 add-on to the capital conservation buffer in the range of 0% to 2.5% when fully implemented (potentially resulting in total buffers of between 2.5% and 5%).

The implementation of the Basel III final capital framework will commence January 1, 2013. On that date, banks will be required to meet the following minimum capital ratios:

- 3.5% CET1 to risk-weighted assets;
- 4.5% Tier 1 capital to risk-weighted assets; and
- 8.0% Total capital to risk-weighted assets.
The Basel III final framework provides for a number of new deductions from and adjustments to CET1, the implementation of which will begin on January 1, 2014 and will be phased-in over a five-year period (20% per year). The implementation of the capital conservation buffer will begin on January 1, 2016 at 0.625% and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The phase-in periods for the various components of the Basel III capital framework are addressed in detail in our memorandum to clients, dated September 30, 2010 and referred to in endnote 6 hereto.

Basel III Final Liquidity Framework

The Basel III final liquidity framework requires banks to comply with two measures of liquidity risk exposure:

- the “Liquidity Coverage Ratio”, or “LCR”, based on a 30-day time horizon and calculated as the ratio of the “stock of high-quality liquid assets” divided by “total net cash outflows over the next 30 calendar days”, which must be at least 100%; and
- the “Net Stable Funding Ratio”, or “NSFR”, calculated as the ratio of the “available amount of stable funding” divided by the “required amount of stable funding”, which must be at least 100%.

Each of the components of these ratios is defined, and the ratio calculated, in accordance with detailed requirements in the Basel III liquidity framework. Although the Basel Committee has not asked for additional comment on the LCR and NSFR, both are subject to observation periods and transitional arrangements, with the Basel III liquidity framework providing that:

- revisions to the LCR will be made by mid-2013, and the LCR will be introduced as a requirement on January 1, 2015; and
- revisions to the NSFR will be made by mid-2016, and the NSFR will be introduced as a requirement on January 1, 2018.

BASEL III FINAL CAPITAL FRAMEWORK

The Capital Base

The Basel III final capital framework carries forward the three components for the regulatory capital base set forth in the Basel III proposals: CET1, Additional Tier 1 capital (which, together with CET1, comprise “Tier 1 capital”) and Tier 2 capital (which, together with Tier 1 capital, comprises “Total capital”).

CET1

The Basel III final framework, like the Basel III proposals, defines CET1 by reference to 14 criteria. For most banks, the only security that will qualify as CET1 is voting common stock.

The requirements for CET1 qualification in the Basel III final framework as compared to the Basel III proposals differ in only two respects:
the Basel III final framework expressly prohibits inclusion of an otherwise qualifying instrument if the bank “directly or indirectly. . . funded the purchase of the instrument.” This change appears to be merely a conforming change to a similar requirement in the criteria for Additional Tier 1 capital and Tier 2 capital; and

- the Basel III final framework permits inclusion of minority interests in CET1, subject to the criteria discussed below under “Minority Interests”, whereas the Basel III proposals precluded any inclusion of minority interests in CET1.

The Basel III final framework carries forward the Basel III proposals that intangibles (including mortgage servicing rights (“MSRs”)), deferred tax assets (“DTAs”) dependent upon future taxable income, and significant investments in non-consolidated financial entities, as well as certain other items, be deducted from the CET1 component of Tier 1 capital, with some modifications and clarifications as follows:

- The July Amendments provided that MSRs, DTAs and significant investments in capital instruments (and not just common stock) of non-consolidated financial entities (now specified to mean banks, insurance companies and other financial entities) would each be subject to a limit of 10% of CET1 and 15% of CET1 in the aggregate, with the excess above those limits being deducted from CET1. The July Amendments did not specify a risk-weighting for the non-deducted portion of those items, with the consequence that the non-deducted exposures to MSRs and DTAs, and under Basel I standards in most circumstances investments in non-consolidated financial entities, would be risk-weighted 100%. The Basel III final framework specifies that the portion of those three items not deducted from CET1 will be risk-weighted 250%, commencing January 1, 2018. This will, of course, create a further disincentive to hold such assets, even within the so-called “sin bucket” (that is, the 10% and 15% limitations described above).

- The Basel III final framework draws a distinction between investments in non-consolidated financial entities where the investing bank holds 10% or less of the common stock of the financial entity (an “insignificant investment”) as compared to one where the investing bank owns more than 10% of the common stock of the financial entity (a “significant investment”).

  - If a bank’s aggregate investments in “capital instruments” of financial entities as to which the bank’s common stock investments are insignificant investments exceed 10% of the bank’s CET1, then (i) the bank is required to deduct from CET1 the aggregate amount of such investments in capital instruments above 10% of the bank’s CET1 (after all other adjustments other than for investments in non-consolidated financial entities) but (ii) the non-deducted portion is not subject to the 250% risk-weighting described above.

  - In the case of a bank’s investments in capital instruments of financial entities as to which the bank’s common stock investments are significant investments, (i) the bank is required to deduct from CET1 the aggregate amount of such investments pursuant to the 10%/15% limitations described above for MSRs, DTAs and significant investments in non-consolidated financial entities, taken together, and (ii) the non-deducted portion is subject to the 250% risk-weighting described above.

  - The determination of whether an investment is a significant or insignificant investment keys off of the bank’s ownership of common stock, but the adjustment for CET1 keys off of the bank’s ownership of capital instruments. The term “capital instruments” is specified to include direct, indirect and synthetic holdings, whether in the banking book or trading book, and is not limited to common stock. Accordingly, capital instruments presumably include preferred stock and subordinated debt that qualifies as Additional Tier 1 capital or Tier 2 capital.

  - The Basel III final framework excludes from these calculations securities owned by a bank as part of its “[u]nderwriting positions held for five working days or less . . . .” It does not address securities held in connection with market-making activities. The sufficiency of five working days to dispose of underwriting positions, and failure to address securities held in connection with market-making activities, are almost certain to be the subject of further comment and debate as national regulators propose regulations to implement Basel III.
The Basel III final framework carries forward the provision in the Basel III proposals requiring that each defined benefit pension fund asset carried on a bank’s balance sheet be deducted from CET1 net of any associated deferred tax liability which would be extinguished if the asset should become impaired or be recognized under relevant accounting standards. However, it clarifies that assets in the defined benefit pensions fund “to which the bank has unrestricted and unfettered access can, with supervisory approval, offset the deduction.”

The Basel III final framework implements unchanged the provision in the Basel III proposals that no adjustment should be applied to remove from CET1 unrealized gains or losses recognized on the balance sheet. For U.S. banks, this means that other comprehensive income/loss recorded to shareholders’ equity under the Financial Accounting Standards Board’s Financial Accounting Statement No. 115, which is currently “filtered” out of regulatory capital in reports filed with the U.S. bank regulatory agencies, will no longer be subject to that filter. This has raised a concern with respect to volatility in capital ratios that will result from including within CET1 the mark-to-market amounts for securities held as available for sale. The Basel III final framework includes a statement in a footnote that the Basel Committee will continue to review “the appropriate treatment of unrealized gains taking into account the evolution of the accounting framework.”

Additional Tier 1 Capital

The Basel III final framework, like the Basel III proposals, also defines Additional Tier 1 capital by reference to 14 criteria (albeit different from the criteria for CET1). For U.S. banks, the only broadly-issued securities that are likely to qualify as additional Additional Tier 1 capital are non-cumulative perpetual preferred stock.

The Basel III final framework’s requirements for Additional Tier 1 capital are substantially the same as the requirements in the Basel III proposals, with several exceptions, including:

- the final language specifies that a step-up in a security’s dividend or interest rate is an incentive to redeem that disqualifies the security from qualification as Additional Tier 1 capital;
- the final language specifies that securities with a “dividend pusher” (that is, a provision that requires the issuer to pay dividends on the security if it pays dividends on common stock or another more subordinated instrument) may not be included in Additional Tier 1 capital; and
- although the Basel III proposals permitted some inclusion of minority interests in Additional Tier 1 capital, the criteria for inclusion as set forth in the final Basel III final framework are substantially more detailed, as discussed below.

The criteria for Additional Tier 1 capital in the Basel III proposals specifying that instruments in this category must be perpetual and non-cumulative disqualify U.S.-style trust preferred securities as Additional Tier 1 capital. The features described in the first and second bullets of the preceding paragraph will have the effect of also disqualifying from Additional Tier 1 capital many hybrid securities issued by European banks. Many of those securities have limited step-ups in dividend rates as permitted by the Sydney Agreement. Additionally, because applicable law in many European jurisdictions reserves for shareholders the right to declare dividends, a U.S.-style “dividend stopper” provision (where the issuer is precluded from paying dividends on common stock or other more junior securities if it fails to pay dividends on the hybrid security) is not permitted under applicable law in those jurisdictions. Banks in those jurisdictions have sought to achieve a result that is similar to a dividend stopper by including in
hybrid securities a dividend pusher requiring that dividends be paid on the hybrid securities for designated periods if dividends have been paid on common stock or other more junior securities.

The Basel III proposals, after giving effect to the September Amendments, provided that Tier 1 and Tier 2 capital instruments no longer qualifying as Additional Tier 1 capital or Tier 2 capital will be phased out over a ten-year period beginning January 1, 2013. The Basel III final framework clarifies a number of open questions with respect to calculations under the phase-out formula, including that:

- the phase-out formula applies to disqualified instruments outstanding on January 1, 2013;
- the phase-out will be applied to a bank’s non-qualifying Additional Tier 1 and Tier 2 capital instruments separately by class (that is, the phase-out formula will apply separately to aggregated disqualified Additional Tier 1 instruments and aggregated disqualified Tier 2 instruments); and
- for each category of disqualified instruments (that is, Additional Tier 1 or Tier 2), their recognition will be capped at a declining percentage of the nominal (presumably meaning principal or stated) amounts of the relevant category outstanding on January 1, 2013, with the percentage capped at 90% commencing on January 1, 2013 and declining by 10% on January 1 of each subsequent year. Optional redemptions of disqualified instruments do not reduce the percentage cap.

**Tier 2 Capital**

The Basel III final framework, like the Basel III proposals, defines Tier 2 capital by reference to nine criteria. For U.S. banks, the securities that most typically qualify as Tier 2 capital (both under existing regulations and under the Basel III final framework) are subordinated debt, cumulative preferred stock and term preferred stock.

The criteria for Tier 2 capital in the Basel III final framework are substantially the same as those in the Basel III proposals, with the exception (as in the case of CET1 and Additional Tier 1 capital) that more detailed provisions with respect to eligible minority interests are included.

The Basel III proposals were silent on whether any portion of the allowance for loan and lease losses, or “ALLL”, may be counted as Tier 2 capital. The Basel III final framework confirms that the ALLL may be included in Tier 2 capital up to 1.25% of risk-weighted assets, but only for banks using the standardized approach for credit risk under Basel I (as is currently the case).

**Minority Interests**

The Basel III proposals did not permit common stock issued by consolidated subsidiaries to third parties, or “minority interests”, to be included in CET1 and provided only general parameters for when minority interests could be included in the parent bank’s Additional Tier 1 capital or Tier 2 capital. The Basel III final framework, subject to a number of limitations, permits minority interests in bank subsidiaries and other operating subsidiaries to be included in the parent bank’s CET1, Tier 1 capital and Tier 2 capital. The basic limitations and calculations are as follows:
Minority interests arising from the issue of common stock by a subsidiary may be included in the parent bank’s CET1 only if (i) the common stock giving rise to the minority interest would qualify as CET1 if issued directly by the bank and (ii) the issuing subsidiary is itself a bank.

Other minority interests will be includible in Tier 1 capital or Total capital only if (i) the instrument giving rise to the minority interest would, if issued by the parent bank, qualify as Tier 1 capital (that is, as CET1 or Additional Tier 1 capital) or Tier 2 capital and (ii) if the issuing subsidiary is not a bank, the subsidiary is an “operating entity”. That term is defined as “an entity set up to conduct business with the clients with the intention of earning a profit in its own right.” The consequence of these provisions is that common stock minority interests issued by a non-bank operating entity subsidiary of the parent bank may be included in Tier 1 capital (implicitly as an Additional Tier 1 capital component) but not in CET1 of the parent bank.

In addition to the foregoing provisions, the amount of minority interests in subsidiaries that may be included in CET1, Tier 1 capital or Total capital is subject to a limitation calculated by reference to a formula set forth in the Basel III capital framework. The text describes the purpose of this formula as being to limit the amount of the surplus capital in the subsidiary that may be included in the parent bank’s regulatory capital. Using as an example common stock issued by a subsidiary bank analyzed for inclusion in the parent bank’s CET1, the limitation, generally described, is calculated as (i) the excess of CET1 calculated at the subsidiary bank level over the minimum CET1 required to be maintained by the subsidiary bank inclusive of buffers (that is, 7% so long as only the capital conservation buffer applies but potentially a higher percentage if the countercyclical capital buffer or other buffers apply) multiplied by (ii) the ratio of the bank subsidiary’s common stock minority interests issued to third parties divided by its total common stock, with (iii) the result of that calculation then being deducted from the minority interest common stock sold to third parties. The amount resulting from the calculation in the preceding sentence may then be included in the parent bank’s CET1.

A similar calculation applies to limitations on minority interests that may be included in Tier 1 capital or Total capital.

The expanded inclusion of minority interests in a parent bank’s capital has generally been perceived as more important to European banks than to U.S. banks. The Basel III final framework provides for a five-year phase-out, commencing January 1, 2013, for minority interests currently includible by a bank in a component of capital but no longer includible under the new standards. The phase-out is 20% per year, reaching 100% on January 1, 2018.

Leverage Ratio

The Basel III final framework implements the leverage proposal outlined in the Basel III proposals, with some clarifications. The basic components of the leverage ratio are:

- the numerator is Tier 1 capital;
- the denominator, described as the “exposure measure”, is the sum of on-balance sheet assets and certain off-balance sheet items;
- the ratio will be calculated on a quarterly basis as the average of the “monthly leverage ratio for the quarter”, apparently meaning based on the average of the calculations of both the numerator and the denominator at the end of each of the three months in the quarter; and
- the ratio will not be applied as a requirement until January 1, 2018.

The clarifications in the Basel III final framework as compared to the Basel III proposal include the following:

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The July Amendments, in response to industry comments, modified the initial proposal to provide that unconditionally cancellable commitments (for example, bank obligations to fund credit card usage as well as unconditionally cancellable lines of credit) would be converted to an asset equivalent for the ratio’s denominator using a 10% credit conversion factor instead of the 100% credit conversion factor provided for in the Basel III proposals. The July Amendments did not address whether a 100% credit conversion factor or some lesser factor would apply to other off-balance sheet items (for example, other lending commitments, letters of credit, bankers’ acceptances and unsettled securities). The Basel Committee ultimately chose to apply a 100% credit conversion factor to those other items.

The Basel III final framework carries forward the change in the initial proposals announced as part of the July Amendments to permit Basel II netting of derivative exposures (including credit derivatives). The Basel III final framework provides that banks may also apply Basel II regulatory netting rules to repurchase agreements and other securities financing transactions. The July Amendments did not address these agreements and transactions.

The Basel III final framework provides for extended review and monitoring of the leverage ratio prior to its implementation as a requirement on January 1, 2018. Supervisory monitoring will commence on January 1, 2011, with the focus being on developing templates to track in a consistent manner the components of the numerator and denominator in the ratio; banks will be required to calculate their leverage ratios commencing January 1, 2013 and begin disclosing their leverage ratios starting on January 1, 2015; and any final adjustments to the components of the ratio and its calibration will be carried out in the first half of 2017.

**Capital Conservation Buffer**

The Basel III final framework carries forward unchanged the capital conservation buffer provisions in the Basel III proposals. The key terms are:

- The buffer must be composed entirely of CET1 and is added as an incremental component on top of each of the minimum risk-weighted capital ratios – that is, CET1, Tier 1 capital and Total capital to risk-weighted assets.
- The amount of the buffer is 2.5% when fully phased in, with the phase-in commencing on January 1, 2016 at 0.625% and increasing by 0.625% on each successive January 1 until it reaches 2.5% on January 1, 2019.
- Banks that fall into the buffer zone will be limited in the percentage of earnings that may be paid in the subsequent financial year as dividends, to fund stock buybacks, as discretionary payments on other Tier 1 capital instruments or as discretionary bonus payments to staff, or collectively, “capital distributions”. As banks fall more deeply into their buffer zones, the sanctions may create a dilemma for banks forced to choose between limiting dividends versus limiting discretionary bonus payments to staff. The Basel III final framework recites that the “constraints . . . only relate to distributions, not the operation of the bank.”
- The buffer zone is divided into five bands in 25% increments, with banks that exceed the risk-based capital requirements plus the buffer (as the top tier band) being unrestricted in their ability to make capital distributions, banks that maintain less than 25% of the required buffer being required to retain 100% of earnings (as the bottom tier band), and those in the middle bands being required to retain 40%, 60% or 80% of earnings and, accordingly, being limited to capital distributions equal to 60%, 40% or 20%, as applicable) depending on how far into the buffer zone the bank’s capital ratios fall.

If the countercyclical capital buffer is invoked, the buffer bands described above are expanded to include the additional countercyclical capital buffer.
Countercyclical Capital Buffer

The Basel III final framework generally incorporates and provides additional details with respect to the countercyclical capital buffer initially described in the Basel III proposals. In a separate publication, the Basel Committee provides guidance for national authorities for purposes of making countercyclical buffer related decisions. The key terms of the countercyclical buffer include the following:

- A buffer, generally of up to 2.5% of risk-weighted assets if fully implemented, imposed by appropriate national regulators to the extent it is determined that excess aggregate credit growth in the applicable jurisdiction becomes associated with a build up of systemic risk.
- The buffer is intended to be reciprocal among jurisdictions so that, for internationally active banks, the buffer is equal to the weighted average of the buffers deployed in each of the jurisdictions in which a particular institution has credit exposures.
- Banks that fail to meet the additional countercyclical buffer would be subject to the same band-based restrictions on capital distributions as described above with respect to the capital conservation buffer.

The changes and/or clarifications set forth in the Basel III final framework as compared to the Basel III proposals with respect to the countercyclical buffer include:

- The Basel III final framework clarifies that the countercyclical buffer will operate as an extension of the capital conservation buffer and, if implemented to its maximum allowable limit, be subject to a phase-in period parallel with the conservation buffer – that is commencing at 0.625% on January 1, 2016 and increasing by 0.625% on each successive January 1 until it reaches 2.5% of risk-weighted assets on January 1, 2019.
- While the general upper limit of the calibrated countercyclical buffer is 2.5% if fully implemented, the framework indicates that national regulators can impose a countercyclical buffer in excess of 2.5% or accelerate the phase-in provisions for banks in their jurisdiction. However, such excess or accelerated countercyclical buffers would not be subject to the reciprocity provisions envisioned by the Basel III final framework.
- National regulators are supposed to pre-announce the decision to raise the level of the countercyclical buffer by up to 12 months, whereas the Basel III proposals contemplated a standard 12-month period to effectiveness.
- The countercyclical buffer requirement currently is to be met with CET1 only, while leaving open the possibility of also using other loss absorbing capital if and when the Basel Committee issues further guidance in this area. The Basel III proposals initially indicated that this buffer could be met by CET1 or other fully loss-absorbing capital.
- In the agreed-upon guidance to national authorities, the Basel Committee clarifies that such authorities should review available macroeconomic data and make countercyclical decisions at least on a quarterly basis and develop communications strategies for regularly communicating updates of “their assessments of the macro financial situation and the prospects for potential buffer actions” in order to prepare banks and financial markets more broadly for countercyclical buffer decisions.

Counterparty Credit Risk

Banks and regulators alike generally agreed that the financial crisis exposed weaknesses in the calculation of exposures under Basel II’s internal models approaches. Areas of particular focus included: (i) exposures to counterparties under credit and other derivatives (including the failure of models to recognize “wrong-way” risk – that is, circumstances where the amount of a bank’s exposure to a counterparty increases as the financial health of the counterparty weakens; (ii) the failure of internal
models to fully capture the risk arising from declines in market values of exposures that are in excess of declines relating to changes in the credit quality of the counterparty; and (iii) at least in the view of bank regulators, the perception that systemic inter-connectedness warrants enhanced capital requirements for exposures to large financial institutions.

The Basel III final framework implements the principal components of the Basel III proposals, after giving effect to the July Amendments, including:

- application of a “bond equivalent approach” for measuring risk to counterparties in derivatives transactions, with adjustments addressing industry comments on the treatment of hedging, risk capture, effective maturity and double counting; and
- application of a 1.25 multiplier to the asset value correlation of exposures to large regulated financial firms with assets of at least $100 billion.

The Basel III final framework’s provisions addressing these matters are detailed and complex, in many cases reflected in revised formulas and algorithms in amended provisions of Basel II. Other items addressed include:

- expanded requirements for the use of stressed inputs, stress testing, model validation and backtesting;
- detailed provisions with respect to the calculation of capital charges to cover mark-to-market losses arising from the bank’s exposure to counterparties in OTC derivatives transactions;
- in connection with transactions where the counterparty is required to post additional collateral as its credit quality deteriorates, a prohibition against banks taking into account the benefit of that additional collateral to reduce the bank’s estimate of its exposure to the counterparty at default; and
- strengthened standards for collateral management and initial margining, including requirements that banks with large and illiquid derivatives exposures apply longer margining periods.

The Basel III final framework does not address the regulatory capital treatment for exposures to central counterparties, or “CCPs”. As a result of regulatory reform in many jurisdictions, including the Dodd-Frank Act in the United States, over time many derivatives transactions currently documented as two-party OTC transactions will be required to be implemented through CCPs. The Basel III final framework refers to on-going work of the Committee on Payment and Settlement Services and the International Organization of Securities Commissions regarding the appropriate capital charges and other measures relating to central counterparties and notes that, in due course, the Basel framework “will apply a regulatory capital treatment for exposures to CCPs based in part on the compliance of the CCP with the enhanced CPSS-IOSCO standards.” On December 20, 2010, the Basel Committee released a separate consultative document entitled Capitalization of bank exposures to central counterparties. That document seeks comment on proposals to address CCP risk that include, among other things, a 2% risk-weight for exposures to a qualifying CCP. Comments on that document are due on February 4, 2011.

Other Provisions

Other significant provisions in the Basel III final framework include the following:
The Basel III final framework carries forward the provision in the Basel III proposals specifying that a 1250% risk-weight will apply to regulatory adjustments that, prior to Basel III were deducted 50% from each of Tier 1 capital and Tier II capital, including not only certain securitization exposures (primarily unrated exposures) but also “significant investments in commercial entities”.

The Basel III final framework includes a variety of provisions designed to encourage or require the more responsible use of external credit ratings. These provisions include, for example, (i) as an amendment to Basel II’s standardized approach, a requirement that banks “assess exposures” where the risk-weighting is dependent upon external credit ratings “and determine . . . whether the risk-weights applied to such exposures . . . are appropriate for their inherent risk”, and (ii) enumeration of additional criteria for external credit ratings used in Basel II’s standardized and internal ratings based approaches to securitizations (including that the ratings must be “publicly available, on a non-selective basis and free of charge”). However, the various Basel accords and frameworks continue to make extensive use of external credit ratings. Although use of ratings in capital calculations and for other regulatory purposes is an international issue, this is a particularly troublesome area for U.S. banks and their regulators because of the provisions in Section 939A of the Dodd-Frank Act requiring that ratings as a measure of credit-worthiness be removed from U.S. banking regulations.

The Basel III final framework does not address contingent capital or bail-in debt as a component of regulatory capital. “Contingent capital” is the term used to refer to Tier 1 and Tier 2 capital instruments that would mandatorily convert into common stock if a specified trigger event occurred. “Bail-in debt” is the term used to refer to a broader range of debt securities (possibly including senior debt securities) that would mandatorily convert into common stock or, alternatively, be written off, if a specified trigger event occurred. The trigger events that have been focused on in these contexts have been events that would occur before a point of viability determination (that is, determination by the responsible national regulator that the bank will go into bankruptcy or receivership absent conversion of regulatory capital instruments into common stock) of the type contemplated by the Basel Committee’s loss absorbency proposal and might include, for example, (i) a determination by a national authority that a systemic event had occurred with respect to the nation’s economy or (ii) a bank specific trigger event, such as the bank’s capital ratios falling below a designated level. The Basel Committee noted, in the final framework, that it “continues to review the role that contingent capital should play in the regulatory capital framework”. Although bail-in debt continues to be a subject of discussion among national regulators, particularly in the context of international resolution regimes, the Basel III final framework does not refer to it.

**BASEL III FINAL LIQUIDITY FRAMEWORK**

The Basel III final liquidity framework carries forward the three key liquidity-related elements of the Basel III proposals, which are:

- a “Liquidity Coverage Ratio”, or “LCR”, designed to ensure that a bank maintains an adequate level of unencumbered, high-quality assets that can be converted into cash to meet its liquidity needs for a 30-day time horizon under an acute liquidity stress scenario specified by supervisors;
- a “Net Stable Funding Ratio” or “NSFR”, designed to promote more medium and long-term funding of the assets and activities of banks over a one-year time horizon; and
- a set of common metrics, referred to as “monitoring tools”, that the Basel Committee indicates should be considered as the minimum types of information that banks should report to supervisors, as applicable, and supervisors should use in monitoring the liquidity-risk profiles of supervised entities.
Liquidity Coverage Ratio

As described in the “Background and Summary” section of this memorandum, the LCR is defined as the ratio of a bank’s stock of high-quality liquid assets divided by its total net cash outflows over the next 30 calendar days. The ratio must be at least 100%, such that the stock of high-quality liquid assets is always at least equal to total net cash outflows. The Basel III final framework, like the Basel III proposals, describes the scenario that the LCR is intended to address. The stress scenario contemplated by the final framework, however, specifies a bank’s access to unsecured wholesale funding and secured short-term financing is partially lost, not entirely lost as contemplated by the Basel III proposals.

Stock of Liquid Assets

The Basel III final framework does not fundamentally change the components of the stock of liquid assets as set forth in the Basel III proposals, after giving effect to the July Amendments. The stock of liquid assets is divided into two categories:

- **“Level 1 assets”**, which consist of cash, central bank reserves that can be drawn down in times of stress, and marketable securities representing claims on or guaranteed by sovereigns, central banks, non-central government public sector entities, or “PSEs”, and certain multi-national bodies (with the new qualification added in the final standards that these instruments must have a “proven record as a reliable source of liquidity”); and

- **“Level 2 assets”**, which consist of marketable securities issued by 20% risk-weighted sovereigns, central banks and non-central government PSEs (for example, Fannie Mae and Freddie Mac), AA- or higher-rated corporate bonds and covered bonds (again with the added qualifier that these instruments must have a “proven record as a reliable source of liquidity”).

Each Level 2 asset is subject to a 15% haircut as applied to its current market value. Level 2 assets are limited to 40% of the total stock of liquid assets after haircuts (or two-thirds of Level 1 assets after haircuts).

The final standards, like the ones in the Basel III proposals, require that an asset be unencumbered in order to be included in the numerator of the ratio. However, they provide several important modifications with respect to what it means to be “unencumbered”. First, they treat as unencumbered assets received in reverse repo and securities financing transactions (that is, transactions where the bank is the lender and takes in securities as collateral) that are held at the bank, have not been re-hypothecated, and are legally and contractually available for the bank’s use. Second, they treat as unencumbered assets that have been pledged by a bank to its central bank or a PSE “but are not used”. The final framework does not explain the phrase “but are not used”; although ambiguous, it appears to mean assets that are subject to a global security interest but that have not been segregated or otherwise delivered to the central bank or PSE. Third, they permit assets pledged under short-term funding arrangements (repurchase agreements, for example) to be included in liquid assets in the LCR’s numerator. More specifically as to this third point, the Basel III final framework provides that the numerator includes Level 1 and Level 2 assets that would otherwise be held by the bank if a short-term (defined as 30-calendar days) secured
funding, secured lending or collateral swap transaction under which the Level 1 and Level 2 assets are otherwise pledged were unwound.

**Total Net Cash Outflows Over the Next 30 Calendar Days**

The denominator in the LCR is calculated as the excess of cash outflows over the next 30 calendar days minus cash inflows over the next 30 calendar days, in each case calculated and determined pursuant to detailed and specific requirements in the Basel III final framework. The requirements include specified “run-off factors” for various types of deposits and other liabilities. Commenters on the Basel III liquidity proposals had expressed concern that some of the run-off factors with respect to deposits, as well as assumptions with respect to when banks (as lenders) would be required to fund credit and liquidity facilities, and when banks (as borrowers) would be able to draw on credit and liquidity facilities, were unduly conservative and asymmetrical. The July Amendments made some modifications to the initial proposals to address these concerns. However, the Basel III final framework’s modifications to the denominator in the LCR, on balance, likely will make the LCR more restrictive.

- With respect to cash outflows as a component of the LCR’s denominator, changes in the Basel III final framework as compared to the Basel III proposals include the following:
  - The Basel III final framework carries forward the provision applying a lower run-off factor to unsecured wholesale deposits where the bank has an operational relationship with the depositor than would apply if the bank did not have an operational relationship (25% as compared to 75%). However, it imposes new limitations on when the lower 25% run-off factor may apply that will narrow the scope of its availability. Most importantly, it provides that deposits benefitting from the 25% run-off factor “must be priced below the market in comparison to deposits of a similar duration and held in specifically designated accounts.” The pricing standard, in particular, may be difficult for banks to meet in many cases, notwithstanding their view that the deposits warrant a lower run-off factor (and are demonstrably “sticky”) because of the operational relationships.
  - The Basel III proposals required banks to assume, in calculating cash outflows as a component of the denominator in the LCR, that funding from a bank’s sovereign, central bank (the Federal Reserve through its discount window, for example) or a PSE (the Federal Home Loan Banks, or “FHLBs”, for example) would not be available (and, accordingly, would not be extended or renewed) unless the underlying assets qualified as Level 1 assets. The Basel III final framework moderates that provision by requiring banks to assume, instead of a 100% run-off factor, run-off factors of 15% where the underlying assets are Level 2 assets and 25% where the underlying assets are neither Level 1 nor 2 assets (except that borrowings from a PSE receiving this treatment must be limited to those that are 20% or lower risk-weighted). Because FHLB advance facilities generally are secured by mortgage and mortgage-related assets that are not 20% or lower risk-weighted, this provision is not likely to provide relief with respect to FHLB facilities as a liquidity source.
  - The Basel III final framework requires banks to assume that, if the total of its contractual obligations to fund retail and non-financial corporate clients within the next 30 days (and not otherwise captured as a cash outflow) exceeds 50% of the total contractual cash inflows from those same clients, the excess should be reported as a cash outflow. That provision was not included in the Basel III proposals.
  - The Basel III final framework, compared to the Basel III proposals, provides limited relief for derivatives payable. It does this by providing that known amounts payable and receivable are taken into account on a net basis and that the amounts are also calculated net of Level 1 and Level 2 collateral (but only if that collateral is not included in the stock of liquid assets as
part of the numerator in the LCR). If a net payable exists after taking into account those features, it will receive a 100% run-off factor.

- The Basel III final framework requires that non-Level 1 liquid asset securities pledged to secure the bank's obligations under derivatives are subject to an assumption, as a cash outflow, that 20% of the value of such posted collateral will be required to be added to the collateral in connection with mark-to-market valuation adjustments. The Basel III proposals identified the need to post additional collateral in connection with mark-to-market valuations as a potential source of liquidity but did not impose a specific test, instead suggesting that national supervisors would work with banks in their jurisdictions to determine the liquidity risk.

- With respect to cash inflows as a component of the LCR's denominator, changes in the Basel III final framework as compared to the Basel III proposals include:
  - Cash inflows are capped at 75% of total expected cash outflows in calculating the total net cash outflows over the next 30 days (that is the denominator in the ratio, generally described as cash outflows minus cash inflows). The effect of this requirement is that a bank must maintain a stock of liquid assets equal to at least 25% of the expected cash outflows for the next 30 calendar days even if the net cash outflow amount would otherwise be zero.
  - Although banks are required to assume that reverse repos and securities borrowing agreements secured by Level 1 assets will be rolled-over and not give rise to any cash inflows (both in the proposals and the final version), banks are to assume 15% cash inflows for such agreements secured by Level 2 liquid assets. This assumption results from the expectation that banks will reduce the amount of funds that they will extend against that type of collateral.
  - The Basel III proposals did not expressly address the cashflow consequences for the LCR's denominator of contractually due wholesale cash inflows (for example, amounts that borrowers are required to repay on loans extended by the bank, including repayments on maturity dates that fall within the 30-day window). The Basel III final framework addresses these inflows, but it requires banks to assume that they will re-loan to borrowers a proportion of the amount the borrower is contractually obligated to pay. Significantly, the Basel III final framework provides that banks may assume that all “fully performing contractual wholesale cash inflows” will be paid but that the bank also must assume that it will continue to extend loans to wholesale clients at a rate of (i) in the case of financial institution borrowers, 0% of the inflow amount and (ii) in the case of non-financial corporate, sovereign, central bank or PSE borrowers, 50% of the inflow amount. As a consequence, the resulting assumed cash inflow would be calculated as 100% of the lending bank’s entitlement in the case of financial institution counterparties and 50% of the lending bank’s entitlement in the case of non-financial wholesale counterparties.
  - The Basel III final framework specifies that the bank must assume that none of its deposits held by the bank and other financial institutions for operational purposes (such as clearing, custody and cash management purposes) are able to be withdrawn from the other financial institution. The Basel III proposals were silent on this issue.

Net Stable Funding Ratio

As described in the “Background and Summary” section of this memorandum, the NSFR is defined as the ratio of the bank’s available amount of stable funding divided by its required amount of stable funding. The ratio must be at least equal to 100% such that the available amount of stable funding always equals or exceeds the required amount. In comments submitted to the Basel Committee on the liquidity proposals as part of the initial round of comments due in April 2010, commenters were severely critical of the NSFR. In the July Amendments the Basel Committee acknowledged that the NSFR required substantial attention, noting that “the initial NSFR calibration as set forth in the December 2009 proposal needs to be modified” and stating that the Committee would issue a new proposed NSFR by year-end.
The NSFR in the Basel III final framework, as to concept and basic structure, is, however, essentially identical to the NSFR included in the Basel III proposals. The changes in the final version, as opposed to the proposals, are in the ASF factors and the RSF factors. The changes, generally described, recalibrate the ASF factors and RSF factors (with the ASF factors generally increasing for certain equity and liability categories and the RSF factors generally decreasing for certain categories of assets). The consequence of those changes is that, under the final version, the numerator in the ratio would be higher and the denominator smaller, making it easier for a bank to achieve the required 100% ratio that is expected to be implemented as a requirement on January 1, 2018, subject to whatever intervening changes may be made.

With respect to ASF factors, both the Basel III final framework and the Basel III proposals included five percentage bands, but where in the Basel III proposals the bands were 100%, 85%, 70%, 50% and 0%, in the Basel III final framework the bands are 100%, 90%, 80%, 50% and 0%. In the Basel III final framework:

- the ASF factor applied to stable deposits of retail and small business customers is 90% compared to 85% in the Basel III proposals;
- the ASF factor applied to less stable deposits of retail and small business customers is 80%, as compared to the 70% provided for in the Basel III proposals.

With respect to the RSF factors, where the Basel III proposals provided for six percentage bands (0%, 5%, 20%, 50%, 85% and 100%), the final version provides for seven percentage bands (0%, 5%, 20%, 50%, 65%, 85% and 100%). As an example of the changes, the Basel III final framework applies:

- a 65% RSF factor to unencumbered residential mortgage loans and other unencumbered loans (excluding loans to financial institutions) with a remaining maturity of one year or greater, in each case that would qualify for a 35% or lower risk-weight under the Basel II standardized approach, instead of the 100% RSF factor that was applied under the Basel III proposals; and
- lowered the extent to which off-balance sheet commitments would need to be pre-funded, by applying a 5% RSF factor to conditionally revocable and irrevocable credit and liquidity facilities instead of the 10% RSF factor that would have applied under the Basel III proposals.

Monitoring Tools

The Basel III proposals outlined monitoring tools, or "metrics", that were described, together with the LCR and NSFR, as being intended to “provide the cornerstone of information that aids supervisors in assessing the liquidity risk of a bank”. The Basel III final framework carries forward those metrics essentially unchanged and adds a fifth metric — calculation of the LCR by each significant currency. A “significant currency” is defined as one where the aggregate liability as denominated in that currency amounts to 5% or more of the bank’s total liabilities. Evaluation of the LCR by each significant currency is a Pillar II supervisory and monitoring tool, not a requirement. Accordingly, the Basel III final framework does not, for example, specify any expectation that a bank’s LCR by significant currency would be 100% (or any other particular percentage) or require that it be publicly disclosed.
CONCLUDING OBSERVATIONS

The Basel III final framework, like the other Basel accords and frameworks, is not directly binding on the U.S. bank regulatory agencies or other national regulators. However, there will be substantial international pressure, political and otherwise, on national regulators in most countries to implement the Basel III final framework largely as set forth in the documents released on December 15, 2010, as supplemented or revised in coming months to address loss absorbency, possible surcharges for SIFIs and G-SIFIs, and CCP risk. There may also be domestic political pressure in some countries to accelerate the transition periods (formally or informally) for full implementation of the Basel III framework.

Contemporaneously with releasing the Basel III final framework, the Basel Committee published a summary of the results of the quantitative impact study, or “QIS”, undertaken in connection with Basel III.17 The QIS summary divided banks that participated in the QIS into two groups – “Group 1 banks” (defined as those having Tier 1 capital in excess of €3 billion, are well diversified and are internationally active) and “Group 2 banks” (which are all banks other than Group 1 banks).18 The QIS summary’s conclusions included, subject to the assumptions set forth in the study, the following (which are premised on static calculations as of December 31, 2009):

- a capital shortfall for Group 1 banks is estimated to be between €165 billion for the CET1 minimum requirement of 4.5% and €577 billion for a CET1 target level of 7.0%;
- a capital shortfall for Group 2 banks between €8 billion for a CET1 minimum requirement of 4.5% and €25 billion for a CET1 target level of 7.0%;
- the CET1 of Group 1 banks would fall by an average of 41.3% and the CET1 of Group 2 banks by an average of 24.7%, as a result of the adjustments to common stockholders’ equity required by the Basel III final framework in calculating CET1;
- overall risk-weighted assets of Group 1 banks would increase by 23.0%;
- the weighted average leverage ratio, using the standards in the Basel III final framework for testing during the parallel run, is 2.8% for Group 1 banks and 3.8% for Group 2 banks;
- Group 1 banks have an average LCR of 83%, and Group 2 banks have an average LCR of 98%; and
- Group 1 banks have an average NSFR of 93% and Group 2 banks have an average NSFR of 103%.

Industry estimates of the impact of the Basel III final framework, as to both capital and liquidity, vary, with some showing larger shortfalls (both as to capital and liquidity measures) than the QIS summary and others showing smaller shortfalls. One thing appears certain – that capital and liquidity reform, including as a result of the implementation of the Basel III final framework, will result in substantial changes in banks’ balance sheets (both as to the assets they own and the components of their capital) as well as their activities. The Basel III final framework encourages (and, in effect, mandates) that banks maintain a higher proportion of their balance sheets in lower-risk assets and de-risk their activities. The result is likely to be lower returns on equity for bank investors – apparently a result intended by at least some national regulators participating in the Basel process.
The U.S. bank regulatory agencies have not yet set forth a formal timeline for a notice of proposed rulemaking or final adoption of regulations responsive to Basel III. However, they have indicated informally that a notice of proposed rulemaking likely will be released in mid-2011, with final amendments to regulations becoming effective in mid-2012.

* * *

ENDNOTES

1 The Basel Committee on Banking Supervision, or the “Basel Committee” is a committee of banking supervisory authorities which was established by the central bank governors of the Group of Ten countries at the end of 1974. The base risk-based capital guidelines initially adopted by bank regulators in the Organization for Economic Co-operation and Development are based upon the Basel Committee’s December 1987 consultative paper entitled Proposals for international convergence of capital measurement and capital standards, often referred to as “Basel I”. In June 2006, the Basel Committee released a comprehensive new accord titled International convergence of capital measurement and capital standards – A revised framework, often referred to as “Basel II”. Although Basel II has three approaches – a standardized approach and two advanced approaches – the United States regulators have adopted only the most advanced approach referred to as the internal ratings-based approach, or “IRB”, and have applied it only to so-called core banking organizations that have either more than $250 billion in assets or $10 billion in foreign exposures.


5 These amendments were set forth in a release and a related annex published by the Group of Governors and Heads of Supervision, or “GHOS”, of the Basel Committee, the oversight body of the Basel Committee, on July 26, 2010, and are referred to herein as the “July Amendments”. See S&C’s memo to clients, dated July 28, 2010, entitled “Bank Capital and Liquidity Requirements: Basel Committee Oversight Body Announces Amendments to December 2009 ‘Basel III’ Proposals to Strengthen Bank Capital and Liquidity Regulation.”

6 These calibrations were set forth in a September 12, 2010 press release of the GHOS, and are referred to herein as the “September Amendments”. See S&C’s memo to clients, dated September 13, 2010, entitled “Basel III Capital and Liquidity Standards: Basel Committee Calibrates Capital Standards and Establishes Phase-In Periods for Capital and Liquidity Standards.”

The Financial Stability Board, or “FSB”, which was established in April 2009 by the G-20 as the successor to the Financial Stability Forum founded in 1999 by the G-7 Finance Ministers, and the Basel Committee laid out a general timeframe for addressing the “moral hazard” posed by SIFIs and G-SIFIs in connection with the G-20 meeting in Seoul, South Korea in November 2010. The agreements at that time called upon the FSB to address a variety of issues relating to SIFIs (including possible capital and liquidity surcharges and cross-border resolution regimes) by mid-2011. See S&C’s memo to clients, dated November 15, 2010, entitled “Basel III and FSB Proposals: G-20 Summit Endorses Basel Committee Proposals and Financial Stability Board Recommendations Regarding Systemically Important Financial Institutions.”

The Basel III final framework uses the term “bank” but specifies that its capital requirements follow the scope of applications set out in Basel II, where the term “bank” is defined to mean any “bank, banking group or other entity (for example, holding company) whose capital is being measured.”

Existing capital standards, including those of the U.S. bank regulatory agencies, require that voting common stock be the “predominant” component of Tier 1 capital but do not specify a particular percentage that must consist of such instruments.

Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, or the “Dodd-Frank Act” also disqualifies U.S.-styled trust preferred securities and cumulative preferred stock from bank holding company capital. For “large” banks (that is, those with $15 billion or more in total assets as of December 31, 2009), such instruments must be phased-out of banking holding company capital “incrementally” over a three-year period commencing on January 1, 2013. The Federal Reserve has yet to propose regulations implementing the phase-out requirement, including defining what the term “incrementally” means in this context.

The “Sydney Agreement” is the term commonly applied to the October 27, 1998 press release of the Basel Committee entitled Instruments eligible for inclusion in Tier 1 capital that addresses eligibility requirements for so-called “innovative capital instruments”.

The limitations on capital distributions by banks that fall into the buffer zone overlap with initiatives by national regulators, including in the United States, concerning when banks may pay or increase dividends as well as compensation policy more generally. For example, on November 17, 2010, the Board of Governors of the Federal Reserve System issued new supervisory guidance applicable to the 19 bank holding companies that participated in the 2009 Supervisory Capital Assessment Program addressing, among other things, dividends and other capital distributions (Revised Temporary Addendum to SR letter 09-4: Dividend Increases and Other Capital Distributions for the 19 Supervisory Capital Assessment Program Bank Holding Companies). See S&C’s memo to clients, dated November 22, 2010, entitled “Supervisory Guidance for Large Bank Holding Companies: Federal Reserve Issues New Supervisory Guidance for Large Bank Holding Companies Regarding Capital Plans, Second Round of Stress Tests, Dividend Payments and Other Capital Distributions.”

Guidance for national authorities operating a countercyclical capital buffer (Basel Committee, December 2010).

Generally described, the numerator in the NSFR – that is, the available amount of stable funding – is calculated by applying to designated items on the right side of the balance sheet (that is, items that are sources of funding) a factor – called an “ASF factor” – ranging (as initially proposed) from 100% to 0% depending upon the particular equity or liability component, with the factor reflecting stability of funding.

Generally described, the denominator in the NSFR – that is, the required amount of stable funding – is calculated by applying to each asset on the left side of the balance sheet and certain off-balance sheet commitments (that is, items requiring funding) a specified required funding factor – called an “RSF factor” – ranging (as initially proposed) from 0% to 100% depending on the particular asset or asset-equivalent component, with the factor reflecting the amount of the particular item that supervisors believe should be supported with stable funding.
The QIS study indicated that a total of 263 banks from 23 jurisdictions participated in the study, including 94 Group 1 banks and 169 Group 2 banks.
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