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Regulatory Capital Reform under Basel III

January 2011

Table of Contents

Overview

Relevant Basel Committee Publications

- “Enhancements to the Basel II framework” published July 2009
- “Revisions to the Basel II market risk framework July 2009” published July 2009
- “Basel III: A global regulatory framework for more resilient banks and banking systems” published December 2010
- “Basel III: International framework for liquidity risk measurement, standards and monitoring” published December 2010
- “Annex: Minimum requirements to ensure loss absorbency at the point of non-viability” published January 2011

Nature of reforms

- Both the above-described modifications published in July 2009 (collectively referred to as “Basel 2 ½”) and the above-described modifications published in December 2010 and January 2011 (collectively referred to as “Basel III”) all modify the existing Basel II Regulatory Capital Accord originally published in 2004 and updated through June 2006. Neither Basel 2 ½ nor Basel III are self-standing sets of rules.

Summary of reforms

- *Increased overall capital requirement*: Between 2013 and 2019, the common equity component of capital (core Tier 1) will increase from 2% of a bank’s risk-weighted assets before certain regulatory deductions to 4.5% after such deductions. A new 2.5% capital conservation buffer will be introduced, as well as a zero to 2.5% countercyclical capital buffer. The overall capital requirement (Tier 1 and Tier 2) will increase from 8% to 10.5% over the same period.

Overview (cont'd)

Summary of reforms (cont'd)

- *Narrower definition of regulatory capital*: Common equity will continue to qualify as core Tier 1 capital, but other hybrid capital instruments (upper Tier 1 and Tier 2) will be replaced by instruments that are more loss-absorbing and do not have incentives to redeem. Distinctions between upper and lower Tier 2 instruments, and all of Tier 3 instruments, will be abolished. All non-qualifying instruments issued on or after 12 September 2010, and non-qualifying core Tier 1 instruments issued prior to that date, will both be derecognised in full from 1 January 2013; other non-qualifying instruments issued prior to 12 September 2010 will generally be phased out 10% per year from 2013 to 2023.
- *Increased capital charges*: Commencing 31 December 2010, re-securitisation exposures and certain liquidity commitments held in the banking book will require more capital. In the trading book, commencing 31 December 2010, banks will be subject to new "stressed" value-at-risk models, increased counterparty risk charges, more restricted netting of offsetting positions, increased charges for exposures to other financial institutions and increased charges for securitisation exposures.
- *New leverage ratio*: A minimum 3% Tier 1 leverage ratio, measured against a bank's gross (and not risk-weighted) balance sheet, will be trialled until 2018 and adopted in 2019.
- *Two new liquidity ratios*: A "liquidity coverage ratio" requiring high-quality liquid assets to equal or exceed highly-stressed one-month cash outflows will be adopted from 2015. A "net stable funding ratio" requiring "available" stable funding to equal or exceed "required" stable funding over a one-year period will be adopted from 2018.

Timing

- Basel III will be phased in over a twelve-year period commencing 1 January 2011, with most changes becoming effective within the next six years

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What remains from Basel II

Evolution of Reform

Basel I

- In effect since 1988
- Very simple in application
- Easy to achieve significant capital reduction with little or no risk transfer

Overly simple rules were subject to "regulatory arbitrage" and poor risk management

Basel II

- In effect since 2004
- More risk sensitive
- Treats both exposures and banks very unequally

Profoundly altered bank behaviour but contained "gaps" that banks exploited

Basel III

- Fully implemented only in 2023
- Addresses perceived shortcomings of Basel II
- Greatest impact on trading book, bank liquidity and bank leverage

Will increase capital charges materially and make certain banking activities much more capital intensive

Scope of Application

Banks

- Applied on consolidated basis to internationally active banks
- All banking and other financial activities (whether or not regulated) captured through consolidation
- Financial activities do not include insurance
- Majority-owned subsidiaries not consolidated: deduct equity and capital investments
- Significant minority investments without control: deduct equity and capital investments
- Deduction of investments 50% from tier 1 and 50% from tier 2 capital
- But CRD applies to solo entities as well as groups, and to investment firms

Insurance entities

- Generally, banks must deduct equity and other capital investments held in insurance subsidiaries
- However, some G10 countries will retain current risk weighting treatment (100% for standardised banks) for competitiveness reasons
- Supervisors may permit recognition by bank of excess capital invested in insurance subsidiary over required amount

Commercial entities

- Generally, banks must deduct “significant investments” in commercial entities above materiality thresholds
- “Significant investments” in commercial entities below materiality thresholds carry risk weight of 100%

Types of Banks

Standardised

- Measure credit risk pursuant to fixed risk weights based on external credit assessments (ratings)
- Least sophisticated capital calculations; least differentiation in required capital between safer and riskier credits
- generally highest capital burdens

Foundation IRB

- Measure credit risk using sophisticated formulas using internally determined inputs of probability of default (PD) and inputs fixed by regulators of loss given default (LGD), exposure at default (EAD) and maturity (M).
- More risk sensitive capital requirements; more differentiation in required capital between safer and riskier credits

Advanced IRB

- Measure credit risk using sophisticated formulas and internally determined inputs of PD, LGD, EAD and M
- Most risk-sensitive (although not always lowest) capital requirements; most differentiation in required capital between safer and riskier credits
- Transition to Advanced IRB status only with robust internal risk management systems and data

Under Basel II and Basel III, banks have strong incentive to move to IRB status by improving risk management systems, thereby reducing required total regulatory capital

Banking Book and Trading Book

Banking Book

- All exposures not held in trading book must be held in banking book
- “Philosophy” of banking book capital is to cover unexpected credit losses incurred over a one-year holding period

Trading Book

- Exposures can be held in trading book only if actively managed and held for “trading intent” (e.g., obtain trading or arbitrage profits)
- “Philosophy” of trading book capital is to cover losses in value during a very short period (e.g., 10 to 20 days) prior to exiting an exposure

Three Pillars of Regulation

Pillar I

Regulatory Capital Charges: Minimum capital requirements based on market, credit and operational risk to (a) reduce risk of failure by cushioning against losses and (b) provide continuing access to financial markets to meet liquidity needs, and (c) provide incentives for prudent risk management

Pillar II

Supervision: Qualitative supervision by regulators of internal bank risk control and capital assessment process, including ability to require banks to hold more capital than required under Pillar I

Pillar III

Market Discipline: Public disclosure requirements compel improved bank risk management

Regulatory Capital Charges

Banking Book Exposures

- Formula for calculating capital charges for banking book exposures:

$$Capital\ charge = EA \times RW \times GCR$$

Where: EA = amount of exposure
RW = risk weight of exposure
GCR = general capital requirement (currently 8% under Basel II)

- Further multiplied by credit conversion factor (CCF) if unfunded commitment
- Risk weight calculation method varies depending on type of exposure, e.g.:
  - Claims on central governments, regional or local authorities, administrative bodies, multi-lateral development banks and international organisations
  - Claims on institutions (banks and insurance companies)
  - Claims on corporates
  - Retail claims
  - Claims secured by real estate
  - Specialised lending exposures
  - Securitisation positions
  - Equity exposures
  - Off-balance sheet items

Regulatory Capital Charges (cont'd)

Banking Book Exposures (cont'd)

- Risk Weight calculation method also varies depending upon type of bank:
  - For Standardised Banks, determined on basis of ratings of exposure
  - For IRB Banks, determined on basis of formulas
- Sample capital calculation for banking book exposures
  - €100 million unrated senior corporate exposure
  - 100% risk weight
  - General capital requirement (8% under Basel II; increasing under Basel III)
  - Capital charge for that exposure = €8 million

Trading Book Exposures

- Standardised Method
  - Exposure Amount: Firms use set parameters to determine the exposure and simplifying assumptions are applied, but the approach is more risk sensitive than the notional based add-on approach. The exposure amount is the product of (a) the larger of the net current market value or a "supervisory EPE" times (b) a scaling factor
  - Regulatory Capital: "Building block" approach in which specific risk charge for position and general market risk charge are determined separately

Regulatory Capital Charges (cont'd)

Trading Book Exposures (cont'd)

- Internal Model Method (subject to supervisory approval)
  - Exposure Amount: Subject to regulatory approval firms may use own estimates of EAD calculated by an internal model. Effective expected positive exposure over a 1 year time horizon can be employed as an exposure measure for OTC derivatives and SFTs
  - Regulatory Capital: Value-at-risk (VaR) approach with add-on if model does not capture specific risk adequately
- Counterparty Risk Charge
  - Additional credit counterparty risk charge on all over-the-counter derivatives in trading book
  - Alternative counterparty risk "add-on" of 5% or 10% for credit default swaps only
- Combining Standardised Method and Model Method
  - Regulatory capital charge may entail combination of standardised and model methodology where bank does not have model approval for all financial instrument types

All Exposures: Operational risk charges

- Require banks to hold capital against operating risks (fraud, legal, documentation, etc.)

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Reforms under Basel III

Overview

Summary of reforms

- Increased overall capital requirement
- Narrower definition of qualifying regulatory capital
- Increased capital charges for banking book exposures
- Increased capital charges for trading book exposures
- New leverage ratio
- Two new liquidity ratios

Timing

- Basel III will be phased in over a twelve-year period commencing this year, with Basel III in full effect by 2023, as follows:
  - Increased capital requirement:
    - Increase in minimum common equity capital ratio: 2013 – 2014
    - Introduction of new capital conservation buffer: 2016 – 2018
    - Introduction of new countercyclical capital buffer: 2016 – 2018
    - Phase-in of deductions from core Tier 1: 2014 – 2017
  - Narrower definition of qualifying capital: phase-out of non-qualifying instruments 2013 – 2023
  - Increased capital charges for banking book exposures: commending end 2010
  - Increased charges for trading book exposures: commencing end 2010
  - New leverage ratio: supervisory monitoring until 2012, parallel run 2013 – 2018, migration to Pillar 1 capital requirement 2018
  - New liquidity ratios:
    - Liquidity coverage ratio: observation period 2011 – 2014, commencement of new standard 2015
    - Stable funding ratio: observation period 2012 – 2017, commencement of new standard 2018

Increased Capital Requirement

Increases in Required Capital Ratios

- Under Basel III, both the quantum and the quality of required capital will increase substantially
- New ratios calculated *after* "regulatory deductions and other adjustments" (see below)
- Capital levels increased as follows:
  - Minimum requirement for common equity more than doubled from 2% before deductions to 4.5% after deductions
    - Phased in commencing 1 January 2013 until complete 1 January 2015
  - New 2.5% "capital conservation buffer"
    - Phased in commencing 1 January 2016 until complete 1 January 2019
    - Must be met entirely by CET 1 after deductions
    - Items subject to restriction: dividends, share buybacks, other payments and distributions on Tier 1 capital instruments, discretionary bonuses
    - Capital conservation buffer effectively raises total common equity requirement to minimum of 7%; however, in practice, banks likely to hold more than 7% common equity to avoid falling into buffer zone
    - If bank breaches buffer it must retain percentage of earnings (i.e., distributable profits prior to regulatory deductions)

Individual Bank Minimum Capital Conservation Standards	
Common Equity Tier 1 Ratio	Minimum Capital Conservation Ratio (as percentage of earnings)
4.5% - 5.125%	100%
> 5.125% - 5.75%	80%
> 5.75% - 6.375%	60%
> 6.375% - 7.0%	40%
> 7.0%	0%

Increased Capital Requirement (cont'd)

Increases in Required Capital Ratios (cont'd)

- New zero to 2.5% "countercyclical capital buffer"
  - Phased in commencing 1 January 2016 until complete 1 January 2019
  - National authority to set counter-cyclical buffer by public announcement (increases generally subject to 12-month pre-announcement; decreases generally immediately effective)
  - Must be met entirely by CET 1 (BIS Committee considering whether other fully loss-absorbing capital may qualify)
  - Buffer to apply to banks on basis of geographic composition of credit exposures (based on location of obligor and not booking of exposure)
  - Items subject to restriction: dividends, share buybacks, other payments and distributions on Tier 1 capital instruments, discretionary bonuses
  - If bank breaches buffer it must retain percentage of earnings (i.e., distributable profits prior to regulatory deductions)
  - Capital conservation buffer and countercyclical capital buffer combine to determine required retention:

Individual Bank Minimum Capital Conservation Standards (when subject to 2.5% countercyclical capital requirement)	
Common Equity Tier 1 Ratio	Minimum Capital Conservation Ratio (as percentage of earnings)
4.5% - 5.75%	100%
> 5.75% - 7.0%	80%
> 7.0% - 8.25%	60%
> 8.25% - 9.5%	40%
> 9.5%	0%

Increased Capital Requirement (cont'd)

Regulatory Deductions and Other Adjustments ("Deductions")

- Under Basel II, qualifying Tier 1 and Tier 2 capital determined on basis of "gross" instruments *prior* to deduction of various items that reduced amount of capital available to withstand credit shocks
- Under Basel III, banks must determine available Tier 1 capital *after* deductions, including:
  - Goodwill and other Intangibles
    - Goodwill and other intangibles must be deducted from Tier 1 common equity (mortgage servicing rights treated separately below)
    - Amount deducted should be net of any associated deferred tax liability which would be extinguished if goodwill becomes impaired or derecognised under relevant accounting standards
    - Banks may use IRFS definitions of intangible assets with supervisory approval
  - Deferred Tax Assets
    - Deferred tax assets (DTAs) that rely on future profitability of bank to be realised must be deducted from Tier 1 common equity
    - DTAs may be netted with associated deferred tax liabilities (DTLs) only if DTA and DTL relate to taxes of same authority and netting is permitted
    - DTAs relating to temporary differences dealt with under "Threshold Deductions" below
    - No netting of DTL permitted if DTL already deducted when determining intangibles, goodwill or defined pension assets
    - Allocation of DTAs must be *pro rata* between full and threshold deduction
  - Cashflow hedge reserve
    - Amount of cash flow hedge reserve relating to items not held at fair value on balance sheet must be deducted from Tier 1 common equity (positive amounts deducted, negative amounts added back)
    - Adjustment removes artificial volatility in common equity
  - Shortfall of Provisions to Expected Losses. IRB banks just deduct from Tier 1 common equity any shortfall of provisions to expected losses (not reduced by any expected tax effects)
  - Gains on Sale from Securitisations. Any equity increase resulting from securitisation transactions (such as recognition of future margin income) must be deducted from Tier 1 common equity

Increased Capital Requirement (cont'd)

Regulatory Deductions (cont'd)

- Changes in own credit. Unrealised gains and losses resulting from changes in fair value of liabilities due to changes in bank's own credit risk must be derecognised from Tier 1 common equity
- Defined benefit pension fund assets and liabilities
  - Defined benefit pension fund liabilities included on balance sheet must not be recognised in Tier 1 common equity (i.e., Tier 1 common equity cannot be increased by derecognising liabilities)
  - Defined benefit pension fund asset must be deducted from Tier 1 common equity net of associated DTL that would be extinguished if assets impaired or derecognised
  - Asset in fund to which bank has unfettered access can (at relevant risk weight) offset deduction with supervisory approval
- Investments in Own Shares (Treasury Stock)
  - All investments in own common shares (unless already derecognised under relevant accounting standards) and any own stock which banks could be contractually obliged to purchase must be deducted from Tier 1 common equity, irrespective of location of exposure in trading or banking book
  - Gross positions may be deducted net of short positions only if short positions involve no counterparty risk
  - Banks should look through index holdings to deduct exposures in own shares (net of short positions in same index)
  - Same rules apply to bank holdings in own Tier 1 Additional Going-Concern Capital and Tier 2 Gone-Concern Capital
- Reciprocal Holdings in Banking, Financial and Insurance Entities
  - Applicable to holdings where entities are outside scope of regulatory consolidation and where bank owns not more than 10% of issued common share capital of entity
  - Holdings include direct and indirect holdings (e.g., look through index holding); both banking and trading book holdings included; net long position to be included if short position matches long position maturity or has residual maturity of at least one year; includes common stock and all other types of cash and synthetic capital instruments; underwriting positions held for more than five working days must be included; national discretion to exclude temporarily holdings to provide assistance to distressed institution with supervisory approval
  - If total of all holdings exceeds 10% of bank's common equity, excess above 10% must be deducted from Core Tier 1, Additional Tier 1 and Tier 2 capital using "corresponding deduction" method (i.e., proportional deduction from component of capital corresponding to type of instrument) (if insufficient capital for deduction, deduction made from next higher tier of capital)
  - Amounts below threshold (and not deducted) continue to be subject to Pillar I capital charge according to appropriate risk weight

Increased Capital Requirement (cont'd)

Regulatory Deductions (cont'd)

- Significant Holdings in Banking, Financial and Insurance Entities
  - Applicable to holdings where entities are outside scope of regulatory consolidation and where bank owns more than 10% of issued common share capital of entity or where entity is affiliate of bank
  - Holdings include direct and indirect holdings (e.g., look through index holding); both banking and trading book holdings included; net long position to be included if short position matches long position maturity or has residual maturity of at least one year; includes common stock and all other types of cash and synthetic capital instruments; underwriting positions held for more than five working days must be included; national discretion to exclude temporarily holdings to provide assistance to distressed institution with supervisory approval
  - All investments other than common stock must be deducted from Core Tier 1, Additional Tier 1 and Tier 2 capital using "corresponding deduction" approach (i.e., proportional deduction from component of capital corresponding to type of instrument) (if insufficient capital for deduction, deduction made from next higher tier of capital)
  - Common stock must be deducted as provided in "Threshold Deductions" below

- Threshold Deductions
  - Instead of full deduction, following items may *each* receive limited recognition when calculating Tier 1 common equity, with recognition capped at 10% of bank's common equity (after deductions):
    - Significant investments (i.e., more than 10%) in non-consolidated banking, insurance and financial entities
    - Mortgage servicing rights (MSRs)
    - DTAs that arise from temporary differences
  - Aggregate limitation:
    - From 1 January 2013, bank must deduct amount by which aggregate of three above items exceeds 15% of common equity *prior to deductions*, subject to full disclosure
    - From 1 January 2018, bank must deduct amount by which aggregate of three above items exceeds 15% of common equity *after deductions*, subject to full disclosure
  - Amount of three items not subject to deduction risk weighted at 250%

Increased Capital Requirement (cont'd)

Regulatory Deductions (cont'd)

- Former Deductions from Capital
  - For unrated securitisation exposures, certain equity exposures under PD/LGD approach, failed delivery-versus-payment transactions, and significant investments in commercial entities
  - Under Basel II deducted 50% from Tier 1 and 50% from Tier 2
  - Under Basel III give 1250% risk weighting (effectively increasing capital charge for banks holding capital above 8% threshold)
- Disclosure. Banks must disclose:
  - Full reconciliation of all regulatory capital requirements to balance sheet in audited financial statements
  - Separate disclosure of regulatory adjustments and items not deducted from Tier 1 common Equity under "Threshold Deductions" above
  - Description of all limits and minima, identifying the positive and negative elements of capital to which the limits and minima apply
  - Description of main features of capital instruments issued
  - Banks which disclose ratios involving components of regulatory capital (e.g., "Equity Tier 1", "Core Tier 1" or "Tangible Common Equity" ratios) must accompany disclosures with comprehensive explanation of how ratios are calculated
  - On bank's own website, full terms and conditions of all instruments included in regulatory capital
  - During transition phase, including capital instruments and deductions, all instruments benefitting from transitional provisions

Increased Capital Requirement (cont'd)

Timing – Phase-in of Capital Ratio Increases and Deductions

- Shading indicates transition period
- All dates as of 1 January

	2011 (B II)	2012	2013	2014	2015	2016	2017	2018	2019 (B III)
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%	0%	0%	0%	0%	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	0%	0%	0%	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 conservation buffer	8.0%	8.0%	8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%

Redefinition of Qualifying Capital

Redefining Qualifying Tier 1 and Tier 2 Capital

- Under Basel III:
  - Instruments qualifying for recognition as Tier 1 or Tier 2 capital will be restricted substantially
  - Distinction between upper Tier 2 and lower Tier 2 will be eliminated
  - Tier 3 capital will be eliminated
- In summary, in order to qualify, new non-common equity Tier 1 and Tier 2 instruments must:
  - be more loss-absorbing
  - not contain incentives to redeem prior to their stated maturity
  - be written off or converted to equity at the determination by the relevant supervisor either that the bank would not be viable without the write-off or that a public sector capital injection is to be made
- Changes render ineligible wide range of outstanding upper Tier 1 and Tier 2 instruments
  - Most ineligible instruments (e.g., innovative hybrid capital instruments with incentives to redeem), formerly limited to 15% of T1 capital base, phased out or even fully derecognised from 2013 (see "Timing" below)

Components of Common Equity Tier 1 Capital (CET 1)

- Common shares issued by bank (for specific criteria see slides 27 – 33 below)
- Stock surplus (share premium)
- Retained earnings (including interim profit or loss)
- Accumulated other comprehensive income and other disclosed reserves
- Common shares issued by consolidated subsidiaries of the bank and held by third parties (i.e., minority interest) that meet criteria for CET 1 (subject to additional conditions below)
- Regulatory deductions (see above)
- Dividends removed from CET 1 in accordance with applicable accounting standards

Redefinition of Qualifying Capital (cont'd)

Components of Additional Tier 1 Capital (AT 1)

- Instruments meeting criteria for inclusion as AT 1 (for specific criteria see slides 27 – 33 below)
- Stock surplus (share premium) resulting from instruments included in AT 1
- Instruments issued by consolidated subsidiaries of the bank and held by third parties (i.e., minority interest) that meet criteria for AT 1 (subject to additional conditions below)
- Regulatory deductions (see above)

Components of Tier 2 Capital (T 2)

- Instruments meeting criteria for inclusion as T 2 (for specific criteria see slides 27 – 33 below)
- Stock surplus (share premium) resulting from instruments included in T 2
- Instruments issued by consolidated subsidiaries of the bank and held by third parties (i.e., minority interest) that meet criteria for T 2 (subject to additional conditions below)
- Certain loan loss provisions or reserves
  - Standardised banks: loan loss provisions or reserves held against future, presently unidentifiable losses that are freely available to meet losses, limited to 1.25% of risk weighed assets
  - IRB banks: excess (if any) of total eligible provisions (as provided in Basel II) over total expected loss amounts, limited to 0.60% of risk weighted assets
- Regulatory deductions (see above)

Redefinition of Qualifying Capital (cont'd)

Table : Summary of Required Features

Feature	Tier 1 Capital Common Equity	Tier 1 Capital Additional Going-Concern Capital	Tier 2 Capital Gone-Concern Capital
A. ISSUER			
1. General	• Bank • Fully-consolidated subsidiary of bank meeting conditions below	• Bank • Consolidated subsidiary of bank meeting conditions below • Special purpose vehicle ("SPV") meeting conditions below	• Bank • Consolidated subsidiary of bank meeting conditions below • SPV meeting conditions below
2. Subsidiary Issuers	• Held by third parties • Common equity, if issued by bank, would qualify as Tier 1 Common Equity in all respects • Subsidiary is itself a bank • Amount recognised limited to total amount of common equity of subsidiary minus surplus attributable to minority shareholders (if any) (surplus calculated as lower of (i) minimum Tier 1 Common Equity requirement of subsidiary plus capital buffer (i.e., 7.0% of risk weighted assets) and (ii) portion of consolidated minimum Tier 1 requirement plus capital buffer relating to subsidiary)	• Held by third parties • Instrument, if issued by bank, would qualify as Tier 1 capital in all respects • Amount recognised limited to total amount of Tier 1 capital of subsidiary minus surplus attributable to third party investors (if any) (surplus calculated as lower of (i) minimum Tier 1 requirement of subsidiary plus capital buffer (i.e., 8.5% of risk weighted assets) and (ii) portion of consolidated minimum Tier 1 requirement plus capital buffer relating to subsidiary) • Excludes any instruments recognised as Tier 1 Common Equity	• Held by third parties • Instrument, if issued by bank, would qualify as Tier 1 or Tier 2 capital in all respects • Amount recognised limited to total amount of total capital of subsidiary minus surplus attributable to third party investors (if any) (surplus calculated as lower of (i) minimum total capital requirement of subsidiary plus capital buffer (i.e., 10.5% of risk weighted assets) and (ii) portion of consolidated minimum Tier 1 requirement plus capital buffer relating to subsidiary) • Excludes any instruments recognised as Tier 1 Common Equity or Tier 1 Additional Going-Concern Capital

Redefinition of Qualifying Capital (cont'd)

Feature	Tier 1 Capital Common Equity	Tier 1 Capital Additional Going-Concern Capital	Tier 2 Capital Gone-Concern Capital
3. SPV issuers		• proceeds of instrument issued by SPV must be immediately available without limitation to operating entity or holding company in form meeting or exceeding all other criteria for inclusion in Tier 1 Additional Going Concern Capital	• proceeds of instrument issued by SPV must be immediately available without limitation to operating entity or holding company in form meeting or exceeding all other criteria for inclusion in Tier 2 Gone-Concern Capital
4. Source of funds		• Neither bank nor related party over which bank exercises control or significant influence can have purchased instrument, nor can bank directly or indirectly have funded purchase of instrument	• Neither bank nor related party over which bank exercises control or significant influence can have purchased instrument, nor can bank directly or indirectly have funded purchase of instrument
B. TERM			
1. In general	• Perpetual	• Perpetual • No step-ups or other incentives to redeem	• Minimum original maturity of at least 5 years • Recognition in regulatory capital in remaining 5 years before maturity amortised on straight line basis • No step-ups or other incentives to redeem (an option to call after 5 years but prior to start of amortisation period, without creating expectation of call, is not incentive to redeem)

Redefinition of Qualifying Capital (cont'd)

Feature	Tier 1 Capital Common Equity	Tier 1 Capital Additional Going-Concern Capital	Tier 2 Capital Gone-Concern Capital
2. Redemption/ Repayment	• Principal perpetual and never repaid outside of liquidation • Discretionary repurchases and other discretionary means of effectively reducing capital permitted if allowable under national law	• Repayment of principal (*e.g.*, through repurchase or redemption) only with prior supervisory approval • Instrument cannot have features hindering recapitalisation, such as provisions requiring issuer to compensate investors if new instrument issued at lower price during specified time frame	• Investor must have no rights to accelerate repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation
3. Call		• Callable at initiative of issuer only after minimum of five years: a. To exercise call option bank must receive prior supervisory approval; and b. Bank must not do anything creating expectation that call will be exercised; and c. Bank must not exercise call unless: i. bank replaces called instrument with capital of same or better quality and replacement done at conditions sustainable for income capacity of bank (replacement must be concurrent with call, not after); or ii. bank demonstrates that capital position well above minimum capital requirement after call exercised ("minimum" requirement refers to national law not Basel III rules)	• Callable at initiative of issuer only after minimum of five years: a. To exercise call option bank must receive prior supervisory approval; and b. Bank must not do anything creating expectation that call will be exercised; and c. Bank must not exercise call unless: i. bank replaces called instrument with capital of same or better quality and replacement done at conditions sustainable for income capacity of bank (replacement must be concurrent with call, not after); or ii. bank demonstrates that capital position well above minimum capital requirement after call exercised ("minimum" requirement refers to national law not Basel III rules)

Redefinition of Qualifying Capital (cont'd)

Feature	Tier 1 Capital Common Equity	Tier 1 Capital Additional Going-Concern Capital	Tier 2 Capital Gone-Concern Capital
4. No Expectation	• Bank does nothing to create expectation at issuance that instrument will be bought back, redeemed or cancelled nor do statutory or contractual terms provide any feature which might give rise to such expectation	• Bank should not assume or create market expectation that supervisory approval for repayment of principal will be given	• Bank must not do anything creating expectation that call will be exercised
C. DISTRIBUTIONS/ COUPONS			
1. Source	• Distributions paid out of distributable items (retained earnings included) • Level of distributions not in any way tied or linked to amount paid in at issuance and not subject to cap (except to extent bank unable to pay distributions exceeding level of distributable items)	• Dividends/coupons paid out of distributable items	

Redefinition of Qualifying Capital (cont'd)

Feature	Tier 1 Capital Common Equity	Tier 1 Capital Additional Going-Concern Capital	Tier 2 Capital Gone-Concern Capital
2. No obligation	• No circumstances under which distributions obligatory • Non-payment not event of default	• Dividend/coupon discretion: a. bank must have full discretion at all times to cancel distributions/ payments ("dividend pushers" and requirement to pay distribution/ payment "in kind" both explicitly prohibited) b. cancellation of discretionary payments must not be event of default c. banks must have full access to cancelled payments to meet obligations as they fall due d. cancellation of distributions/ payments must not impose restrictions on bank except in relation to distributions to common stockholders	• Investor must have no rights to accelerate repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation

Redefinition of Qualifying Capital (cont'd)

Feature	Tier 1 Capital Common Equity	Tier 1 Capital Additional Going-Concern Capital	Tier 2 Capital Gone-Concern Capital
3. Priority	• Distributions paid only after all legal and contractual obligations met and payments on more senior capital instruments made • No preferential distributions, including in respect of other elements classified as highest quality issued capital		
4. Margin adjustment		• Instrument may not have a credit sensitive dividend feature, *i.e.*, dividend/coupon reset periodically based in whole or part on bank's current credit standing	• Instrument may not have a credit sensitive dividend feature, *i.e.*, dividend/coupon reset periodically based in whole or part on bank's current credit standing
D. SUBORDINATION			
1. Priority	• Represents most subordinated claim in liquidation of bank • Entitled to claim of residual assets proportional with share of issued capital after all senior claims repaid in liquidation (*i.e.*, unlimited and variable claim, not fixed or capped claim)	• Subordinated to depositors, general creditors and subordinated debt of bank	• Subordinated to depositors and general creditors of bank

Redefinition of Qualifying Capital (cont'd)

Feature	Tier 1 Capital Common Equity	Tier 1 Capital Additional Going-Concern Capital	Tier 2 Capital Gone-Concern Capital
2. Loss-absorbency	• Takes first and proportionately greatest share of any losses as occur • Within highest quality capital; absorbs losses on going-concern basis proportionately and *pari passu* with all others	• Instruments classified as liabilities must have principal loss absorption through either (a) conversion to common shares at objective pre-specified trigger point or (b) write-down mechanism allocating losses to instrument at pre-specified trigger point • Write-down will have following effects (a) reduce claim of instrument in liquidation, (b) reduce amount re-paid when call is exercised, and (c) partially or fully reduce coupon/dividend payments on instrument	
3. Equity-like nature	• Paid-in amount recognised as equity capital (*i.e.*, not recognised as liability) for determining balance sheet insolvency • Paid-in amount classified as equity under relevant accounting standards	• Instrument cannot contribute to liabilities exceeding assets if balance sheet test forms part of national insolvency law	

Redefinition of Qualifying Capital (cont'd)

Feature	Tier 1 Capital Common Equity	Tier 1 Capital Additional Going-Concern Capital	Tier 2 Capital Gone-Concern Capital
4. Security	• Neither secured nor covered by guarantee of issuer or related entity or subject to other arrangement legally or economically enhancing seniority of claim	• Neither secured nor covered by guarantee of issuer or related entity or other arrangement legally or economically enhancing seniority of claim *vis-à vis* bank creditors	• Neither secured nor covered by guarantee of issuer or related entity or other arrangement legally or economically enhancing seniority of claim *vis-à vis* depositors and general bank creditors
E. MISCELLANEOUS			
1. Issuance	• Directly issued and paid-up; bank cannot directly or indirectly have funded purchase of instrument • Only issued with approval of owners of issuing bank, either given directly by owners or, if permitted by applicable law, by Board of Directors or by other persons duly authorised by owners	• Issued and paid-in	• Issued and paid-in
2. Disclosure	• Clearly and separately disclosed on bank's balance sheet		

Redefinition of Qualifying Capital (cont'd)

Feature	Tier 1 Capital Common Equity	Tier 1 Capital Additional Going-Concern Capital	Tier 2 Capital Gone-Concern Capital
3. Other		• Criteria above also apply to instruments appearing in the consolidated accounts as minority interest • Tier 1 Capital – Additional Going-Concern Capital to be net of appropriate corresponding deductions related to holding of non-common equity capital instruments in other financial institutions	• Criteria above also apply to instruments appearing in the consolidated accounts as minority interest • Tier 2 Capital to be net of appropriate corresponding deductions related to holding of non-common equity capital instruments in other financial institutions

Redefinition of Qualifying Capital (cont'd)

Timing

- Transition:
  - Non-qualifying CET 1 instruments fully derecognised from 1 January 2013 (limited exception for certain non-stock company equity)
  - Non-qualifying AT 1 and T 2 instruments phased out (i.e., not recognised as capital) by 10% each year, commencing 2013 and finishing 2023 (redemptions and amortisations of non-qualifying instruments after 1 January 2013 do not reduce base for phase-out calculation)
- Exceptions for instruments with incentives to redeem:
  - Instrument (i) with call or step-up (or other incentive to redeem) prior to 1 January 2013, (ii) not called or redeemed, and (iii) meets criteria on forward-looking basis, continues to be recognised in capital
  - Instrument (i) with call or step-up (or other incentive to redeem) on or after 1 January 2013, (ii) not called or redeemed, and (iii) meets criteria on forward-looking basis, phased out from 1 January 2013
  - Instrument (i) with call or step-up (or other incentive to redeem) between 12 September 2013 and 1 January 2013, (ii) not called or redeemed, and (iii) does not meet criteria on forward-looking basis, fully derecognised from 1 January 2013
  - Instrument (i) with call or step-up (or other incentive to redeem) on or after 1 January 2013, (ii) not called or redeemed, and (iii) does not meet criteria on forward-looking basis, (A) fully derecognised from effective maturity date and (B) until then phased out from 1 January 2013
  - Instrument (i) with call or step-up (or other incentive to redeem) on or prior to 12 September 2010, (ii) not called or redeemed, and (iii) does not meet criteria on forward-looking basis, phased out from 1 January 2013
- Full derecognition for instruments issued after 12 September 2010:
  - non-qualifying instruments issued on or after 12 September 2010 fully derecognised from 1 January 2013
- Existing public sector capital injections grandfathered until 1 January 2018

Redefinition of Qualifying Capital (cont'd)

Minority Interests

- Common Equity Tier 1
  - Must qualify as CET 1 as if issued by parent bank
  - Issuing subsidiary must itself be bank
  - Amount recognised equal to total minority interest minus surplus (i.e., above 7.0%) attributable to minority investors
- Additional Tier 1
  - Must qualify as AT 1 as if issued by parent bank
  - Amount recognised equal to total minority interest minus surplus (i.e., above 8.5%) attributable to minority investors
  - Excludes minority interests recognised as CET 1 above
- Tier 2
  - Must qualify as T 2 as if issued by parent bank
  - Amount recognised equal to total minority interest minus surplus (i.e., above 10.5%) attributable to minority investors
  - Excludes minority interests recognised as CET 1 and AT 1 above
- Special Purpose Vehicles
  - No capital issued by SPVs qualifies as CET 1; however, can qualify as AT 1 and T 2
  - Capital issued to third parties through SPV via fully-consolidated subsidiary of bank treated as if subsidiary had issued directly to third parties (and may thus be included in AT 1 or T 2 subject to criteria described above)

Banking Book Changes

Resecuritisation Exposures

- Risk weights for “resecuritisation exposures” increased (actual size of increase depends on rating of exposure)
  - approximately 200% higher than comparably rated non-resecuritisation exposures for banks under standardised approach (SA)
  - approximately 300% higher than comparably rated non-resecuritisation exposures for banks subject to internal ratings-based (IRB) approach
- Definition
  - resecuritisation exposure is exposure where one or more underlying exposures is securitisation exposure as defined in BIS Accord
  - traditional securitisation exposure is one where cash flow from underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk
- Critically, exposure will be resecuritisation even only one securitisation exposure in underlying pool, irrespective of number and quantity of other exposures
  - Effect on risk-weight of ABCP issued by multi-seller or hybrid conduits unclear (are trade receivables deals “securitisations”?)
- Also, banks subject to additional capital requirements if resecuritisation exposure not most senior
  - definition of senior will prevent a bank from taking mezzanine resecuritisation exposure, creating two tranches (for instance, a junior tranche of 0.1% and a senior tranche of 99.9%) and claiming that senior tranche qualifies for senior column of resecuritisation risk weights

Banking Book Changes (cont'd)

Resecuritisation exposure risk weights

- Tables of risk weights for resecuritisation exposures for standardised banks:

Long-term Rating	Securitisation Exposures	Resecuritisation Exposures
AAA to AA-	20	**40**
A+ to A-	50	**100**
BBB+ to BBB-	100	**225**
BB+ to BB-	350	**650**
B- and below or unrated	Deduction	

Short-term Rating	Securitisation Exposures	Resecuritisation Exposures
A-1/P-1	20	**40**
A-2/P-2	50	**100**
A-3/P-3	100	**225**
All other ratings or unrated	Deduction	

Banking Book Changes (cont'd)

Resecuritisation exposure risk weights (cont'd)

- Tables of risk weights for resecuritisation exposures for IRB banks:

	Securitisation Exposures			Resecuritisation Exposures	
Long-term Rating	**Senior, Granular**	**Non-senior, Granular**	**Non-granular**	**Senior**	**Non-senior**
AAA	7	12	20	**20**	**30**
AA	8	15	25	**25**	**40**
A+	10	18	35	**35**	**50**
A	12	20	35	**40**	**65**
A-	20	35	35	**60**	**100**
BBB+	35	50	50	**100**	**150**
BBB	60	75	75	**150**	**225**
BBB-	100	100	100	**200**	**350**
BB+	250	250	250	**300**	**500**
BB	425	425	425	**500**	**650**
BB-	650	650	650	**750**	**850**
Below	Deduction				

	Securitisation Exposures			Resecuritisation Exposures	
Short-term Rating	**Senior, Granular**	**Non-senior, Granular**	**Non-granular**	**Senior**	**Non-senior**
A1	7	12	20	**20**	**30**
A2	12	20	35	**40**	**65**
A3	60	75	75	**150**	**225**
Below	Deduction				

Banking Book Changes (cont'd)

Liquidity Facilities

- Standardised banks:
  - abolish distinction between eligible liquidity with an original maturity of one year or less (currently credit conversion factor (CCF) of 20%) and those of more than one year (currently CCF of 50%)
  - instead, CCF for all eligible liquidity facilities provided by standardised banks will be 50%.
- IRB banks:
  - Clarify circumstances under which liquidity recognised as senior
  - liquidity is most senior if it is sized to cover all outstanding ABCP of a conduit (and other senior debt supported by underlying pool), so that no cash flows from the pool can be transferred to other creditors until all liquidity draws are repaid in full
- Eliminate disruption-only risk weights

Use of ratings subject to self-guarantee

- Banks not permitted to recognise internal ratings based on any unfunded guarantees or similar support provided by bank itself
- In addition, bank's capital for such exposures held in the trading book must be at least the amount required under banking book treatment
- Accordingly, if bank ABCP conduit sponsor provides liquidity or credit enhancement, but buys ABCP instead of funding liquidity or CE, it must treat ABCP as unrated
  - Bank may use internal assessments approach (IAA) if authorised
  - Bank may also use supervisory formula approach (SFA) (but SFA does not work well with ABCP conduits for some technical reasons)
  - If unable to determine risk weight using either IAA or SFA, deduction is required

Banking Book Changes (cont'd)

Operating criteria for use of securitisation rules

- Banks must hold and use minimum information regarding securitisation exposures to use securitisation rules to determine risk weights of such exposures
- New requirements apply to both standardised and IRB banks, and are applicable equally to exposures in banking book and trading book
- If bank does not meet new requirements for any exposure, it must be deducted from capital
- In general, information required will permit a bank to achieve comprehensive understanding of risk characteristics of individual securitisation exposures, whether on or off balance sheet, as well as risk characteristics of pools underlying those exposures (i.e., can determine own internal ratings if needed)
- Information includes:
  - on-going and timely underling pool performance information such as exposure type; percentage of loans 30, 60 and 90 days past due; default rates; prepayment rates; loans in foreclosure; property type; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographic diversification
  - for resecuritisations, information regarding characteristics and performance of pools underlying securitisation tranches

Eligible Guarantors

- Eliminate requirement that "eligible guarantors" under CRM rules be externally rated A- or better

Timing

- Effective commencing 31 December 2010

Trading Book Changes

New Definition of "Correlation Trading Portfolio"

- Incorporates securitisation and nth-to-default credit derivatives that meet the following criteria:
  - Positions are neither resecuritisation positions, nor derivatives of securitisation exposures that do not provide a pro-rata share in the proceeds of a securitisation tranche (this therefore excludes options on a securitisation tranche, or a synthetically leveraged super-senior tranche)
  - All reference entities are single-name products, including single-name credit derivatives, for which a liquid two-way market exists (i.e., independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined within one day and settled at such price within a relatively short time conforming to trade custom)
- Positions excluded from correlation trading portfolio:
  - Positions referencing underlying that would be treated as a retail exposure, a residential mortgage exposure or a commercial mortgage exposure under standardised approach to credit risk
  - Positions referencing claim on special purpose entity
- Banks may also include in correlation trading portfolio positions that hedge positions described above and which are neither securitisation exposures nor nth-to-default credit derivatives and where a liquid two-way market (as described above) exists for the instrument or its underlying(s)
- Specific risk capital charge for correlation trading portfolio determined as follows:
  - The bank computes (i) total specific risk capital charges applying just to net long positions from net long correlation trading exposures combined, and (ii) total specific risk capital charges applying just to net short positions from the net short correlation trading exposures combined
  - Specific risk capital charge is larger of two total amounts

Trading Book Changes (cont'd)

Revision to Specific Risk Capital Charge for Securitisation Exposures

- Specific risk capital charge for securitisation instruments held in trading book increased to equal same charge as if held in banking book
- Capital charge applied to net position, whether long or short
- Additional options for IRB banks
  - IRB Banks permitted to use Supervisory Approach in trading book with supervisor approval
  - IRB banks permitted to use 8% capital charge multiplied by concentration ratio equal to sum of nominal amounts of all tranches divided by sum of nominal amounts of all tranches junior or pari passu to position (capped at 12.5)
- Capital charge determined as provided in tables below
  - Table for securitisation exposures held by Standardised Bank in trading book:

External Credit Assessment	AAA to AA- A-1/P-1	A+ to A- A-2/P-2	BBB+ to BBB- A-3/P-3	BB+ to BB-	Below BB- and below A-3/P-3 or unrated
Securitisation exposures	1.6%	4%	8%	28%	Deduction
Resecuritisation exposures	3.2%	8%	18%	52%	Deduction

Trading Book Changes (cont'd)

Securitisation Exposures (cont'd)

- Table for securitisation exposures held by IRB Bank in trading book:

<table>
<tr><th></th><th colspan="3">Securitisation Exposures</th><th colspan="2">Resecuritisation Exposures</th></tr>
<tr><th>Long-term Rating</th><th>Senior, Granular</th><th>Non-senior, Granular</th><th>Non-granular</th><th>Senior</th><th>Non-senior</th></tr>
<tr><td>AAA
A-1/P-1</td><td>0.56%</td><td>0.96%</td><td>1.60%</td><td>1.60%</td><td>2.40%</td></tr>
<tr><td>AA</td><td>0.64%</td><td>1.20%</td><td>2.00%</td><td>2.00%</td><td>3.20%</td></tr>
<tr><td>A+</td><td>0.80%</td><td>1.44%</td><td rowspan="3">2.80%</td><td>2.80%</td><td>4.00%</td></tr>
<tr><td>A
A-2/P-2</td><td>0.96%</td><td>1.60%</td><td>3.20%</td><td>5.20%</td></tr>
<tr><td>A-</td><td>1.60%</td><td>2.80%</td><td>4.80%</td><td>8.00%</td></tr>
<tr><td>BBB+</td><td>2.80%</td><td colspan="2">4.00%</td><td>8.00%</td><td>12.00%</td></tr>
<tr><td>BBB
A-3/P-3</td><td>4.80%</td><td colspan="2">6.00%</td><td>12.00%</td><td>18.00%</td></tr>
<tr><td>BBB-</td><td colspan="3">8.00%</td><td>16.00%</td><td>28.00%</td></tr>
<tr><td>BB+</td><td colspan="3">20.00%</td><td>24.00%</td><td>40.00%</td></tr>
<tr><td>BB</td><td colspan="3">34.00%</td><td>40.00%</td><td>52.00%</td></tr>
<tr><td>BB-</td><td colspan="3">52.00%</td><td>60.00%</td><td>68.00%</td></tr>
<tr><td>Below BB-
Below A-3/P-3</td><td colspan="5">Deduction</td></tr>
</table>

Trading Book Changes (cont'd)

Nth-to-Default Derivatives

- First-to-default: Capital charge for specific risk for a first-to-default credit derivative is lesser of (1) sum of specific risk capital charges for individual reference credit instruments in basket, and (2) the maximum possible credit event payment under the contract
  - Where bank has risk position in one of reference credit instruments underlying first-to-default credit derivative and credit derivative hedges bank's risk position, bank allowed to reduce with respect to hedged amount both capital charge for specific risk for reference credit instrument and part of capital charge for specific risk for credit derivative that relates to such reference credit instrument
  - Where bank has multiple risk positions in reference credit instruments underlying first-to-default credit derivative, offset allowed only for underlying reference credit instrument having lowest specific risk capital charge
- Nth-to-default: Capital charge for specific risk for nth-to-default credit derivative with n greater than one is lesser of (1) the sum of specific risk capital charges for individual reference credit instruments in basket but disregarding n-1 obligations with lowest specific risk capital charges and (2) the maximum possible credit event payment under contract
  - For nth-to-default credit derivatives with n greater than 1, no offset of the capital charge for specific risk with any underlying reference credit instrument allowed
- External rating: If first or other nth-to-default credit derivative is externally rated, then protection seller must calculate specific risk capital charge using rating and apply respective securitisation risk weights
- Both long and short: Capital charge against each net nth-to-default credit derivative position applies irrespective of whether bank has a long or short position, i.e. obtains or provides protection

Trading Book Changes (cont'd)

Internal Models

- New Stressed Value-at-Risk Requirement
  - Banks must calculate 'stressed value-at-risk' measure
  - Measure to replicate value-at-risk calculation generated on bank's current portfolio if relevant market factors experiencing period of stress; based on 10-day, 99th percentile, one-tailed confidence interval value-at-risk measure of current portfolio, with model inputs calibrated to historical data from continuous 12-month period of significant financial stress relevant to bank's portfolio
  - Two major goals are (a) evaluate capacity of bank's capital to absorb potential large losses, and (b) identify steps bank can take to reduce risk and conserve capital
  - Scenarios requiring simulation by banks include 1987 equity crash, ERM crises of 1992 and 1993, fall in bond markets in Q1 1994, 1998 Russian financial crisis, 2000 technology bubble burst, 2007/2008 sub-prime turbulence (last event new)
- Revised Capital Charge
  - Each bank must meet, on daily basis, capital requirement expressed as sum of:
    - higher of (1) previous day's value-at-risk number (VaRt-1) and (2) average of daily value-at-risk measures on each of preceding sixty business days (VaRavg), multiplied by multiplication factor (mc), plus
    - higher of (1) latest available stressed-value-at-risk number above (sVaRt-1) and (2) an average of stressed value-at-risk numbers over the preceding sixty business days (sVaRavg), multiplied by multiplication factor (ms)
  - Multiplication factors mc and ms set by relevant supervisory authority on basis of assessment of quality of bank's risk management system, subject to absolute minimum of 3 for mc and absolute minimum of 3 for ms, plus additional factor between 0 and 1 directly related to ex-post performance ("backtesting") of bank's model (based on value-at-risk only and not stressed value-at-risk)

Trading Book Changes (cont'd)

Internal Models (cont'd)

- Other required improvements in model risk measurement
  - Models must capture incremental default and migration risks
  - Models must include all factors relevant to bank's pricing model, or omission must be justified to supervisor
  - Banks must establish procedures for calculating valuation adjustments for less liquid positions, in addition to changes in value for financial reporting
  - If bank model does not capture incremental risks, bank must use specific risk capital charges under standardised measurement method
  - Actual market prices or observable inputs should be used even where the market is less liquid than volumes, unless those prices are the result of forced liquidation or distress sale
  - Supervisor must be satisfied that proxies used show a good track record for the actual position held
  - Banks must update data sets no less frequency than monthly, and must have in place processes to update data sets more frequently, and banks must reassess data sets whenever market prices are subject to material change
- Correlation trading portfolio models may be adapted to cover not only incremental default and migration risk but all price risks ("comprehensive risk measure") including:
  - cumulative risk arising from multiple defaults, including ordering of defaults in tranched products
  - credit spread risk, including gamma and cross-gamma effects
  - volatility of implied correlations, including cross effect between spreads and correlations
  - basis risk, including both basis between the spread of an index and those of its constituent single names and basis between implied correlation of an index and that of bespoke portfolios
  - recovery rate volatility, as it relates to the propensity for recovery rates to affect tranche prices; and
  - to extent comprehensive risk measure incorporates benefits from dynamic hedging, risk of hedge slippage and potential costs of rebalancing such hedges

Trading Book Changes (cont'd)

Counterparty Credit Risk Capital Charge

- With effect from 1 January 2013, counterparty credit risk capital charges will be strengthened in significant ways:
  - Default Risk. To address "wrong way" risk (i.e., a bank's exposure to a counterparty increases as the counterparty's creditworthiness decreases), the default risk capital charge for counterparty credit risk must equal the greater of the portfolio-level capital charge (not including the CVA charge described below) based on "Effective EPE" (Effective Expected Positive Exposure) using current market data and the portfolio-level capital charge based on Effective EPE using stressed data.
  - CVA Risk Charge. In addition to the default risk charge, banks must add a capital charge to cover the risk of mark-to-market losses on expected counterparty risk (referred to as credit value adjustments, or CVA) for all over-the-counter derivatives (but not transactions with central counterparties or securities financing transactions). The CVA charge is determined pursuant to a formula, dependant upon whether the bank has internal model approval or uses the standardised method for determining trading book capital.
  - Asset Value Correlation (AVC) Multiplier. For all exposures to financial institutions held by IRB banks, the bank holding the exposure will be required to determine probability of default (PD) and loss given default (LGD), two inputs in determining Pillar I capital requirements, using a 1.25 multiplier for (i) all regulated financial institutions whose total assets are equal to or greater than US$100 million and (ii) all unregulated financial institutions regardless of size. For this purpose, unregulated financial institutions are legal entities whose main business includes management of financial assets, lending, factoring, leasing, provision of credit enhancement, securitisation, investments, financial custody, central counterparty services, proprietary trading and other activities identified by supervisors.

Trading Book Changes (cont'd)

Counterparty Credit Risk Capital Charge (cont'd)

- Increased Margin Period of Risk. The risk period to be covered by trading book capital will be extended to 20 days for OTC derivatives and securities financing transactions (SFTs) netting sets that exceed 5,000 trades, have illiquid collateral, or represent hard-to-replace derivatives. In addition, the risk margin period will be doubled for netting sets with more than two call disputes in the past two quarters that last longer than margin risk period.
- Preclude Recognition of Downgrade Triggers. Banks using internal models may not adjust their exposure at default (EAD) for any counterparty if the collateral agreement with that counterparty contains downgrade triggers.
- Subject Securitisation Collateral to Additional Haircuts. Resecuritisation exposures are no longer eligible as financial collateral. In addition, haircuts applicable to non-sovereign exposures are doubled for securitisation exposures compared with non-securitisation corporate exposures at the same rating level.
- Central Clearing Parties. The Committee has issued for comment (for finalisation in 2011) incentives to use Central Clearing Parties (CCPs) for OTC derivatives. The Committee has proposed that collateral and mark-to-market exposures to CCPs should have risk weight of 2 percent if they comply with CPSS/IOSCO recommendations for CCPs and satisfy other conditions.

Timing

- Effective commencing 31 December 2010 except where otherwise noted

New Leverage Ratio

Summary

- A non-risk based “backstop” measure (supplementary to risk-based ratio described above) based on gross exposures designed to constrain the build-up of excessive leverage in banks
- Ratio of 3% (i.e., 33 times maximum leverage), calculated as average over fiscal quarter, to be tested during parallel run period from 1 January 2013 to 1 January 2017

Capital Measure

- Tier 1 (i.e., CET 1 and AT 1) (BIS Committee to collect data on using only CET 1 or all capital)
- Measured after full regulatory deductions described above
- Assets of financial entities in which bank holds minority investments deducted in proportion to capital excluded

Exposure Measure

- General principles: Approach generally follows accounting treatment:
  - On-balance sheet, non-derivative exposures measured net of provisions and valuation adjustments
  - Physical or financial collateral, guarantees or credit risk mitigation not allowed to reduce exposure
  - Netting of loans and deposits not allowed
- On-balance sheet items: Measured at accounting balance sheet value
  - Repurchase agreements and securities finance transactions: accounting measure of exposure, applying Basel II netting rules (other than cross-product netting)
  - Derivatives: accounting measure of exposure plus add-on for future exposure (under Basel II CEM method), applying Basel II netting rules (other than cross-product netting)

Leverage Ratio (cont'd)

Exposure Measure (cont'd)

- Off-balance sheet items:
  - Includes commitments (including liquidity commitments), unconditionally cancellable commitments, direct credit substitutes, acceptances, standby letters of credit, trade letters of credit, failed transactions and unsettled securities (but not repurchase agreements and securities finance transactions – see above)
  - 100% credit conversion factor for all off-balance sheet items, other than 10% conversion factor for unconditionally cancellable commitments (subject to further BIS Committee review)

Timing

- Supervisory monitoring from 1 January 2011
- Parallel run from 1 January 2013 to 1 January 2018
- Migration to Pillar 1 capital requirement on 1 January 2018

Two New Liquidity Ratios

Liquidity Coverage Ratio (LCR)

- Requires bank to maintain unencumbered high-quality assets sufficient to meet 100% (or more) of net cash outflows over 30-day period under stipulated stress scenario:
  - run-off of proportion of retail deposits
  - partial loss of unsecured wholesale funding capacity
  - partial loss of secured, short-term funding with certain collateral and counterparties
  - additional contractual outflows arising from downgrade in bank's public credit rating of up to and including three notches, including collateral posting requirements
  - increases in market volatilities that impact quality of collateral or potential future exposure of derivatives positions, thus requiring larger collateral haircuts or additional collateral
  - unscheduled draws on committed but unused credit and liquidity facilities
  - potential need to buy back debt or honour non-contractual obligations honoured in interest of mitigating reputational risk
- Liquid assets
  - Fundamental characteristics:
    - Low credit and market risk
    - Ease and certainty of valuation
    - Low correlation with risky assets
    - Listed on developed and recognised exchange market
  - Market-related characteristics:
    - Active and sizeable market
    - Presence of committed market makers
    - Low market concentration
    - Investors show tendency to move into asset during systemic crisis

Liquidity Ratios (cont'd)

Liquidity Coverage Ratio (cont'd)

- Liquid assets (cont'd)
  - Level 1 Definition
    - Cash
    - Central bank reserves, to the extent that they can be drawn down in times of stress
    - Marketable securities representing claims on or claims guaranteed by sovereigns, central banks, non-central government public sector entities (PSEs), the Bank for International Settlements, the International Monetary Fund, the European Commission, or multilateral development banks as long as (a) assigned 0% risk-weight under Basel II standardised approach, (b) traded in large, deep and active repo-markets, (c) proven record as reliable source of liquidity during stressed markets (i.e. maximum price decline of 10% over 30-day period), and (d) not obligation of any financial institution or affiliate
    - Debt securities representing claims on non-0% risk weighted sovereigns or central banks issued in domestic currencies in country in which liquidity risk is being taken or in bank's home country
    - Debt securities representing claims on non-0% risk weighted sovereigns or central banks issued in foreign currencies to extent currency matches currency needs of bank's operations in that country
  - Level 2 Definition
    - Subject to cap of 40% of all liquid assets and subject to 15% haircut
    - Marketable securities representing claims on or guaranteed by sovereigns, central banks, non-central government PSEs as long as (a) assigned 20% risk-weight under Basel II standardised approach, (b) traded in large, deep and active repo-markets, (c) proven record as reliable source of liquidity during stressed markets (i.e. maximum price decline of 10% over 30-day period), and (d) not obligation of any financial institution or affiliate
    - corporate and covered bonds (a) rated AA- and above (or equivalent PD), (b) not issued by financial institution or affiliate (in case of corporate bond), (c) not issued by bank or affiliate (in case of covered bond), (d) traded in large, deep and active repo-markets, and (e) proven record as reliable source of liquidity during stressed markets (i.e. maximum price decline of 10% over 30-day period)
  - Jurisdictions with insufficient liquid assets: BIS Committee considering various options:
    - Option 1: Contractual committed liquidity from central bank
    - Option 2: Foreign currency liquid assets
    - Option 3: Additional use of Level 2 assets with higher haircuts

Liquidity Ratios (cont'd)

Liquidity Coverage Ratio (cont'd)

- Net Cash Outflows
  - Net cash outflows = total expected cash outflows minus total expected cash inflows (with inflows capped at 75% of outflows)
  - Cash Outflows (and minimum run-off rate)
    - Retail Deposits (natural persons only): stable deposits (5%); less stable deposits (10%) (includes deposits chasing yield, high-net worth depositors, not covered by deposit insurance or sovereign guarantee); fixed term deposits with maturity of more than 30 days not included unless bank allows withdrawal without penalty (with "exceptional circumstances" exception)
    - Unsecured Wholesale Deposits (excluding derivative collateral deposits): small business customers (5%, 10% and higher as with retail); operating relationships (25%) (but not correspondent banking or prime brokerage relationships); cooperative bank network (25%) (only for required deposits); provided by non-financial corporates, sovereigns, central banks and public sector entities (75%); all others (100%)
    - Secured Funding: backed by Level 1 assets (0%); backed by Level 2 assets (15%); with sovereigns, central banks and public sector entities (25%); all others (100%)
    - Derivatives Payables: 100% (on net basis)
    - Downgrade Triggers: 100%
    - Valuation Changes on Posted Collateral: with Level 1 collateral (0%); with other collateral (20%)
    - Loss of Funding of ABS, Covered Bonds and Other Structured Securities: 100% of instruments maturing within 30-day stress period
    - Loss of Funding for ABCP Conduits, SIVs, etc: 100% of maturing assets and returnable assets ("liquidity puts")
    - Committed Credit and Liquidity Facilities (revolving credit facilities for general corporate or working capital purposes classified as credit facilities): committed credit and liquidity to retail and small business customers (5%); committed credit facilities to non-financial corporates, sovereigns, central banks, PSEs and multilateral development banks (10%); committed liquidity facilities to non-financial corporates, sovereigns, central banks, PSEs and multilateral development banks (100%); committed credit and liquidity facilities to other entities (100%)
    - Other Contractual Obligations: 100%
    - Non-Contractual Obligations: at national discretion (includes guarantees, letters of credit, trade finance instruments, etc.)

Liquidity Ratios (cont'd)

Liquidity Coverage Ratio (cont'd)

- Net Cash Outflows (cont'd)
  - Cash Inflows (and specified inflow rate)
    - Reverse Repo and Securities Borrowing: Level 1 Assets (0%); Level 2 assets (15%); other collateral (100%) (0% for all if collateral used to cover short position maturing outside of 30-day stress period)
    - Lines of Credit: 0%
    - Other Inflows: retail and small business scheduled repayments (no default) (50%); other wholesale scheduled repayments (no default) (100% financial obligors; 50% non-financial obligors)
    - Operational Deposits: 0%
    - Derivatives: 100% of known amounts payable and receivable (on net basis; net of Level 1 and Level 2 collateral not counted in stock of liquid assets)
- Application issues
  - Compliance and reporting: Meet LCR requirement continuously; report at least monthly, with capacity to increase to weekly or even daily during periods of stress (reporting time lag should not exceed two weeks)
  - Scope of application: Generally follows Basel II (i.e., consolidated group)
  - Home/Host Issues: Generally follow home jurisdiction rules; follow host rules regarding retail/small business
  - Timing
    - Observation period: 1 January 2011 to 1 January 2015
    - Commencement of LCR: 1 January 2015

Liquidity Ratios (cont’d)

Net Stable Funding Ratio (NSFR)

- Purposes
  - Establish minimum acceptable amount of stable funding based on liquidity characteristics of bank’s assets and activities over one-year horizon
  - Incentivise structural changes in liquidity risk profile of banks away from short-term funding mismatches and toward more stable, longer-term funding of assets and business activities
  - Ensure that investment banking inventories, off-balance sheet exposures, securitisation pipelines and other assets and activities are funded with at least minimum amount of stable liabilities in relation to liquidity risk profile of bank
- Requirement: Available Stable Funding must equal or exceed Required Stable Funding
- Available Stable Funding
  - Capital (both Tier 1 and Tier 2) after deductions
  - Preferred stock not included in Tier 2 with effective remaining maturities of one year or greater
  - Liabilities with effective remaining maturities of one year or greater
  - Subject to “ASF Factor” of 90% (i.e., 10% haircut): “Stable” non-maturity deposits and/or term deposits with maturities of less than one year provided by retail and small business customers
  - Subject to ASF Factor of 80%: “Less stable” non-maturity deposits and/or term deposits with maturities of less than one year provided by retail and small business customers
  - Subject to ASF Factor of 50%: Unsecured wholesale funding, no-maturity deposits and/or term deposits with residual maturity of less than one year provided by non-financial corporates, sovereigns, central banks, PSEs and multilateral development banks
  - Subject to ASF Factor of 0% (i.e., not included in ratio): Other liabilities and equity categories not described above

Liquidity Ratios (cont'd)

Net Stable Funding Ratio (cont'd)

- Required Stable Funding equals sum of (a) assets held by bank and off-balance sheet commitments of bank (b) multiplied by relevant required stable funding factor:
  - 0% RSF Factor: Unencumbered cash and money market instruments; unencumbered securities with effective remaining maturities of less than one year; unencumbered securities where bank has offsetting reverse repo with same CUSIP or ISIN; unencumbered loans to financial institutions that are not renewable or for which lender has irrevocable call right
  - 5% RSF Factor: Assets: Unencumbered marketable securities with residual maturities of one year or greater representing claims on sovereigns, central banks, BIS, IMF, EC, non-central government PSEs or multilateral development banks rated AA or higher and assigned 0% risk weight under Basel II standardised approach, provided that active repo-markets exists
  - 20% RSF Factor: Unencumbered corporate bonds or covered bonds (but not loans) rated at least AA- with effective maturity of one year or greater satisfying all Level 2 criteria for corporate and covered bonds under LCR; unencumbered marketable securities with residual maturities of one year or greater representing claims on sovereigns, central banks, non-central government PSEs satisfying all Level 2 criteria under LCR
  - 50% RSF Factor: Unencumbered gold; unencumbered equity securities not issued by financial institutions or affiliate listed on major exchange and included in a large capital market index; and unencumbered corporate bonds and covered bonds (a) eligible for central bank intraday and overnight liquidity needs, (b) not issued by financial institutions and affiliates, (c) not issued by bank or affiliate, (d) rated A+ to A- (or equivalent PD), and (e) traded in large, deep and active markets; loans to non-financial corporate clients having a residual maturity of less than one year
  - 65% RSF Factor: Unencumbered residential mortgages of whatever maturity qualifying for 35% risk weight under Basel II standardised approach; unencumbered loans (excluding loans to financial institutions) with maturity of one year or greater qualifying for 35% risk weight under Basel II standardised approach
  - 85% RSF Factor: Unencumbered loans to retail and small business customers with residual maturity of less than one year
  - 100% Factor: All other on balance sheet assets

Liquidity Ratios (cont’d)

Net Stable Funding Ratio (cont’d)

- Required Stable (cont’d)
  - Off-balance sheet exposures: Conditionally revocable and irrevocable credit and liquidity facilities to any client (5% RSF Factor); other contingent funding obligations (RSF Factor specified by national supervisory) (includes guarantees, letters of credit, other trade instruments; non-contractual obligations, etc.)
- Application issues
  - Compliance and reporting: Meet and report on NSFR quarterly (reporting time lag should not exceed two weeks)
  - Scope of application: Generally follows Basel II (i.e., consolidated group)
  - Home/Host Issues: Generally follow home jurisdiction rules; follow host rules regarding retail/small business
  - Timing: Commencement 1 January 2018

Looking Forward

Ongoing work of the BIS Committee

- Fundamental Review of Trading Book. The Committee is studying whether the distinction between the banking book and the trading book should be maintained, how trading activities are defined and how risks in trading books (and possibly market risk more generally) should be captured by regulatory capital. This review is targeted for completion by year-end 2011.
- Systemically Important Banks. The Committee will develop by end 2010 a provisional methodology for assessing the systemic importance of financial institutions globally, and will complete by mid-2011 a study of the magnitude of additional loss absorbency that globally systemically important banks should have.
- Ratings and Securitisations. The Committee is working to reduce reliance on external ratings in rules and regulations for securitisation exposures.
- Contingent Capital. The Committee will complete by mid-2011 an assessment of the going-concern loss absorbency which could be provided by various proposed contingent capital instruments.
- Reducing Pro-cyclicality. The Committee is reviewing additional measures to reduce pro-cyclicality, including by using the Pillar 2 process to provide non-cyclical or through-the-cycle PD determinations and by promoting stronger provisioning by moving entirely to an expected loss provisioning approach under applicable accounting standards.
- Large Exposures. The Committee is reviewing large exposure rules across various jurisdictions to strengthen guidance in this area.

Looking Forward (cont'd)

Ongoing work (cont'd)

- Cross-Border Bank Resolution. The Committee is working on cross-border bank resolution issues, building on its 2010 *Report and Recommendations of the Cross-border Bank Resolution Group*.
- Review of Core Principles for Effective Banking Supervision. The Committee is revising its 2006 *Core Principles for Effective Banking Supervision and Core Principles Methodology*.
- Standards Implementation. The Committee, through its Standards Implementation Group, has issued a Standards Surveillance Framework that will be piloted in 2011.

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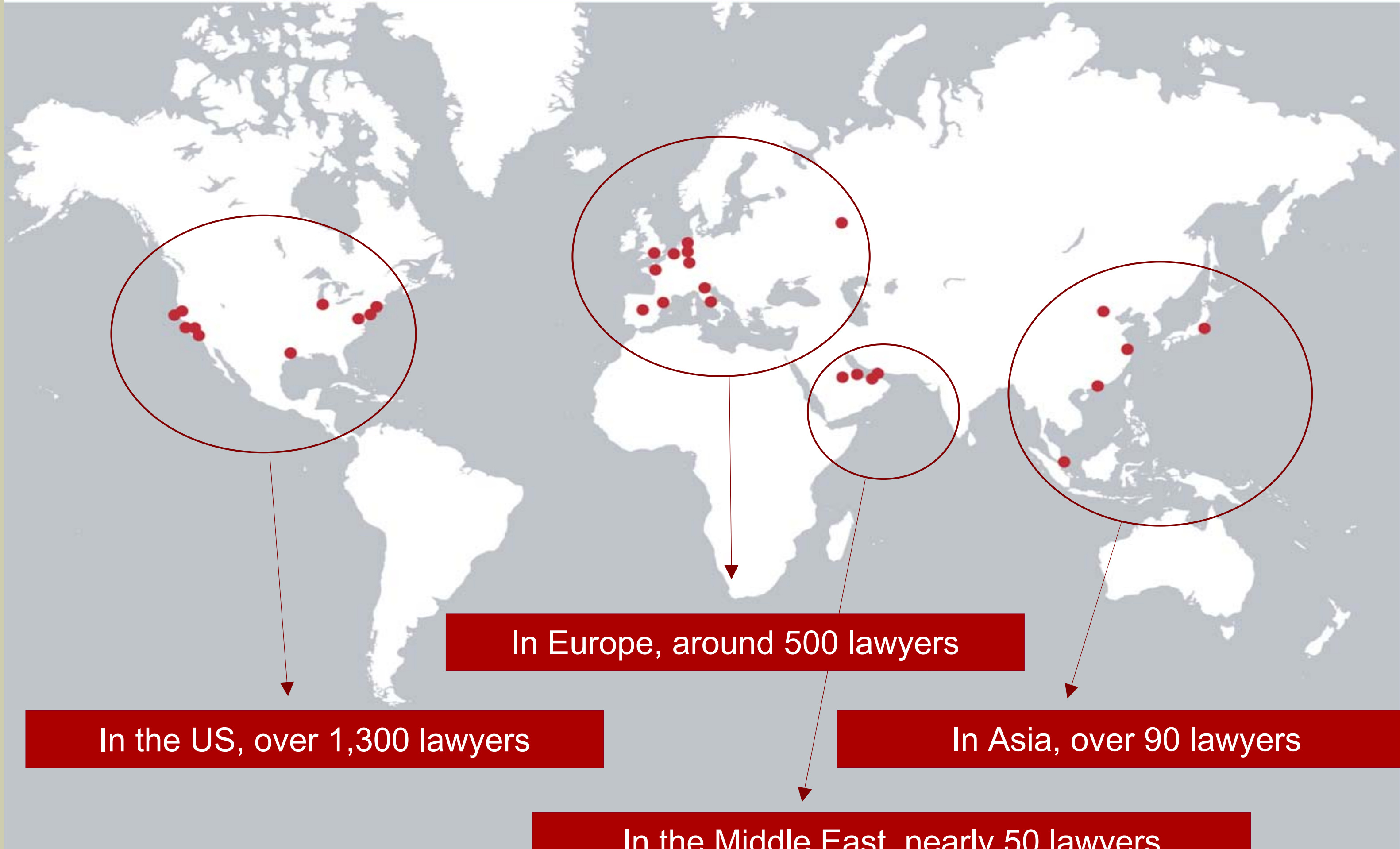

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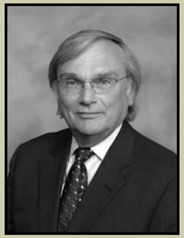

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