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Jerusalem  
May 30, 2013  
**Circular no. C-06-2386**

Attn:  
**The banking corporations and the credit card companies**

**Re: Capital adequacy and measurement—regulatory capital**  
(Proper Conduct of Banking Business Directive no. 202)

**Introduction**

1. The global financial crisis led to the conclusion that there is a need to strengthen the quality and size of capital held by banking systems worldwide. Accordingly, on December 16, 2010, the Basel Committee published a new framework—"Basel III: A global regulatory framework for more resilient banks and banking systems" (hereinafter, "Basel III"). The main component of the new framework, in terms of defining capital, was the equity capital that serves as the highest quality component of a banking corporation's capital.
2. This directive adopts the recommendations of Basel III in Israel, and is formulated, among other things, after carrying out a Quantitative Impact Survey to examine the effects on the banking system in Israel.
3. Pursuant to the above, after consulting with the Advisory Committee on Matters Related to Banking Businesses and with the approval of the Governor, I have amended Proper Conduct of Banking Business Directive No. 202, on Regulatory Capital.

**Main amendments to the Directive**

**4. Structure of regulatory capital**

Regulatory capital is made up of two tiers:

- a. Tier 1 Capital, which includes Common Equity Tier 1 and Additional Tier 1 Capital.
- b. Tier 2 Capital

**Explanatory notes**

- a. Additional requirements were set for components eligible to be included in Common Equity Tier 1 Capital, which is the highest quality level of capital. In addition, the

distinction between upper Tier 2 and lower Tier 2 capital was cancelled, as well as the requirement for Tier 3 capital to cover market risks.

- b. The limitations on Tier 2 capital relative to Tier 1 capital will continue to exist until a re-examination of the quantitative limitations defined for the overall capital base.

#### **5. Common Equity Tier 1 Capital**

- a. Eligibility criteria were set for common equity classified as Common Equity Tier 1 capital.
- b. A dividend declared or announced after the balance sheet date is not to be deducted from Common Equity Tier 1 capital.
- c. No adjustment is made to exclude from Common Equity Tier 1 capital any profits or losses that have not yet been recognized in the balance sheet.
- d. Limitations were set on the amount of minority interest that can be recognized for regulatory capital. In addition, minority interest deriving from the issue of capital instruments that are not shares shall be recognized in the relevant capital tier and not in Common Equity Tier 1 capital.

#### **6. Regulatory adjustments and deductions from capital**

- a. Most regulatory adjustments and deductions from capital shall be made from Common Equity Tier 1 capital.
- b. Deferred tax assets and investments in financial corporations shall be deducted from capital in accordance with the handling of “threshold deductions” as detailed in the Directive.
- c. A defined benefit pension fund that is listed as an asset on the balance sheet shall be deducted from capital.
- d. With regard to liabilities in respect of derivative instruments, it was established that all fair value accounting adjustments deriving from changes in the bank’s own credit risk are to be deducted.
- e. In accordance with the “corresponding deduction approach”, the following investments shall be deducted from the relevant capital tier:
  - (1) Self investment in shares
  - (2) Reciprocal cross holdings
  - (3) Investments in financial institutions
- f. Definitions were set for “investment” and “financial institution” as detailed in the Directive.

#### **7. Additional Tier 1 capital**

- a. Eligibility criteria were set for capital instruments classified as Additional Tier 1 capital. Among other things, it was determined that Additional Tier 1 capital instruments are to have a principal loss absorption mechanism, by which conversion to common shares or a principal write-down will be carried out when the ratio of the banking corporation’s Common Equity Tier 1 capital falls below 7 percent.

**Explanatory notes**

The criteria were established in accordance with the Basel III recommendations. We intend to examine in the future the need to add an appendix with regard to the procedure for submitting a request to approve Additional Tier 1 capital instruments.

- b. Requirements were set for loss absorption at the point of non-viability.

**Explanatory notes**

In accordance with the provisions in the Basel Committee's press release that was published on January 13, 2011. The Banking Supervision Department intends to act in the future to clarify these requirements in accordance with promoting the planned legislative amendments on the issue of handling an insolvent bank.

**8. Tier 2 capital**

- a. Eligibility criteria were established for capital instruments classified as Tier 2 capital. In addition, a requirement was added according to which the instruments must have a principal loss absorption mechanism by which conversion to common shares or a principal write-down will be carried out when the ratio of the banking corporation's Common Equity Tier 1 capital falls below 5 percent.

**Explanatory notes**

The criteria were established in accordance with the Basel III recommendations. We intend to examine in the future the need to add an appendix with regard to the procedure for submitting a request to approve Tier 2 capital instruments.

- b. Requirements were set for loss absorption at the point of non-viability.

**9. Items weighted at 1,250 percent**

Certain items that in the past were deducted 50 percent from Tier 1 capital and 50 percent from Tier 2 capital shall be risk weighted at 1,250 percent.

**10. Surplus investment in a single non-financial corporation**

It was established that surplus investment by a banking corporation in a single non-financial corporation of over 5 percent of Common Equity Tier 1 capital of the banking corporation shall be weighted at 1,250 percent.

**Explanatory notes**

Reducing the proportion needed to determine "surplus investment" in a single non-financial corporation from 15 percent of total capital to 5 percent of Common Equity Tier 1 capital is intended to lead to reduced concentration risk in such investments.

**Effective date**

- 11. The provisions of this circular shall go into effect on January 1, 2014.

**Transition provisions**

12. Proper Conduct of Banking Business Directive no. 299 details the transition provisions that were set.

**Revised file**

13. Following are the update page for the Proper Conduct of Banking Business Directive file. Following are the revision instructions:

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Sincerely,

**David Zaken**

Supervisor of Banks