

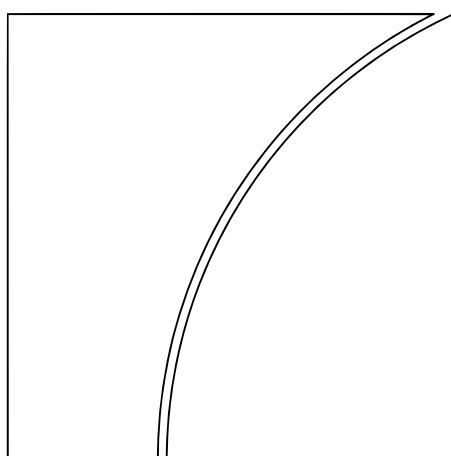
Basel Committee on Banking Supervision

CAP

Definition of capital

CAP99

Application guidance



This chapter contains supporting information on the definition of indirect and synthetic holdings, the calculation of minority interests and the application of transitional arrangements.

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First version in the format of the consolidated framework.



BANK FOR INTERNATIONAL SETTLEMENTS

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Minority interest illustrative example

99.1

Minority interest receives limited recognition in regulatory capital, as described in [CAP10.20](#) to [CAP10.26](#). The following paragraphs provide an illustrative example of how to calculate the amount eligible for inclusion.

99.2

A banking group consists of two legal entities that are both banks. Bank P is the parent and Bank S is the subsidiary and their unconsolidated balance sheets are set out below.

Bank P balance sheet		Bank S balance sheet	
Assets		Assets	
Loans to customers	100	Loans to customers	150
Investment in Common Equity Tier 1 of Bank S	7		
Investment in the Additional Tier 1 of Bank S	4		
Investment in the Tier 2 of Bank S	2		
Liabilities and equity		Liabilities and equity	
Depositors	70	Depositors	127
Tier 2	10	Tier 2	8
Additional Tier 1	7	Additional Tier 1	5
Common equity	26	Common equity	10

99.3

The balance sheet of Bank P shows that in addition to its loans to customers, it owns 70% of the common shares of Bank S, 80% of the Additional Tier 1 of Bank S and 25% of the Tier 2 capital of Bank S. The ownership of the capital of Bank S is therefore as follows:

Capital issued by Bank S			
	Amount issued to parent (Bank P)	Amount issued to third parties	Total

Common Equity Tier 1	7	3	10
Additional Tier 1	4	1	5
Tier 1	11	4	15
Tier 2	2	6	8
Total capital	13	10	23

99.4

The consolidated balance sheet of the banking group is set out below:

Consolidated balance sheet	
Assets	
Loans to customers	250
Liabilities and equity	
Depositors	197
Tier 2 issued by subsidiary to third parties	6
Tier 2 issued by parent	10
Additional Tier 1 issued by subsidiary to third parties	1
Additional Tier 1 issued by parent	7
Common equity issued by subsidiary to third parties (ie minority interest)	3
Common equity issued by parent	26

99.5

For illustrative purposes Bank S is assumed to have risk-weighted assets of 100. In this example, the minimum capital requirements of Bank S and the subsidiary's contribution to the consolidated requirements are the same since Bank S does not have any loans to Bank P. This means that it is subject to the following minimum plus capital conservation buffer requirements and has the following surplus capital:

Minimum and surplus capital of Bank S

	Minimum plus capital conservation buffer	Surplus
Common Equity Tier 1	7.0 (= 7.0% of 100)	3.0 (=10 - 7.0)
Tier 1	8.5 (= 8.5% of 100)	6.5 (=10 + 5 - 8.5)
Total capital	10.5 (= 10.5% of 100)	12.5 (=10 + 5 + 8 - 10.5)

99.6

The following table illustrates how to calculate the amount of capital issued by Bank S to include in consolidated capital, following the calculation procedure set out in [CAP10.20](#) to [CAP10.26](#):

Bank S: amount of capital issued to third parties included in consolidated capital					
	Total amount issued (a)	Amount issued to third parties (b)	Surplus (c)	Surplus attributable to third parties (ie amount excluded from consolidated capital) (d) =(c) * (b)/(a)	Amount included in consolidated capital (e) = (b) - (d)
Common Equity Tier 1	10	3	3.0	0.90	2.10
Tier 1	15	4	6.5	1.73	2.27
Total capital	23	10	12.5	5.43	4.57

99.7

The following table summarises the components of capital for the consolidated group based on the amounts calculated in the table above. Additional Tier 1 is calculated as the difference between Common Equity Tier 1 and Tier 1 and Tier 2 is the difference between Total Capital and Tier 1.

	Total amount issued by parent (all of which is to be included in consolidated capital)	Amount issued by subsidiaries to third parties to be included in consolidated capital	Total amount issued by parent and subsidiary to be included in consolidated capital
Common Equity Tier 1	26	2.10	28.10
<i>Additional Tier 1</i>	<i>7</i>	<i>0.17</i>	<i>7.17</i>
Tier 1	33	2.27	35.27
<i>Tier 2</i>	<i>10</i>	<i>2.30</i>	<i>12.30</i>
Total capital	43	4.57	47.57

Indirect and synthetic holdings

99.8

[CAP30.18](#) to [CAP30.31](#) describes the regulatory adjustments applied to a bank's investments in its own capital or other total loss-absorbing capacity (TLAC) instruments or those of other financial entities, even if they do not have direct holdings. More specifically, these paragraphs require banks to capture the loss that a bank would suffer if the capital or TLAC instrument is permanently written off, and subject this potential loss to the same treatment as a direct exposure. This section defines indirect and synthetic holdings and provides examples.

99.9

An indirect holding arises when a bank invests in an unconsolidated intermediate entity that has an exposure to the capital of an unconsolidated bank, financial or insurance entity and thus gains an exposure to the capital of that financial institution.

99.10

A synthetic holding arises when a bank invests in an instrument where the value of the instrument is directly linked to the value of the capital of an unconsolidated bank, financial or insurance entity.

99.11

Set out below are some examples of indirect and synthetic holdings to help illustrate this treatment:

1. The bank has an investment in the capital of an entity that is not consolidated for regulatory purposes and is aware that this entity has an investment in the capital of a financial institution.

2. The bank enters into a total return swap on capital instruments of another financial institution.
3. The bank provides a guarantee or credit protection to a third party in respect of the third party's investments in the capital of another financial institution.
4. The bank owns a call option or has written a put option on the capital instruments of another financial institution.
5. The bank has entered into a forward purchase agreement on the capital of another financial institution.

1 FAQ

FAQ1 *What would be the prudential treatment applicable to a financial instrument where a bank commits itself to buy newly issued shares of an insurance company for a given amount should certain events occur? For example, consider the following case. Bank A enters into a contract with Firm B (an insurance company). The contract stipulates that, if any of the three events defined below occurs within the next three years, Bank A must buy for €10 million new shares of Firm B (leading to a capital increase for Firm B). The new shares are generally issued with a discount (eg 5%) on the average market price recorded on the trading days following the event. In such a case, Bank A has to provide the cash to Firm B within a predefined timeline (eg 10 days). Event 1: Firm B incurs a technical loss above a threshold (eg €1m) for a specific event (eg natural catastrophe). Event 2: The loss ratio of a given line of business is higher than 120% for two consecutive semesters. Event 3: The share price of Firm B falls below a given value. Bank A is not allowed to sell the financial instrument resulting from this contract to other entities. [CAP30.18](#) to [CAP30.31](#) provide that investments in the capital of banking, financial and insurance entities include direct, indirect and synthetic holdings of capital instruments. These instruments must be deducted following a corresponding deduction approach (potentially with the application of a threshold). [CAP99.8](#) to [CAP99.12](#) defines indirect and synthetic holdings and provides examples. The transaction described above has to be regarded as a derivative instrument (in this case, a put option) that has a capital instrument (a share) of a financial sector entity as its underlying. Hence, it should be regarded as a synthetic holding to be deducted from Common Equity Tier 1 as per the applicable deduction rules.*

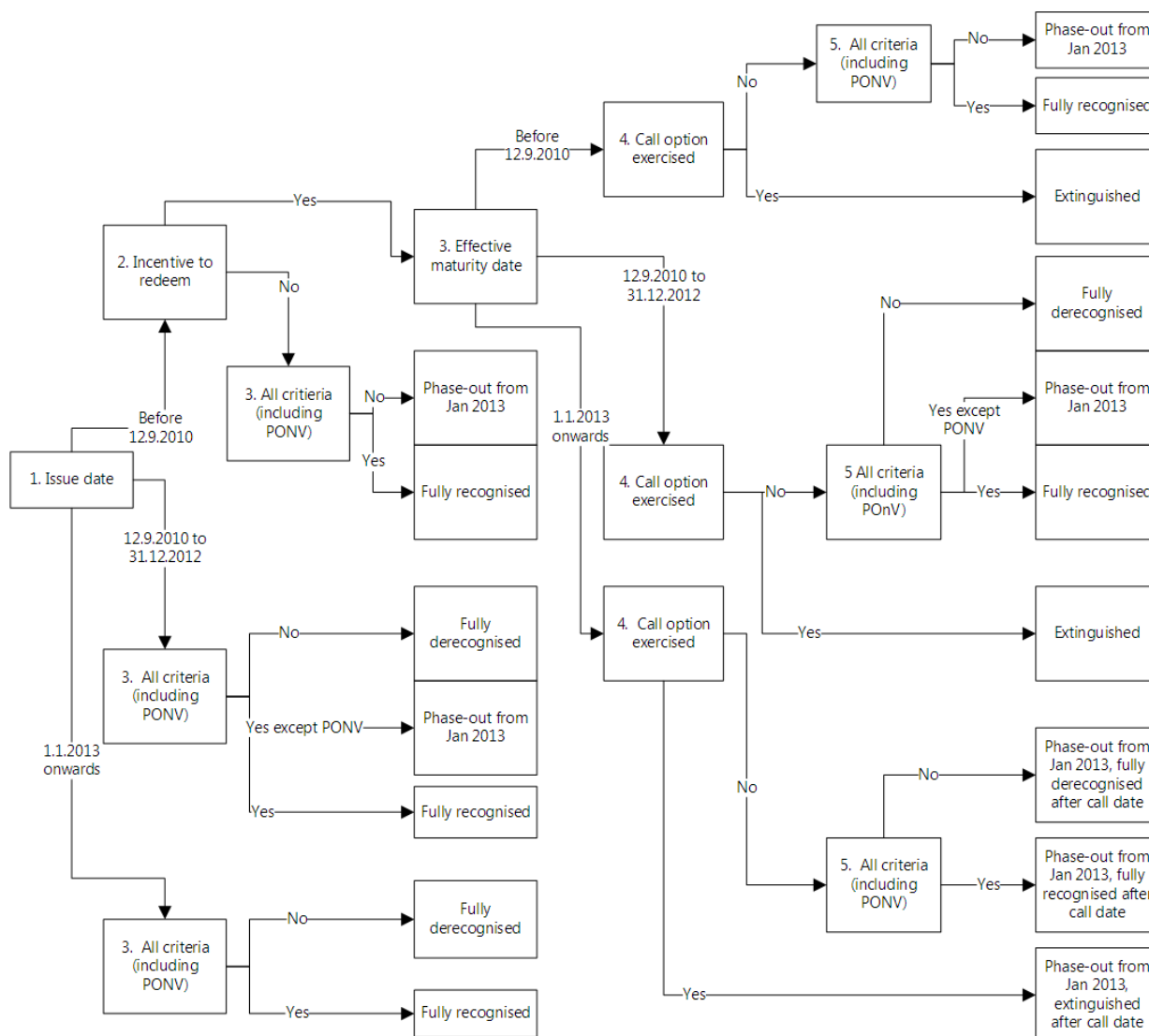
99.12

In all cases, the loss that the bank would suffer on the exposures if the capital of the financial institution is permanently written-off is to be treated as a direct exposure (ie subject to a deduction treatment).

Flowcharts illustrating transitional arrangements

99.13

The flowchart below illustrates the application of transitional arrangements in [CAP90.1](#) to [CAP90.3](#) and [CAP90.5](#). "Phase-out" refers to those transitional arrangements. "PONV" refers to the non-viability requirements in [CAP10.11](#)(16) and [CAP10.16](#)(10).



99.14

The flowchart below illustrates the application of transitional arrangements in [CAP90.4](#), which also sets out the "three conditions" and "phase-out" arrangements.

