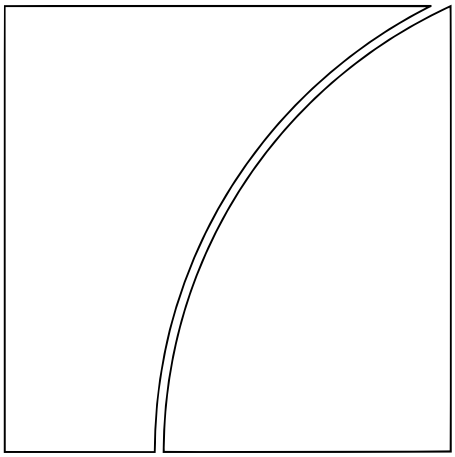
Basel Committee on Banking Supervision

CAP

Definition of capital

CAP10

Definition of eligible capital



This chapter sets out the eligibility criteria for regulatory capital. Three categories of instruments are permitted: Common Equity Tier 1, Additional Tier 1 and Tier 2.

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Updated to include the following FAQs: CAP10.11 FAQ24 and CAP10.16 FAQ10.

BANK FOR INTERNATIONAL SETTLEMENTS

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Components of capital

10.1

Regulatory capital consists of three categories, each governed by a single set of criteria that instruments are required to meet before inclusion in the relevant category.

1. Common Equity Tier 1 (going-concern capital)
2. Additional Tier 1 (going-concern capital)
3. Tier 2 Capital (gone-concern capital)

10.2

Total regulatory capital is the sum of Common Equity Tier 1, Additional Tier 1 and Tier 2 capital, net of regulatory adjustments described in CAP30. Tier 1 capital is the sum of Common Equity Tier 1 and Additional Tier 1 capital, net of the regulatory adjustments in CAP30 applied to those categories.

10.3

It is critical that banks' risk exposures are backed by a high-quality capital base. To this end, the predominant form of Tier 1 capital must be common shares and retained earnings.

10.4

Throughout CAP10 the term "bank" is used to mean bank, banking group or other entity (eg holding company) whose capital is being measured.

10.5

A bank must seek prior supervisory approval if it intends to include in capital an instrument which has its dividends paid in anything other than cash or shares.

Common Equity Tier 1

10.6

Common Equity Tier 1 capital consists of the sum of the following elements:

1. Common shares issued by the bank that meet the criteria for classification as common shares for regulatory purposes (or the equivalent for non-joint stock companies);
2. Stock surplus (share premium) resulting from the issue of instruments included Common Equity Tier 1;
3. Retained earnings;
4. Accumulated other comprehensive income and other disclosed reserves;
5. Common shares issued by consolidated subsidiaries of the bank and held by third parties (ie minority interest) that meet the criteria for inclusion in Common Equity Tier 1 capital. See CAP10.20 to CAP10.26 for the relevant criteria; and
6. Regulatory adjustments applied in the calculation of Common Equity Tier 1.

10.7

Retained earnings and other comprehensive income include interim profit or loss. National

authorities may consider appropriate audit, verification or review procedures. Dividends are removed from Common Equity Tier 1 in accordance with applicable accounting standards. The treatment of minority interest and the regulatory adjustments applied in the calculation of Common Equity Tier 1 are addressed in separate sections.

Common shares issued by the bank

10.8

For an instrument to be included in Common Equity Tier 1 capital it must meet all of the criteria that follow. The vast majority of internationally active banks are structured as joint stock companies and for these banks the criteria must be met solely with common shares. In the rare cases where banks need to issue non-voting common shares as part of Common Equity Tier 1, they must be identical to voting common shares of the issuing bank in all respects except the absence of voting rights.

1. Represents the most subordinated claim in liquidation of the bank.
2. Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (ie has an unlimited and variable claim, not a fixed or capped claim).
3. Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).
4. The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.
5. Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).
6. There are no circumstances under which the distributions are obligatory. Non payment is therefore not an event of default. Among other things, this requirement prohibits features that require the bank to make payments in kind.
7. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.
8. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and pari passu with all the others.
9. The paid-in amount is recognised as equity capital (ie not recognised as a liability) for determining balance sheet insolvency.
10. The paid-in amount is classified as equity under the relevant accounting standards.
11. It is directly issued and paid-in and the bank cannot directly or indirectly have funded the instrument or the purchase of the instrument.
12. The paid-in amount is neither secured nor covered by a guarantee of the issuer or related entity or subject to any other arrangement that legally or economically enhances the seniority of the claim.
13. It is only issued with the approval of the owners of the issuing bank, either given directly

by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorised by the owners.

14. It is clearly and separately disclosed on the bank's balance sheet.

Additional Tier 1 capital

10.9

Additional Tier 1 capital consists of the sum of the following elements:

1. instruments issued by the bank that meet the criteria for inclusion in Additional Tier 1 capital (and are not included in Common Equity Tier 1);
2. stock surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital;
3. instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Additional Tier 1 capital and are not included in Common Equity Tier 1 capital. See CAP10.20 to CAP10.26 for the relevant criteria; and
4. regulatory adjustments applied in the calculation of Additional Tier 1 Capital.

10.10

The treatment of instruments issued out of consolidated subsidiaries of the bank and the regulatory adjustments applied in the calculation of Additional Tier 1 capital are addressed in separate sections.

10.11

The following criteria must be met or exceeded for an instrument issued by the bank to be included in Additional Tier 1 capital.

1. Issued and paid-in
2. Subordinated to depositors, general creditors and subordinated debt of the bank. In the case of an issue by a holding company, the instrument must be subordinated to all general creditors.
3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors
4. Is perpetual, ie there is no maturity date and there are no step-ups or other incentives to redeem
5. May be callable at the initiative of the issuer only after a minimum of five years:
    1. To exercise a call option a bank must receive prior supervisory approval; and
    2. A bank must not do anything which creates an expectation that the call will be exercised; and
    3. Banks must not exercise a call unless:
    (i)

    They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; or

    (ii)

The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

4. The use of tax event and regulatory event calls are permitted within the first five years of a capital instrument, but supervisors will only permit the bank to exercise such a call if in their view the bank was not in a position to anticipate the event at issuance.

6. Any repayment of principal (eg through repurchase or redemption) must be with prior supervisory approval and banks should not assume or create market expectations that supervisory approval will be given.
7. Dividend/coupon discretion:
    1. the bank must have full discretion at all times to cancel distributions/payments
    2. cancellation of discretionary payments must not be an event of default
    3. banks must have full access to cancelled payments to meet obligations as they fall due
    4. cancellation of distributions/payments must not impose restrictions on the bank except in relation to distributions to common stockholders.
8. Dividends/coupons must be paid out of distributable items.
9. The instrument cannot have a credit-sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organisation's credit standing.
10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.
11. Instruments classified as liabilities for accounting purposes must have a principal loss-absorption mechanism. This must generate Common Equity Tier 1 under the relevant accounting standards and the instrument will only receive recognition in Additional Tier 1 up to the minimum level of Common Equity Tier 1 generated by the loss-absorption mechanism. The mechanism must operate through either:
    1. conversion to common shares at an objective pre-specified trigger point of at least 5.125% Common Equity Tier 1; or
    2. a writedown mechanism which allocates losses to the instrument at a pre-specified trigger point of at least 5.125% Common Equity Tier 1. The writedown will have the following effects:
    (i)

    Reduce the claim of the instrument in liquidation;

    (ii)

    Reduce the amount repaid when a call is exercised; and

    (iii)

    Partially or fully reduce coupon/dividend payments on the instrument.

12. The aggregate amount to be written down/converted for all instruments classified as liabilities for accounting purposes on breaching the trigger level must be at least the amount needed to immediately return the bank's Common Equity Tier 1 ratio to the trigger level or, if this is not possible, the full principal value of the instruments.
13. Neither the bank nor a related party over which the bank exercises control or significant

influence can have purchased the instrument, nor can the bank directly or indirectly fund the instrument or the purchase of the instrument.

14. The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.
15. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (eg a special purpose vehicle - "SPV"), proceeds must be immediately available without limitation to a single operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital.
16. The terms and conditions must have a provision that requires, at the option of the relevant authority, the instrument to either be written off or converted into common equity upon the occurrence of a trigger event, unless the criteria in CAP10.12 are met. Any compensation paid to instrument holders as a result of a write-off must be paid immediately in the form of common stock (or its equivalent in the case of non-joint stock companies) of either the issuing bank or the parent company of the consolidated group (including any successor in resolution) and must be paid prior to any public sector injection of capital (so that the capital provided by the public sector is not diluted). The issuing bank must maintain at all times all prior authorisation necessary to immediately issue the relevant number of shares specified in the instrument's terms and conditions should the trigger event occur. The trigger event:
    1. is the earlier of:
    (i)

    a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and

    (ii)

    the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority; and

    2. is determined by the jurisdiction in which the capital is being given recognition for regulatory purposes. Therefore, where an issuing bank is part of a wider banking group and the issuing bank wishes the instrument to be included in the consolidated group's capital in addition to its solo capital, the terms and conditions must specify an additional trigger event. This additional trigger event is the earlier of:
    (i)

    a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority in the home jurisdiction; and

    (ii)

    the decision to make a public sector injection of capital, or equivalent support, in the jurisdiction of the consolidated supervisor, without which the firm receiving the support would have become non-viable, as determined by the relevant authority in that jurisdiction.

10.12

The terms and conditions of Additional Tier 1 instruments must include a write-off or conversion provision activated at the option of the relevant authority upon the occurrence of the trigger event (as described in CAP10.11(16)) unless the following criteria are met. The same criteria apply in the case of the requirement for a write-off or conversion provision in Tier 2 instruments (as described in CAP10.16(10)):

1. the governing jurisdiction of the bank has in place laws that:
    1. require such instruments to be written off upon such event, or
    2. otherwise require such instruments to fully absorb losses before tax payers are exposed to loss; and
2. it is disclosed by the relevant regulator and by the issuing bank, in issuance documents issued on or after 1 January 2013, that such instruments are subject to loss under CAP10.12(1).

10.13

Stock surplus (ie share premium) that is not eligible for inclusion in Common Equity Tier 1, will only be permitted to be included in Additional Tier 1 capital if the shares giving rise to the stock surplus are permitted to be included in Additional Tier 1 capital.

Tier 2 capital

10.14

Tier 2 capital consists of the sum of the following elements:

1. instruments issued by the bank that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital);
2. stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital;
3. instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital. See CAP10.20 to CAP10.26 for the relevant criteria;
4. certain loan-loss provisions as specified in CAP10.18 and CAP10.19; and
5. regulatory adjustments applied in the calculation of Tier 2 capital.

10.15

The treatment of instruments issued out of consolidated subsidiaries of the bank and the regulatory adjustments applied in the calculation of Tier 2 capital are addressed in separate sections.

10.16

The objective of Tier 2 is to provide loss absorption on a gone-concern basis. Based on this objective, the following criteria must be met or exceeded for an instrument to be included in Tier 2 capital.

1. Issued and paid-in
2. Subordinated to depositors and general creditors of the bank. In the case of an issue by a holding company, the instrument must be subordinated to all general creditors.

3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general bank creditors
4. Maturity:
    1. Minimum original maturity of at least five years
    2. Recognition in regulatory capital in the remaining five years before maturity will be amortised on a straight line basis.
    3. There are no step-ups or other incentives to redeem.
5. May be callable at the initiative of the issuer only after a minimum of five years:
    1. To exercise a call option a bank must receive prior supervisory approval;
    2. A bank must not do anything that creates an expectation that the call will be exercised; and
    3. Banks must not exercise a call unless:
    (i)

    they replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; or

    (ii)

    the bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

    4. The use of tax event and regulatory event calls are permitted within the first five years of a capital instrument, but supervisors will only permit the bank to exercise such a call if in their view the bank was not in a position to anticipate the event at issuance.
6. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.
7. The instrument cannot have a credit-sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organisation's credit standing.
8. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the instrument or the purchase of the instrument.
9. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (eg an SPV), proceeds must be immediately available without limitation to a single operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 capital.
10. The terms and conditions must have a provision that requires, at the option of the relevant authority, the instrument to either be written off or converted into common equity upon the occurrence of a trigger event, unless the laws of the governing jurisdiction meet the criteria in CAP10.12. Any compensation paid to instrument holders as a result of a write-off must be paid immediately in the form of common stock (or its equivalent in the case of non-joint stock companies) of either the issuing bank or the parent company of the consolidated group (including any successor in resolution) and must be paid prior to any public sector injection of capital (so that the capital provided by the public sector is not diluted. The issuing bank must maintain at all times all prior authorisation necessary to immediately issue the relevant number of shares specified in

the instrument's terms and conditions should the trigger event occur. The trigger event:

1. is the earlier of:
   (i)

   a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and

   (ii)

   the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority; and

2. is determined by the jurisdiction in which the capital is being given recognition for regulatory purposes. Therefore, where an issuing bank is part of a wider banking group and the issuing bank wishes the instrument to be included in the consolidated group's capital in addition to its solo capital, the terms and conditions must specify an additional trigger event. This additional trigger event is the earlier of:
   (i)

   a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority in the home jurisdiction; and

   (ii)

   the decision to make a public sector injection of capital, or equivalent support, in the jurisdiction of the consolidated supervisor, without which the firm receiving the support would have become non-viable, as determined by the relevant authority in that jurisdiction.

10.17

Stock surplus (ie share premium) that is not eligible for inclusion in Tier 1 will only be permitted to be included in Tier 2 capital if the shares giving rise to the stock surplus are permitted to be included in Tier 2 capital.

10.18

Under the standardised approach to credit risk, provisions or loan-loss reserves held against future, presently unidentified losses are freely available to meet losses which subsequently materialise and therefore qualify for inclusion within Tier 2. Provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, should be excluded. Furthermore, general provisions/general loan-loss reserves eligible for inclusion in Tier 2, measured gross of tax effects, will be limited to a maximum of 1.25 percentage points of credit risk-weighted assets (RWA) calculated under the standardised approach.

10.19

Under the internal ratings based approach, where the total expected loss amount is less than total eligible provisions (measured gross of tax effects), as explained in CRE35, banks may recognise the difference in Tier 2 capital up to a maximum of 0.6% of credit risk-weighted assets calculated under the internal ratings-based approach. At national discretion, a limit lower than 0.6% may be applied.

Minority interest (ie non-controlling interest) and other capital issued out of consolidated subsidiaries that is held by third parties

10.20

Minority interest arising from the issue of common shares by a fully consolidated subsidiary of the bank may receive recognition in Common Equity Tier 1 only if:

1. the instrument giving rise to the minority interest would, if issued by the bank, meet all of the criteria for classification as common shares for regulatory capital purposes; and
2. the subsidiary that issued the instrument is itself a bank.

10.21

The amount of minority interest meeting the criteria above that will be recognised in consolidated Common Equity Tier 1 will be calculated as follows:

1. Total minority interest meeting the two criteria above minus the amount of the surplus Common Equity Tier 1 of the subsidiary attributable to the minority shareholders.
2. Surplus Common Equity Tier 1 of the subsidiary is calculated as the Common Equity Tier 1 of the subsidiary minus the lower of:
    1. the minimum Common Equity Tier 1 requirement of the subsidiary plus the capital conservation buffer (ie 7.0% of consolidated RWA); and
    2. the portion of the consolidated minimum Common Equity Tier 1 requirement plus the capital conservation buffer (ie 7.0% of consolidated RWA) that relates to the subsidiary.
3. The amount of the surplus Common Equity Tier 1 that is attributable to the minority shareholders is calculated by multiplying the surplus Common Equity Tier 1 by the percentage of Common Equity Tier 1 that is held by minority shareholders.

10.22

Tier 1 capital instruments issued by a fully consolidated subsidiary of the bank, whether wholly or partly owned, to third-party investors (including amounts under CAP10.21) may receive recognition in Tier 1 capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 capital.

10.23

The amount of this capital that will be recognised in Tier 1 will be calculated as follows:

1. Total Tier 1 of the subsidiary issued to third parties minus the amount of the surplus Tier 1 of the subsidiary attributable to the third-party investors.
2. Surplus Tier 1 of the subsidiary is calculated as the Tier 1 of the subsidiary minus the lower of:
    1. the minimum Tier 1 requirement of the subsidiary plus the capital conservation buffer (ie 8.5% of RWA); and
    2. the portion of the consolidated minimum Tier 1 requirement plus the capital conservation buffer (ie 8.5% of consolidated RWA) that relates to the subsidiary.
3. The amount of the surplus Tier 1 that is attributable to the third party investors is calculated by multiplying the surplus Tier 1 by the percentage of Tier 1 that is held by third-party investors.

4. The amount of this Tier 1 capital that will be recognised in Additional Tier 1 will exclude amounts recognised in Common Equity Tier 1 under CAP10.21.

10.24

Total capital instruments (ie Tier 1 and Tier 2 capital instruments) issued by a fully consolidated subsidiary of the bank, whether wholly or partly owned, to third-party investors (including amounts under CAP10.21 to CAP10.23) may receive recognition in Total Capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 or Tier 2 capital.

10.25

The amount of this capital that will be recognised in consolidated Total Capital will be calculated as follows:

1. Total capital instruments of the subsidiary issued to third parties minus the amount of the surplus Total Capital of the subsidiary attributable to the third-party investors.
2. Surplus Total Capital of the subsidiary is calculated as the Total Capital of the subsidiary minus the lower of:
    1. the minimum Total Capital requirement of the subsidiary plus the capital conservation buffer (ie 10.5% of RWA); and
    2. the portion of the consolidated minimum Total Capital requirement plus the capital conservation buffer (ie 10.5% of consolidated RWA) that relates to the subsidiary.
3. The amount of the surplus Total Capital that is attributable to the third-party investors is calculated by multiplying the surplus Total Capital by the percentage of Total Capital that is held by third-party investors.
4. The amount of this Total Capital that will be recognised in Tier 2 will exclude amounts recognised in Common Equity Tier 1 under CAP10.21 and amounts recognised in Additional Tier 1 under CAP10.23.

10.26

Where capital has been issued to third parties out of an SPV, none of this capital can be included in Common Equity Tier 1. However, such capital can be included in consolidated Additional Tier 1 or Tier 2 and treated as if the bank itself had issued the capital directly to the third parties only if it meets all the relevant entry criteria and the only asset of the SPV is its investment in the capital of the bank in a form that meets or exceeds all the relevant entry criteria (as required by CAP10.11(15) for Additional Tier 1 and CAP10.16(9) for Tier 2). In cases where the capital has been issued to third parties through an SPV via a fully consolidated subsidiary of the bank, such capital may, subject to the requirements of this paragraph, be treated as if the subsidiary itself had issued it directly to the third parties and may be included in the bank's consolidated Additional Tier 1 or Tier 2 in accordance with the treatment outlined in CAP10.23 to CAP10.26.