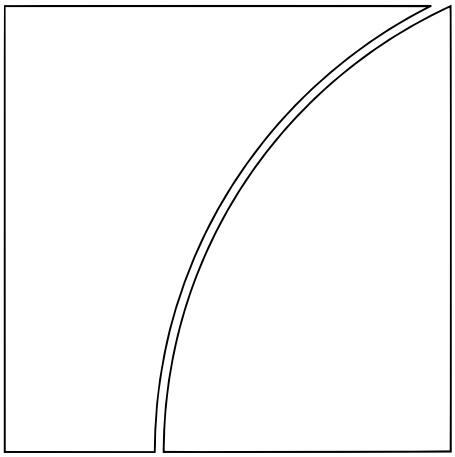
Basel Committee on Banking Supervision

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.

Version effective as of 15 December 2019

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.

2 FAQs

FAQ1 *Does retained earnings include the fair value changes of Additional Tier 1 and Tier 2 capital instruments?*
Retained earnings and other reserves, as stated on the balance sheet, are positive components of Common Equity Tier 1. To arrive at Common Equity Tier 1, the positive components are adjusted by the relevant regulatory adjustments set out in CAP30.
No regulatory adjustments are applied to fair value changes of Additional Tier 1 or Tier 2 capital instruments that are recognised on the balance sheet, except in respect of changes due to changes in the bank's own credit risk, as set out in CAP30.15.
For example, consider a bank with common equity of 500 and a Tier 2 capital instrument that is initially recognised on the balance sheet as a liability with a fair value of 100. If the fair value of this liability on the balance sheet changes from 100 to 105, the consequence will be a decline in common equity on the bank's balance sheet from 500 to 495. If this change in fair value is due to factors other than own credit risk of the bank, eg prevailing changes in interest rates or exchange rates, the Tier 2 capital instrument should be reported in Tier 2 at a valuation of 105 and the common equity should be reported as 495.

FAQ2 *Where associates and joint ventures are accounted for under the equity method, are earnings of such entities eligible for inclusion in the Common Equity Tier 1 capital of the group?*
Yes, to the extent that they are reflected in retained earnings and other reserves of the group and not excluded by any of the regulatory adjustments set out in CAP30.

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[1] 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.[2]

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.[3] 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[4] 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.[5]

5 Footnotes, 3 FAQs

1 *Joint stock companies are defined as companies that have issued common shares, irrespective of whether these shares are held privately or publically. These will represent the vast majority of internationally active banks.*

2 *The criteria also apply to non-joint stock companies, such as mutuals, cooperatives or savings institutions, taking into account their specific constitution and legal structure. The application of the criteria should preserve the quality of the instruments by requiring that they are deemed fully equivalent to common shares in terms of their capital quality as regards loss absorption and do not possess features which could cause the condition of the bank to be weakened as a going concern during periods of market stress. Supervisors will exchange information on how they apply the criteria to non-joint stock companies in order to ensure consistent implementation.*

3 *In cases where capital instruments have a permanent writedown feature, this criterion is still deemed to be met by common shares.*

4 *A related entity can include a parent company, a sister company, a subsidiary or any other affiliate. A holding company is a related entity irrespective of whether it forms part of the consolidated banking group.*

5 *The item should be clearly and separately disclosed in the balance sheet published in the bank's annual report. Where a bank publishes results on a half-yearly or quarterly basis, disclosure should also be made at those times. The requirement applies at the consolidated level; the treatment at an entity level should follow domestic requirements.*

FAQ1 *Regarding CAP10.8(5), if a bank does not earn any distributable profit within a given period does this mean that the bank is prohibited from paying a dividend?*
There are no Basel III requirements that prohibit dividend distributions as long as the bank meets the minimum capital ratios to which it is subject and does not exceed any of the distribution constraints of the capital conservation and countercyclical buffers (extended, as applicable, by any global or domestic systemically important bank higher loss absorbency capital surcharge). Accordingly, dividends may be paid out of reserves available for distribution (including those reserves accumulated in prior years) provided that all minimum ratios and buffer constraints are observed.
Distributable items in the criteria for common shares should be interpreted with reference to those items which are permitted to be distributed according to the relevant jurisdictional requirements, including any prohibitions that form part of those requirement.
For example, consider a jurisdiction in which distributable items consist of a company's retained earnings only and, as such, companies are not permitted to pay dividends (ie make distributions) to shareholders if the payment would result in negative retained earnings. Given that both the payment of dividends on shares reduces retained earnings, their declaration should be precluded in this jurisdiction if payment would result in (or increase) negative retained earnings.

FAQ2 *Does "paid-in" have to be paid-in with cash?*
Paid-in capital generally refers to capital that has been received with finality by the bank, is reliably valued, fully under the bank's control and does not directly or indirectly expose the bank to the credit risk of the investor. The criteria for inclusion in capital do not specify how an instrument must be "paid-in". Payment of cash to the issuing bank is not always applicable, for example, when a bank issues shares as payment for the take-over of another company the shares would still be considered to be paid-in. However, a bank is required to have prior supervisory approval to include in capital an instrument which has not been paid-in with cash.

FAQ3 *Does CAP10.8(11) require an exclusion from regulatory capital where a bank provides funding to a borrower that purchases the capital instruments of the bank where: (a) the bank has full recourse to the borrower; and (b) the funding was not provided specifically for the purpose of purchasing the capital of the bank (eg it was provided for the purpose of holding a diversified portfolio of investments)?*
No. Banks must ensure full compliance with CAP10.8(11) in economic terms irrespective of the specific legal features underpinning the transaction.

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.

1 FAQ

FAQ1 *Can subordinated loans be included in regulatory capital?*
Yes. As long as the subordinated loans meet all the criteria required for Additional Tier 1 or Tier 2 capital, banks can include these items in their regulatory 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;[6] or

    (ii)

    The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.[7]

    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[8]
    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]
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[10] 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.

5 Footnotes, 24 FAQs

6 *Replacement issues can be concurrent with but not after the instrument is called.*

7 *Minimum refers to the regulator’s prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.*

8 *A consequence of full discretion at all times to cancel distributions/payments is that “dividend pushers” are prohibited. An instrument with a dividend pusher obliges the issuing bank to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term “cancel distributions/payments” means extinguish these payments. It does not permit features that require the bank to make distributions/payments in kind. Banks may not allow investors to convert an Additional Tier 1 instrument to common equity upon non-payment of dividends, as this would also impede the practical ability of the bank to exercise its discretion to cancel payments.*

9 *It should be noted that, in many jurisdictions, distributions on Additional Tier 1 instruments (particularly those classified as liabilities but also, in some cases, on instruments that are equity-accounted) will be reflected as an expense item rather than as a distribution of profit (usually for tax reasons). The precondition of “distributable items” as a prudential criterion has therefore to be understood and applied in such a way that such distributions, even if not in violation of any legislation governing distributions by corporates, should not be allowed by the regulator if the distributable items are not adequate to provide for them.*

10 *An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.*

FAQ1 *Does “paid-in” have to be paid-in with cash?*
Paid-in capital generally refers to capital that has been received with finality by the bank, is reliably valued, fully under the bank's control and does not directly or indirectly expose the bank to the credit risk of the investor. The criteria for inclusion in capital do not specify how an instrument must be “paid-in”. Payment of cash to the issuing bank is not always applicable, for example, when a bank issues shares as payment for the takeover of another company the shares would still be considered to be paid-in. However, a bank is required to have prior supervisory approval to include in capital an instrument which has not been paid-in with cash.

FAQ2 *If the instrument provides for an optional dividend to be paid, with prior supervisory approval, equal to the aggregate unpaid amount of any unpaid dividends, would it be considered as meeting CAP10.11(7)(a)? What if the optional dividend is not specifically linked to the unpaid dividends, but structured as a bonus to reward investors in good times?*
No, this contravenes CAP10.11(7) which requires the bank to extinguish dividend/coupon payments. Any structuring as a bonus payment to make up for unpaid dividends is also prohibited.

FAQ3 *Is the term "distributable items" in CAP10.11(8) intended to include "retained earnings", as is the case in CAP10.8(5) for common shares? If yes, then how would this requirement work in the case of an Additional Tier 1 instrument classified as an accounting liability?*
Distributable items in the criteria for common shares and Additional Tier 1 should be interpreted with reference to those items which are permitted to be distributed according to the relevant jurisdictional requirements, including any prohibitions that form part of those requirement.
For example, consider a jurisdiction in which distributable items consist of a company's retained earnings only and, as such, companies are not permitted to pay dividends (ie make distributions) to shareholders if the payment would result in negative retained earnings. Given that both the payment of dividends and coupons on shares / Additional Tier 1 instruments reduces retained earnings, their declaration (in the case of dividends) or payment (in the case of coupons) should be precluded in this jurisdiction if payment would result in (or increase) negative retained earnings.
It should be noted that in many jurisdictions distributions on Additional Tier 1 instruments (particularly those classified as liabilities but also, in some cases, on instruments which are equity accounted) will be reflected as an expense item rather than as a distribution of profit (usually for tax reasons). The precondition of "distributable items" as a prudential criterion has therefore to be understood and applied in such a way that such distributions even if not in violation of any legislation governing distributions by corporates, should not be allowed by the regulator if the distributable items are not adequate to provide for them.

FAQ4 *Can the dividend/coupon rate be based on movements in a market index? Is resetting of the margin permitted at all? Does CAP10.11(9) prevent the use of a reference rate for which the bank is a reference entity (eg the London Interbank Offered Rate)?*
The aim of CAP10.11(9) is to prohibit the inclusion of instruments in Additional Tier 1 where the credit spread of the instrument will increase as the credit standing of the bank decreases. Banks may use a broad index as a reference rate in which the issuing bank is a reference entity, however, the reference rate should not exhibit significant correlation with the bank's credit standing. If a bank plans to issue capital instruments where the margin is linked to a broad index in which the bank is a reference entity, the bank should ensure that the dividend/coupon is not credit sensitive. National supervisors may provide guidance on the reference rates that are permitted in their jurisdictions or may disallow inclusion of an instrument in regulatory capital if they deem the reference rate to be credit sensitive.

FAQ5 *Is CAP10.11(10) irrelevant if national insolvency law does not include an assets exceeding liabilities test?*
Yes, it is irrelevant where liabilities exceeding assets does not form part of the insolvency test under the national insolvency law that applies to the issuing bank. However, if a branch wants to issue an instrument in a foreign jurisdiction where insolvency law is different from the jurisdiction where the parent bank is based, the issue documentation must specify that the insolvency law in the parent bank's jurisdiction will apply.

FAQ6 *If a related party of the bank purchases the capital instrument but third-party investors bear all the risks and rewards associated with the instrument and there is no counterparty risk (eg a fund manager or insurance subsidiary invests for the benefit of fund investors or insurance policyholders), does this contravene CAP10.11(13)?*
The intention of the criterion is to prohibit the inclusion of instruments in capital in cases where the bank retains any of the risk of the instruments. The criterion is not contravened if the third-party investors bear all of the risks.

FAQ7 *Does CAP10.11(13) require an exclusion from regulatory capital where a bank provides funding to a borrower that purchases the capital instruments of the bank where: (a) the bank has full recourse to the borrower; and (b) the funding was not provided specifically for the purpose of purchasing the capital of the bank (eg it was provided for the purpose of holding a diversified portfolio of investments)?*
No. Banks must ensure full compliance with CAP10.11(13) in economic terms irrespective of the specific legal features underpinning the transaction.

FAQ8 *Is it correct to assume that regulators are to look at the form of instrument issued to the SPV as well as instruments issued by the SPV to end investors?*
Yes, capital instruments issued to the SPV have to meet fully all the eligibility criteria as if the SPV itself was an end investor – ie the bank cannot issue capital of a lower quality (eg Tier 2) to an SPV and have an SPV issue higher quality capital to third-party investors to receive recognition as higher quality capital.

FAQ9 *Can Tier 2 capital issued by an SPV be upstreamed as Tier 1 capital for the consolidated group?*
If an SPV issues Tier 2 capital to investors and upstreams the proceeds by investing in Tier 1 issued by an operating entity or the holding company of the group, the transaction will be classified as Tier 2 capital for the consolidated group. Furthermore, the instrument issued by the operating entity or holding company must also be classified as Tier 2 for all other requirements that apply to that entity (eg solo or sub-consolidated capital requirements and disclosure requirements).

FAQ10 *Regarding CAP10.11(16), consider a bank that issues capital out of a foreign subsidiary, and wishes to use such capital to meet both the solo requirements of the foreign subsidiary and include the capital in the consolidated capital of the group. Is it correct that the relevant authority in jurisdiction of the consolidated supervisor must have the power to trigger write-down / conversion of the instrument in addition to the relevant authority in the jurisdiction of the foreign subsidiary?*
Yes, this is correct.

FAQ11 *To ensure that the scope of application of the non-viability trigger is exercised consistently across jurisdictions does the Basel Committee intend to issue any further guidance on what constitutes the point of non-viability?*
Banks should seek advice from their relevant national authority if they have questions about national implementation.

FAQ12 *Where a bank uses a special vehicle to issue capital to investors and also provides support to the vehicle (eg by contributing a reserve), does the support contravene CAP10.11(3)?*
Yes, the provision of support would constitute enhancement and breach CAP10.11(3).

FAQ13 *How should conversion at the point of non-viability operate for issues out of SPVs?*
The write-off of the instruments issued from the SPV to end investors should mirror the write-off of the capital issued from the operating entity or holding company to the SPV. Banks should discuss whether the specific arrangements of each instrument meet this broad concept with their relevant national authority.

FAQ14 *Assuming compliance with all relevant legal conditions that may exist can the compensation upon the point of non-viability trigger be paid in the form of common shares of the holding company of the bank?*
Yes, national authorities may allow common shares paid as compensation to be those of the bank's holding company. This is permitted because neither the issuance of shares of the bank nor the issuance of shares of the holding company affect the level of common equity created at the bank when the liability represented by the capital instruments is written off. National authorities may require that banks that intend to do this seek the relevant authority's approval before the issuance of such capital instruments.

FAQ15 *While CAP10.11(11) requires either writedown or conversion to equity of the Additional Tier 1 instrument (accounted for as a liability), the non-viability trigger (ie gone-concern trigger for all non-common equity Tier 1 and Tier 2 instruments) in CAP10.11(16) requires either write-off or conversion to equity. Did the Basel Committee intend to differentiate the loss absorption mechanism between the writedown and write-off?*
Additional Tier 1 instruments accounted for as liabilities are required to meet both the requirements for the point of non-viability and the principal loss-absorbency requirements in CAP10.11(11).
To meet the point-of-non-viability requirements, the instrument needs to be capable of being permanently written off or converted to common shares at the trigger event. Temporary writedown mechanisms cannot meet this requirement.
Regarding the writedown or conversion requirements for Additional Tier 1 instruments accounted for as liabilities, a temporary writedown mechanism is only permitted if it meets the conditions in CAP10.11(11) and CAP10.11(12).

FAQ16 *A deferred tax liability (DTL) could arise when a bank writes down or writes-off an instrument as a result of the principal loss-absorption or the non-viability requirement being triggered. Should the amount recognised as regulatory capital, both at the point of issuance and during the life of the instrument, be net of potential deferred tax liabilities that could arise when the instrument is written down or written off?*
Yes. The amount recognised as regulatory capital should be adjusted to account for any DTLs or tax payment resulting from the conversion or writedown or any other foreseeable tax liability or tax payment related to the instruments due at the moment of conversion or writedown or write-off. The adjustment should be made from the point of issuance. Institutions shall assess and justify the amount of any foreseeable tax liabilities or tax payments to the satisfaction of their supervisory authorities, taking into account in particular the local tax treatment and the structure of the group.
Where netting of DTLs against deferred tax assets is allowed, banks should seek guidance from supervisory authorities on the treatment of DTLs associated with the conversion, writedown or write-off of regulatory capital instrument.

FAQ17 *Regarding the reform of benchmark reference rates, will amendments to the contractual terms of capital instruments that are undertaken to prepare for the transition to the new benchmark rates result in a reassessment of their eligibility as regulatory capital?*
Amendments to the contractual terms of capital instruments could potentially trigger a reassessment of their eligibility as regulatory capital in some jurisdictions. A reassessment could result in an existing capital instrument being treated as a new instrument. This in turn could result in breaching the minimum maturity and call date requirements. Similarly, existing capital instruments issued under Basel II that are being phased out could also fail to meet eligibility requirements if they are treated as new instruments. The Committee confirms that amendments to capital instruments pursued solely for the purpose of implementing benchmark rate reforms will not result in them being treated as new instruments for the purpose of assessing the minimum maturity and call date requirements or affect their eligibility for transitional arrangements of Basel III.

FAQ18 *If a Tier 1 security is structured in such a manner that after the first call date the issuer would have to pay withholding taxes assessed on interest payments that they did not have to pay before, would this constitute an incentive to redeem? It is like a more traditional step-up in the sense that the issuers' interest payments are increasing following the first call date; however, the stated interest does not change and the interest paid to the investor does not change.*
Yes, it would be considered a step-up.

FAQ19 *Can the Committee give additional guidance on what will be considered an incentive to redeem?*

The Committee does not intend to publish an exhaustive list of what is considered an incentive to redeem and so banks should seek guidance from their national supervisor on specific features and instruments. However, the following list provides some examples of what would be considered an incentive to redeem:

-

A call option combined with an increase in the credit spread of the instrument if the call is not exercised.

-

A call option combined with a requirement or an investor option to convert the instrument into shares if the call is not exercised.

-

A call option combined with a change in the reference rate where the credit spread over the second reference rate is greater than the initial payment rate less the swap rate (ie the fixed rate paid to the call date to receive the second reference rate). For example, if the initial reference rate is 0.9%, the credit spread over the initial reference rate is 2% (ie the initial payment rate is 2.9%), and the swap rate to the call date is 1.2% a credit spread over the second reference rate greater than 1.7% (2.9-1.2%) would be considered an incentive to redeem.

Conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in credit spread will not in itself be viewed as an incentive to redeem. However, as required by CAP10.11(5), the bank must not do anything that creates an expectation that the call will be exercised.

Banks must not expect supervisors to approve the exercise of a call option for the purpose of satisfying investor expectations that a call will be exercised.

FAQ20 *An Additional Tier 1 capital instrument must be perpetual, which is further clarified as there being no maturity date, step-ups or other incentives to redeem. In some jurisdictions, domestic law does not allow direct issuance of perpetual debt. If, however, a dated instrument's terms and conditions include an automatic rollover feature, would the instrument be eligible for recognition as Additional Tier 1 capital? What about instruments with mandatory conversion into common shares on a pre-defined date?*

Dated instruments that include automatic rollover features are designed to appear as perpetual to the regulator and simultaneously to appear as having a maturity to the tax authorities and/or legal system. This creates a risk that the automatic rollover could be subject to legal challenge and repayment at the maturity date could be enforced. As such, instruments with maturity dates and automatic rollover features should not be treated as perpetual.

An instrument may be treated as perpetual if it will mandatorily convert to common shares at a pre-defined date and has no original maturity date prior to conversion. However, if the mandatory conversion feature is combined with a call option (ie the mandatory conversion date and the call are simultaneous or near-simultaneous), such that the bank can call the instrument to avoid conversion, the instrument will be treated as having an incentive to redeem and will not be permitted to be included in Additional Tier 1. Note that there may be other facts and circumstances besides having a call option that may constitute an incentive to redeem.

FAQ21 *An instrument is structured with a first call date after 5 years but thereafter is callable quarterly at every interest payment due date (subject to supervisory approval). The instrument does not have a step-up. Does the instrument meet CAP10.11(4) and CAP10.11(5) in terms of being perpetual with no incentive to redeem?*

CAP10.11(5) allows an instrument to be called by an issuer after a minimum period of 5 years. It does not preclude calling at times after that date or preclude multiple dates on which a call may be exercised. However, the specification of multiple dates upon which a call might be exercised must not be used to create an expectation that the instrument will be redeemed at the first call date, as this is prohibited by CAP10.11(4).

FAQ22 *An Additional Tier 1 instrument can be redeemed within the first five years of issuance only on the occurrence of a tax event or regulatory event. Please advise whether: (a) a tax event must relate solely to taxation changes that adversely affect the tax treatment of dividend and interest payments from the issuer's perspective; (b) a tax event could also include tax changes from the holders' perspective, with or without the issuer seeking to compensate the investors with additional payments; and (c) issuers should be allowed to gross up distributions to compensate the investors with additional payments, or whether this should be regarded as akin to a step up and an incentive to redeem (either under a call option related to the "tax event" (if permitted), or otherwise when the five year call date is reached).*
A tax event must relate to taxation changes in the jurisdiction of the issuer that increase an issuer's cash outflows to holders of capital instruments or adversely affect the tax treatment of dividend, interest payments or principal repayments from the issuer's perspective.
Any taxation changes that result in an increase in the cost of the issuance for the bank may be regarded as a tax event where the change in tax law is in the jurisdiction of the issuer and could not be anticipated at the issue date of the instrument. For example, where the issuer is required by a change in taxation law to withhold or deduct amounts otherwise payable to instrument holders, and is also required under the terms of the instrument to make additional payments to ensure that holders receive the amounts they would otherwise have received had no withholding or deduction been required, such a change in taxation law may be regarded as a tax event. Any redemption on account of such a tax event will be subject to all of the conditions applicable to early redemptions within the jurisdiction. In the example, the contractual additional payments required to make investors whole for withholding taxes or deductions, in effect, represent the adverse impact of the tax change on the issuer.

FAQ23 *Can the Basel Committee given an example of an action that would be considered to create an expectation that a call will be exercised?*
If a bank were to call a capital instrument and replace it with an instrument that is more costly (eg has a higher credit spread) this might create an expectation that the bank will exercise calls on its other capital instruments. As a consequence banks should not expect their supervisors to permit them to call an instrument if the banks intends to replace it with an instrument issued at a higher credit spread.

FAQ24 *Are dividend stopper arrangements acceptable (eg features that stop the bank making a dividend payment on its common shares if a dividend/coupon is not paid on its Additional Tier 1 instruments)? Are dividend stopper arrangements acceptable if they stop dividend/coupon payments on other Tier 1 instruments in addition to dividends on common shares?*
Dividend stopper arrangements that stop dividend payments on common shares are not prohibited by the Basel standards. Furthermore, dividend stopper arrangements that stop dividend payments on other Additional Tier 1 instruments are not prohibited. However, stoppers must not impede the full discretion that a bank must have at all times to cancel distributions/payments on the Additional Tier 1 instrument, nor must they act in a way that could hinder the recapitalisation of the bank (see CAP10.11(14)). For example, it would not be permitted for a stopper on an Additional Tier 1 instrument to:
-
attempt to stop payment on another instrument where the payments on this other instrument were not also fully discretionary;
-
prevent distributions to shareholders for a period that extends beyond the point in time that dividends/coupons on the Additional Tier 1 instrument are resumed; or
-
impede the normal operation of the bank or any restructuring activity (including acquisitions/disposals).
A stopper may act to prohibit actions that are equivalent to the payment of a dividend, such as the bank undertaking discretionary share buybacks.

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).

3 FAQs

FAQ1 *Does the option for loss absorbency at the point of non-viability to be implemented through statutory means release banks from the requirement of CAP10.11(11) to have a contractual principal loss absorption mechanism for Tier 1 instrument classified as liabilities?*
No, this option does not release banks from any of the requirements in CAP.

FAQ2 *What should a bank do if it is unsure whether the governing jurisdiction has the laws in place as set out in CAP10.12?*
It should seek guidance from the relevant national authority in its jurisdiction.

FAQ3 *CAP10.11(16) and CAP10.12 describe two scenarios. In the latter, the governing jurisdiction of the bank has sufficient powers to write down Additional Tier 1 and Tier 2 instruments. In the former, these powers are not deemed sufficient and contractual provisions (that amount to an embedded option that is to be triggered by the relevant authority) are required in these instruments. The ability of the relevant authority to exercise an embedded option in a regulatory instrument also requires that they have the authority to do so. What is the difference between the powers required in first and second scenarios?*
In both cases the relevant authority must have the power to write down or convert the instrument. In the latter scenario the authorities have the statutory power to enact the conversion/writedown irrespective of the terms and conditions of the instrument. In the former scenario the authorities have the power to enact the conversion/writedown in accordance with the terms and conditions of the instrument. In both cases, the fact that the instrument is subject to loss as a result of the relevant authority exercising such power must be made clear. In the latter scenario, there needs to be disclosure by the relevant regulator and by the issuing bank, in issuance documents going forward. In the former scenario, this needs to be specified in the terms and conditions of the instrument.

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.

1 FAQ

FAQ1 *Can subordinated loans be included in regulatory capital?*
Yes. As long as the subordinated loans meet all the criteria required for Additional Tier 1 or Tier 2 capital, banks can include these items in their regulatory 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;[11] 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;[12] or

    (ii)

    the bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.[13]

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[14] 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.

4 Footnotes, 10 FAQs

11 *An option to call the instrument after five years but prior to the start of the amortisation period will not be viewed as an incentive to redeem as long as the bank does not do anything that creates an expectation that the call will be exercised at this point.*

12 *Replacement issues can be concurrent with but not after the instrument is called.*

13 *Minimum refers to the regulator's prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.*

14 *An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.*

FAQ1 *Does "paid-in" have to be paid-in with cash?*
Paid-in capital generally refers to capital that has been received with finality by the bank, is reliably valued, fully under the bank's control and does not directly or indirectly expose the bank to the credit risk of the investor. The criteria for inclusion in capital do not specify how an instrument must be "paid-in". Payment of cash to the issuing bank is not always applicable, for example, when a bank issues shares as payment for the takeover of another company the shares would still be considered to be paid-in. However, a bank is required to have prior supervisory approval to include in capital an instrument which has not been paid-in with cash.

FAQ2 *Regarding the reform of benchmark reference rates, will amendments to the contractual terms of capital instruments that are undertaken to prepare for the transition to the new benchmark rates result in a reassessment of their eligibility as regulatory capital?*
Amendments to the contractual terms of capital instruments could potentially trigger a reassessment of their eligibility as regulatory capital in some jurisdictions. A reassessment could result in an existing capital instrument being treated as a new instrument. This in turn could result in breaching the minimum maturity and call date requirements. Similarly, existing capital instruments issued under Basel II that are being phased out could also fail to meet eligibility requirements if they are treated as new instruments. The Committee confirms that amendments to capital instruments pursued solely for the purpose of implementing benchmark rate reforms will not result in them being treated as new instruments for the purpose of assessing the minimum maturity and call date requirements or affect their eligibility for transitional arrangements of Basel III.

FAQ3 *If a related party of the bank purchases the capital instrument but third-party investors bear all the risks and rewards associated with the instrument and there is no counterparty risk (eg a fund manager or insurance subsidiary invests for the benefit of fund investors or insurance policyholders), does this contravene CAP10.16(8)?*
The intention of the criterion is to prohibit the inclusion of instruments in capital in cases where the bank retains any of the risk of the instruments. The criterion is not contravened if the third-party investors bear all of the risks.

FAQ4 *Does CAP10.16(8) require an exclusion from regulatory capital where a bank provides funding to a borrower that purchases the capital instruments of the bank where: (a) the bank has full recourse to the borrower; and (b) the funding was not provided specifically for the purpose of purchasing the capital of the bank (eg it was provided for the purpose of holding a diversified portfolio of investments)?*
No. Banks must ensure full compliance with CAP10.16(8) in economic terms irrespective of the specific legal features underpinning the transaction.

FAQ5 *Can Tier 2 capital issued by an SPV can be upstreamed as Tier 1 capital for the consolidated group?*
If an SPV issues Tier 2 capital to investors and upstreams the proceeds by investing in Tier 1 issued by an operating entity or the holding company of the group, the transaction will be classified as Tier 2 capital for the consolidated group. Furthermore, the instrument issued by the operating entity or holding company must also be classified as Tier 2 for all other requirements that apply to that entity (eg solo or sub-consolidated capital requirements and disclosure requirements).

FAQ6 *Consider a bank that issues capital out of a foreign subsidiary, and wishes to use such capital to meet both the solo requirements of the foreign subsidiary and include the capital in the consolidated capital of the group. Is it correct that the relevant authority in jurisdiction of the consolidated supervisor must have the power to trigger writedown / conversion of the instrument in addition to the relevant authority in the jurisdiction of the foreign subsidiary?*
Yes, this is correct.

FAQ7 *To ensure that the scope of application of the non-viability trigger is exercised consistently across jurisdictions does the Basel Committee intend to issue any further guidance on what constitutes the point of non-viability?*
Banks should seek advice from their relevant national authority if they have questions about national implementation.

FAQ8 *How should conversion at the point of non-viability operate for issues out of SPVs?*
The write-off of the instruments issued from the SPV to end investors should mirror the write-off of the capital issued from the operating entity or holding company to the SPV. Banks should discuss whether the specific arrangements of each instrument meet this broad concept with their relevant national authority.

FAQ9 *Assuming compliance with all relevant legal conditions that may exist can the compensation upon the point of non-viability trigger be paid in the form of common shares of the holding company of the bank?*
Yes, national authorities may allow common shares paid as compensation to be those of the bank's holding company. This is permitted because neither the issuance of shares of the bank nor the issuance of shares of the holding company affect the level of common equity created at the bank when the liability represented by the capital instruments is written off. National authorities may require that banks that intend to do this seek the relevant authority's approval before the issuance of such capital instruments.

FAQ10 *A deferred tax liability (DTL) could arise when a bank writes down or writes off an instrument as a result of the principal loss absorption or the non-viability requirement being triggered. Should the amount recognised as regulatory capital, both at the point of issuance and during the life of the instrument, be net of potential deferred tax liabilities that could arise when the instrument is written down or written off?*
Yes. The amount recognised as regulatory capital should be adjusted to account for any DTLs or tax payment resulting from the conversion or writedown or any other foreseeable tax liability or tax payment related to the instruments due at the moment of conversion or writedown or write-off. The adjustment should be made from the point of issuance. Institutions shall assess and justify the amount of any foreseeable tax liabilities or tax payments to the satisfaction of their supervisory authorities, taking into account in particular the local tax treatment and the structure of the group.
Where netting of DTLs against deferred tax assets is allowed, banks should seek guidance from supervisory authorities on the treatment of DTLs associated with the conversion, writedown or write-off of regulatory capital instrument.

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.

1 FAQ

FAQ1 *Should credit valuation adjustment (CVA) RWA and RWA for exposures to central counterparties (CCPs) be included in the computation base to arrive at the amount of provisions eligible for inclusion in Tier 2 capital?*
CCP RWA should be included in the calculation base used to determine the cap on eligible provisions in Tier 2.
Historically, the understanding is that RWA are comprised of the sum of market capital charges multiplied by 12.5 plus credit RWA. Since CCP RWA are not currently included in the market risk framework, by default they are included in credit RWA for purposes of calculating the base to arrive at the amount of provisions eligible for inclusion in Tier 2 capital. On the other hand, CVA RWA are primarily market-driven risks, so should not be included the calculation base.

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.[15] [16]

2 Footnotes

15 *For the purposes of this paragraph, any institution that is subject to the same minimum prudential standards and level of supervision as a bank may be considered to be a bank.*

16 *Minority interest in a subsidiary that is a bank is strictly excluded from the parent bank's common equity if the parent bank or affiliate has entered into any arrangements to fund directly or indirectly minority investment in the subsidiary whether through an SPV or through another vehicle or arrangement. The treatment outlined above, thus, is strictly available where all minority investments in the bank subsidiary solely represent genuine third party common equity contributions to the subsidiary.*

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.

2 FAQs

FAQ1 *Does minority interest (ie non-controlling interest) include the third parties' interest in the retained earnings and reserves of the consolidated subsidiaries?*
Yes. The Common Equity Tier 1 in the illustrative example in CAP99 should be read to include issued common shares plus retained earnings and reserves in Bank S.

FAQ2 *Regarding the treatment of capital issued out of subsidiaries, how should the surplus capital be calculated if the subsidiary is not regulated on a stand-alone basis but is still subject to consolidated supervision?*
For capital issued by a consolidated subsidiary of a group to third parties to be eligible for inclusion in the consolidated capital of the banking group, CAP10.21 to CAP10.26 requires the minimum capital requirements and definition of capital to be calculated for the subsidiary irrespective of whether the subsidiary is regulated on a stand-alone basis. In addition the contribution of this subsidiary to the consolidated capital requirement of the group (ie excluding the impact of intragroup exposures) must be calculated. All calculations must be undertaken in respect of the subsidiary on a sub-consolidated basis (ie the subsidiary must consolidate all of its subsidiaries that are also included in the wider consolidated group). If this is considered too operationally burdensome the bank may elect to give no recognition in consolidated capital of the group to the capital issued by the subsidiary to third parties. Finally, as set out in CAP10.20, it should be noted that minority interest is only permitted to be included in Common Equity Tier 1 if: (1) the instrument would, if issued by the bank, meet all of the criteria for classification as common shares for regulatory purposes; and (2) the subsidiary that issued the instrument is itself a bank. The definition of a bank for this purpose is any institution that is subject to the same minimum prudential standards and level of supervision as a bank as mentioned in CAP10 (Footnote 15).

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.

1 FAQ

FAQ1 *Regarding the treatment of capital issued out of subsidiaries, how should the surplus capital be calculated if the subsidiary is not regulated on a stand alone basis but is still subject to consolidated supervision?*
For capital issued by a consolidated subsidiary of a group to third parties to be eligible for inclusion in the consolidated capital of the banking group, CAP10.21 to CAP10.26 requires the minimum capital requirements and definition of capital to be calculated for the subsidiary irrespective of whether the subsidiary is regulated on a stand alone basis. In addition the contribution of this subsidiary to the consolidated capital requirement of the group (ie excluding the impact of intra-group exposures) must be calculated. All calculations must be undertaken in respect of the subsidiary on a sub-consolidated basis (ie the subsidiary must consolidate all of its subsidiaries that are also included in the wider consolidated group). If this is considered too operationally burdensome the bank may elect to give no recognition in consolidated capital of the group to the capital issued by the subsidiary to third parties. Finally, as set out in CAP10.20, it should be noted that minority interest is only permitted to be included in Common Equity Tier 1 if: (1) the instrument would, if issued by the bank, meet all of the criteria for classification as common shares for regulatory purposes; and (2) the subsidiary that issued the instrument is itself a bank. The definition of a bank for this purpose is any institution that is subject to the same minimum prudential standards and level of supervision as a bank as mentioned in CAP10 (Footnote 15).

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.

2 FAQs

FAQ1 *Consider the case where the Common Equity Tier 1 and Additional Tier 1 capital of a subsidiary are sufficient to cover the minimum total capital requirement of the subsidiary. For example, assume the minimum total capital requirements of the subsidiary is 15, the sum of Common Equity Tier 1 and Additional Tier 1 is 15 and the Common Equity Tier 1 and Additional Tier 1 are fully owned by the parent of the subsidiary (ie they are not issued to third parties). What is the capital treatment if the subsidiary issues Tier 2 capital of 5 to third-party investors?*
*This treatment is set out in CAP10.25. The surplus total capital of the subsidiary is 5. The proportion of the total capital of 20 which is held by third-party investors is 25% (ie 5/20*100%). Therefore, the amount of the surplus total capital that is attributable to third-party investors is 1.25 (=5*25%). Consequently, 1.25 of the Tier 2 will be excluded from consolidated Tier 2 capital. The residual 3.75 of Tier 2 capital will be included in consolidated Tier 2 capital.*

FAQ2 *Regarding the treatment of capital issued out of subsidiaries, how should the surplus capital be calculated if the subsidiary is not regulated on a stand-alone basis but is still subject to consolidated supervision?*
For capital issued by a consolidated subsidiary of a group to third parties to be eligible for inclusion in the consolidated capital of the banking group, CAP10.21 to CAP10.26 requires the minimum capital requirements and definition of capital to be calculated for the subsidiary irrespective of whether the subsidiary is regulated on a stand-alone basis. In addition the contribution of this subsidiary to the consolidated capital requirement of the group (ie excluding the impact of intragroup exposures) must be calculated. All calculations must be undertaken in respect of the subsidiary on a sub-consolidated basis (ie the subsidiary must consolidate all of its subsidiaries that are also included in the wider consolidated group). If this is considered too operationally burdensome the bank may elect to give no recognition in consolidated capital of the group to the capital issued by the subsidiary to third parties. Finally, as set out in CAP10.20, it should be noted that minority interest is only permitted to be included in Common Equity Tier 1 if: (1) the instrument would, if issued by the bank, meet all of the criteria for classification as common shares for regulatory purposes; and (2) the subsidiary that issued the instrument is itself a bank. The definition of a bank for this purpose is any institution that is subject to the same minimum prudential standards and level of supervision as a bank as mentioned in CAP10 (Footnote 15).

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[17] (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.

1 Footnote, 2 FAQs

17 *Assets that relate to the operation of the SPV may be excluded from this assessment if they are de minimis.*

FAQ1 *Does the Committee have any further guidance on the definition of SPVs? Are SPVs referred to in CAP10.26 those which are consolidated under international financial reporting standards (IFRS) or all SPVs?*
Guidance should be sought from national supervisors. SPVs referred to in CAP10.26 refer to all SPVs irrespective of whether they are consolidated under IFRS or other applicable accounting standards.

FAQ2 *Regarding the treatment of capital issued out of subsidiaries, how should the surplus capital be calculated if the subsidiary is not regulated on a stand-alone basis but is still subject to consolidated supervision?*
For capital issued by a consolidated subsidiary of a group to third parties to be eligible for inclusion in the consolidated capital of the banking group, CAP10.21 to CAP10.26 requires the minimum capital requirements and definition of capital to be calculated for the subsidiary irrespective of whether the subsidiary is regulated on a stand-alone basis. In addition the contribution of this subsidiary to the consolidated capital requirement of the group (ie excluding the impact of intragroup exposures) must be calculated. All calculations must be undertaken in respect of the subsidiary on a sub-consolidated basis (ie the subsidiary must consolidate all of its subsidiaries that are also included in the wider consolidated group). If this is considered too operationally burdensome the bank may elect to give no recognition in consolidated capital of the group to the capital issued by the subsidiary to third parties. Finally, as set out in CAP10.20, it should be noted that minority interest is only permitted to be included in Common Equity Tier 1 if: (1) the instrument would, if issued by the bank, meet all of the criteria for classification as common shares for regulatory purposes; and (2) the subsidiary that issued the instrument is itself a bank. The definition of a bank for this purpose is any institution that is subject to the same minimum prudential standards and level of supervision as a bank as mentioned in CAP10 (Footnote 15).