

# 155

Financial Services Authority

## Tier 1 Capital for Banks: Update to IPRU(Banks)

October 2002





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The Financial Services Authority invites comments on this consultation paper. Comments should reach us by 31 January 2003.

You can send your response by electronic submission using the form on the FSA's website (at [www.fsa.gov.uk/pubs/cp/cp155\\_response.html](http://www.fsa.gov.uk/pubs/cp/cp155_response.html)), by e-mail or in writing to the following:

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**It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.**

# 1 Executive summary

- 1.1 For regulatory purposes international regulators have divided a bank's capital into three tiers, reflecting the extent to which instruments meet the key underlying principles of capital, loss absorbency and permanence. Tier 1 is the highest quality form of capital and so can be included without limit in a bank's capital for regulatory purposes. Tier 2 and Tier 3 capital include features that conform less closely with the underlying principles and are therefore limited to a proportion of the Tier 1 held.
- 1.2 Over recent years, banks have looked for cost-effective ways of raising good quality capital and have increasingly tested the boundaries of what may be included in Tier 1 capital. In October 1998, in response to these market innovations, the Basel Committee on Banking Supervision issued new requirements that divided Tier 1 capital into innovative and non-innovative instruments.
- 1.3 Innovative Tier 1 instruments (which were only partly defined by Basel) are limited to 15% of total Tier 1 capital. As banks have moved closer to their limit of 15% in innovative Tier 1 instruments, the focus has increasingly turned to the boundary between non-innovative (core) and innovative Tier 1. Our current policy, as stated in IPRU (Banks), no longer provides enough clarity about how these instruments should be treated.
- 1.4 This Consultation Paper (CP) seeks comments on proposed changes to our policy on Tier 1 capital as set out in chapter CA of the Interim Prudential sourcebook for Banks (IPRU (Banks)). This CP could affect all banks, but will mainly affect those seeking to issue new or innovative Tier 1 capital. We aim to implement these proposals in IPRU (Banks) in the first half of 2003.
- 1.5 These proposals update IPRU (Banks) by clarifying the underlying principles and requirements of Tier 1 and providing a clear and transparent framework.

Our proposed guidance seeks to make sure that an appropriate proportion of a bank's capital is held in a form that provides maximum protection in terms of loss absorbency and permanence. We hope that this framework will enable issuers to structure instruments with limited pre-consultation with us. This should reduce the time and cost of bringing new issues to the market and result in a stronger, well capitalised UK banking system. Facilitating innovation in Tier 1 capital has also been an important consideration in developing these proposals.

1.6 There are three key elements to the proposals:

Our proposals *clarify*:

- the characteristics of Tier 1 capital;
- that innovative instruments are subject to a 15% limit;
- that all indirect Tier 1 issues should be treated as innovative; and
- that issues incorporating stock settlement of principal should be treated as innovative.

Our proposals represent a *tightening* by:

- requiring that Tier 1 should consist predominantly of ordinary shares, associated reserves and retained earnings.

Our proposals represent a *relaxation* by:

- reducing the Tier 1 limit that banks must meet before issuing innovative capital from 6% to 4%;
- eliminating the 60% Tier 1 repayment test; and
- recognising that capital instruments<sup>1</sup> that are economically equivalent to preference shares could be eligible for non-innovative Tier 1 treatment.

1.7 In due course, these proposals will have implications for a wider range of firms in the context of the draft Integrated Prudential sourcebook (PSB). For insurers, we will consult on the resulting amendments to the PSB as part of the comprehensive package of new insurance requirements (due to be published for consultation early 2003). For building societies and investment firms, we will consult during 2003/04 as part of the full roll-out of the PSB.

1.8 We invite comments on the proposals and questions contained in this CP. Once we have analysed the responses, we plan to issue a Policy Statement in the first half of 2003 giving feedback on the consultation.

**This CP will not be of interest to retail consumers.**

<sup>1</sup> Capital instruments may include instruments that are in all ways economically equivalent to preference shares. Such instruments need not be accounted for as preference shares.

# 2 Introduction

## Context

- 2.1 This Consultation Paper (CP) seeks comments on proposed changes to our policy on Tier 1 capital as set out in chapter CA of the Interim Prudential sourcebook for Banks (IPRU (Banks)). This CP could affect all banks, but will mainly affect those seeking to issue new or innovative Tier 1 capital. We aim to implement these proposals in IPRU(Banks) in the first half of 2003.
- 2.2 In due course, these proposals will have implications for a wider range of firms in the context of the draft Integrated Prudential Sourcebook (PSB). For insurers, the resulting amendments to the PSB will be consulted on as part of the comprehensive package of new insurance requirements (due to be published for consultation early 2003). For building societies we will consult during 2003/04 as part of the full roll-out of the PSB, as our proposals would result in costs but no apparent benefits at this time. We will also consult on amendments for investment firms as part of the full roll-out of the PSB.

## Background

- 2.3 For regulatory purposes, international regulations require us to divide a bank's capital into three tiers, reflecting the extent to which instruments meet the underlying principles of capital, loss absorbency and permanence. Tier 1 ('core' and 'innovative') is the highest quality form of capital and so can be included without limit in a bank's capital for regulatory purposes. Tier 2 (upper and lower) and Tier 3 capital include features that conform less closely with these principles and so are limited, based on the amount of Tier 1 held. In this CP we provide an update to clarify our existing approach to Tier 1 capital and propose a framework to help banks classify capital as non-innovative (core), or innovative, within Tier 1. Our proposed framework should lessen, but not eliminate, the need for banks to consult us on

individual capital issues. Given the degree of innovation in the market this policy may require further development in due course.

- 2.4 Our proposals must be placed in the context of existing Basel and EU requirements. Over recent years, banks have looked for cost-effective ways of raising good quality capital and have increasingly tested the boundaries of what may be included in Tier 1 capital. This prompted the Basel Committee on Banking Supervision (BCBS) to conduct a review which concluded that certain ‘innovative’ instruments may be included in Tier 1 capital subject to a limit of 15%<sup>1</sup>.
- 2.5 The BCBS defined innovative instruments in fairly general terms (except for a detailed requirement on allowable step-ups<sup>2</sup>), leaving some scope for interpretation. As banks have moved closer to their limit of 15% in innovative Tier 1 instruments, the focus has increasingly turned to the boundary between non-innovative (core) and innovative Tier 1. Our current policy, as stated in IPRU(Banks), no longer provides enough clarity about how these new instruments should be treated. This CP and the resulting changes to the relevant chapter in IPRU(Banks) are intended to make the classification of Tier 1 instruments as non-innovative or innovative more transparent.

## Purpose

- 2.6 Overall, this CP aims to reduce the probability of a market disruption or consumers suffering losses that are not compensated, because of prudential failure. Our proposals seek to ensure that an appropriate proportion of each bank’s capital is held in a form that gives maximum protection in terms of loss absorbency and permanence. They aim to achieve this by providing a clear and transparent framework within which banks can classify Tier 1 capital.
- 2.7 Facilitating innovation in Tier 1 capital has been one of the key considerations in developing these proposals. We have tried to strike an appropriate balance between prescription, which provides certainty but which can quickly become outdated, and flexibility to accommodate market developments. Although an increase in Tier 1 capital issued will strengthen the UK banking system, this must be balanced against any possible dilution in the quality of capital within Tier 1.
- 2.8 In this CP, we have attempted to strike a balance that gives us the flexibility to assess Tier 1 issues on an individual basis when required, yet provides the clarity and transparency that are inherent in the statutory objectives and the principles of good regulation. We do recognise, however, that as markets evolve our framework will also need to be flexible enough to adapt.

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1 See BCBS press release entitled ‘Instruments eligible for inclusion in Tier 1 capital – 27 October 1998’.

2 An increase in the coupon rate.

## **Other regulators**

- 2.9 Given the need to conform to both Basel and EU requirements, we also contacted overseas regulators in the pre-consultation process to help us gain a better understanding of the international application of the 15% limit (of Tier 1) on innovative instruments.

## **Timetable**

- 2.10 Chapter 3 of this CP outlines our general approach to Tier 1 capital. It gives an overview of the classification of Tier 1 instruments and outlines our key recommendations. Chapter 4 presents our reasons for thinking that the proposals are compatible with our statutory objectives and general duties, and Annex A outlines the costs and benefits of our proposals. A list of questions in this CP is included as Annex B and the proposed draft chapter of IPRU (Banks) is attached as Annex C. The guidance in Annex C will be made under section 157 of the FSMA.
- 2.11 After considering the comments received during this consultation, we propose to implement the new policy for banks in the first half of 2003. However, we would not want to impede banks wishing to issue Tier 1 capital before this date, and so we encourage banks to contact us should they require individual guidance in this area.

## **Consultation process**

- 2.12 We are publishing this CP in hard copy form and making it available at our website (<http://www.fsa.gov.uk>) and on our monthly CD-ROM issue. We would welcome comments on the specific questions raised throughout this paper (summarised in Annex B) and any other aspects of these proposals. We need your responses by 31 January 2003. An early response would be particularly welcome if it concerns substantial matters.

# 3 Proposed framework for Tier 1 capital

## General approach

- 3.1 This chapter sets out our proposed framework for classifying Tier 1 capital. In line with the Basel analysis in this area, we have taken as our starting point the high level principles underlying the role of capital and the key characteristics of Tier 1 capital that best meet these principles. We have built on this to identify defining features in capital issues. These features have, in turn, been incorporated into a decision chart to help banks classify Tier 1 instruments. Most of these concepts are already well established and are currently reflected in IPRU(Banks). Our aim is to provide clarity within an overall framework, so that consistent policy outcomes may be achieved in an evolving market. We recognise that our proposed framework will not provide a definitive classification of Tier 1 instruments in all cases, nor is it intended to be interpreted in such a prescriptive way. The proposed revisions to IPRU(Banks) that result from this approach are set out in Annex C.

## Core and Innovative Tier 1 capital

- 3.2 To define the boundary between non-innovative and innovative Tier 1 capital, we propose to classify instruments as Core Tier 1 and Innovative Tier 1. Non-innovative instruments such as ordinary shares, traditional preference shares and in some cases, capital instruments<sup>1</sup>, will be considered Core Tier 1. Instruments that incorporate an allowable step-up as defined in the Basel Press release, indirect issues<sup>2</sup> and instruments incorporating certain other features outlined below, will be classified as Innovative Tier 1, if in all other respects they meet all the conditions set out below for inclusion in Tier 1.

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1 Capital instruments may include instruments, which are in all ways economically equivalent to preference shares. Such instruments need not be accounted for as preference shares.

2 Instruments issued through a Special Purpose Vehicle (SPV), not by the bank directly.

## **High level principles underlying capital**

- 3.3 Capital provides a buffer that enables a bank to absorb losses without the interests of the depositors being adversely affected. To meet this role, capital must be able to absorb losses, and must be available permanently.

### **Loss absorbency**

- 3.4 Loss absorbency on a going concern basis (before wind-down, bankruptcy or liquidation) is of primary importance for Tier 1, as it provides capital as a backstop in times of financial stress. Loss absorbency when a bank ceases to be a going concern is also important, since it provides protection to depositors in a wind-down.

### **Permanence**

- 3.5 Permanence of capital is required in Tier 1 to make sure that funds are available in times of financial stress. So, all Tier 1 capital must be undated. Otherwise investors may force the redemption of an issue at a time when the bank is least likely to have the funds available to repay the capital.

## **Characteristics of Tier 1 capital**

- 3.6 These high level principles can be translated into the key characteristics of capital to be considered when deciding whether an instrument is classified as Innovative or Core Tier 1. The characteristics of Tier 1 capital are: subordination; perpetual maturity; and the ability to defer costs by waiving coupon payments.

### **Subordination**

- 3.7 Share capital is the strongest form of capital in terms of loss absorbency. This is because there is statutory subordination under the Companies Act and Insolvency Act. Shareholders are the last to be paid out in the event of a liquidation. Instruments that are not accounted for as Companies Act shares may still meet this requirement, but only if an equivalent degree of subordination is achieved.

### **Perpetual maturity**

- 3.8 To satisfy the permanence principle, Tier 1 capital should be perpetual, subject at most to an issuer call after five years. Features which date an instrument in any way, such as an issuer call with an increase in the coupon rate (step-up), weaken the permanence of capital, and should not be included within Core Tier 1.

## Ability to defer costs

- 3.9 The ability to conserve funds in times of financial stress is essential. To meet this, the issuer should have the legal right to waive coupon payments. Features that allow missed coupons to be deferred and rolled up weaken this characteristic. Instruments with cash cumulative coupons are, therefore, not permitted in Tier 1.

## International constraints

- 3.10 In developing our approach we have considered the Basel Capital Accord and our obligation to comply with EU Directives. These set out certain ground rules, but leave some scope for interpretation – particularly in the case of the more innovative capital structures now being brought to the market.
- 3.11 ‘Own funds’ as defined under the Banking Consolidation Directive<sup>3</sup> (‘the EU Directive’) does not include the concept of ‘innovative’ Tier 1 capital. The key relevant constraints are:
- equity capital for Tier 1 purposes is defined by reference to national law, the Companies Act in the UK (that excludes instruments accounted for as liabilities);
  - Tier 1 capital should exclude cumulative preferential shares; and
  - Tier 2 capital must not exceed Tier 1 capital (net of Tier 1 deductions).
- 3.12 As already mentioned, the BCBS has issued classificatory guidance in this area. This introduced the concept of ‘innovative’ instruments. The key elements of this approach are:
- ordinary shares plus reserves and retained earnings should be the predominant form of Tier 1 capital;
  - ‘innovative’ instruments should be limited to a maximum of 15% of Tier 1 capital;
  - ‘innovative’ was defined by the Basel Committee as any ‘non-common equity Tier 1 instruments with any explicit feature – other than a pure call – which might lead to the instrument being redeemed’;
  - indirect capital issues may be included in Tier 1 only where they meet the established Tier 1 criteria (for example, issued and fully paid, non-cumulative, subordinated etc); and

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3 Directive 2000/12/EC

- moderate step-ups<sup>4</sup> with a call at a minimum of 10 years are allowable as ‘innovative’.

3.13 Although these requirements provide some helpful ground rules, there is still a need for interpretation at the detailed level. This has resulted in differing approaches being adopted by overseas regulators. Mindful of our obligation to have regard to the UK’s competitive position, we have taken these different approaches into account in developing these proposals.

## Accounting treatment

3.14 We base our regulatory valuations on accounting standards, except where there are good reasons to deviate. For the definition of capital, we are required to follow accounting standards to meet the EU Directive minimum. EU Directives require a minimum capital ratio of 8% and a Tier 1 capital ratio of 4%. The 4% Tier 1 minimum requirement must be fulfilled by instruments that are regarded as equity or reserves under national law. If the instrument is not treated under UK law as share capital or reserves, it cannot count towards the EU Directive 4% minimum requirement for Tier 1.

3.15 Beyond this, we have some scope to deviate where this would help us to take account of the underlying characteristics of capital. In the case of Tier 1, we propose to focus on the economic substance of capital instruments, rather than the accounting form, where a bank holds capital in excess of the EU Directive minimum. If the instrument is accounted for as a liability it may qualify for Core Tier 1 treatment provided it has the same economic substance as a preference share.

## Features of Tier 1 capital

3.16 We have used the high level principles and characteristics of capital, and our international obligations in this area, to develop our Tier 1 framework. This is reflected in a decision chart included in Annex C as Appendix 14, to help the industry to classify Tier 1 instruments. This chart is partly subjective, but is designed to provide guidance to aid consistent outcomes. It is not designed to generate definitive answers in a purely mechanical way, since to do so would require a degree of prescription that may impede market development. The continuing evolution of the capital markets means that no framework will provide a definitive answer in all situations.

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4 Defined as an increase over the initial coupon rate of no more than either:  
 (a) 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or  
 (b) 50% of the initial credit spread less the swap spread between the initial index basis and the stepped up basis.

## Key recommendations

- 3.17 Although the concepts above are not new (and indeed, most are already reflected in IPRU(Banks)), we have made several key recommendations as set out below.
- 3.18 Proposals that *clarify* existing policies.

### **The characteristics of Tier 1 capital.**

- 3.19 Capital provides a buffer that enables a bank to absorb losses without the interests of the depositors being adversely affected. To meet this role, capital must be able to absorb losses, and must be available permanently. We have built on the high level principles and characteristics of capital, and our international obligations in this area (Basel and EU), to develop our Tier 1 framework. This is reflected in a decision chart, attached as Appendix 14 in Annex C, to help the industry to classify Tier 1 instruments. The resulting amendments to IPRU (Banks) can be found in Annex C, CA: Section 2.2.

**Question 3.1:** Is assessing the features of specific instruments against the required characteristics of Tier 1 capital in the form of a decision chart a realistic and efficient way to classify capital within Tier 1?

**Question 3.2:** Are there any additional features that would have the same effect on permanence as an issuer call with a step-up and should be included in our framework?

### **Innovative instruments are subject to a 15% limit as in the Basel 1998 press release.**

- 3.20 In line with our existing implementation of Basel requirements, innovative instruments may be included in Tier 1 capital subject to a limit of 15%. This cap applies to the total of Core Tier 1 plus Innovative Tier 1 minus Tier 1 deductions. To calculate the amount of allowable Innovative Tier 1 capital the amount of Core Tier 1 capital is multiplied by 17.65%. This number (17.65%) is derived by dividing 15% (allowable Innovative Tier 1 capital) by 85%. Although banks are free to issue innovative instruments in excess of the 15% limit, these will not be counted in the Tier 1 capital calculation, but may be included in Tier 2, provided the Tier 2 requirements are met. For a worked example of the 15% innovative limit, see Appendix 15 in Annex C. The resulting amendments to IPRU (Banks) can be found in Annex C, CA: Section 4.2.3.

### **All indirect Tier 1 issues should be treated as innovative due to our concerns about legal and operational risk.**

- 3.21 We propose to retain our existing policy that all indirect issues of Tier 1 capital should be classified as innovative. We recognise that some overseas supervisors allow indirect issues without step-ups to be included within Core

(non-innovative) Tier 1. Our approach reflects concerns about the operational risk arising from these cross-jurisdictional structures, and is, we believe, a reasonable interpretation of the BCBS's policy. We are also proposing to clarify our existing policy, that for capital raised indirectly to qualify as (innovative) Tier 1, the bank must show that the criteria for solo consolidation are met. The resulting amendments to IPRU (Banks) can be found in Annex C, CA: Section 5.1.4(e).

**Stock settlement of principal should be limited to Innovative Tier 1, limiting the potential to create a synthetic maturity in a Core Tier 1 instrument.**

- 3.22 There has recently been much debate, in the UK and elsewhere, about the appropriate treatment of instruments which allow for the redemption of the principal amount of preference shares or capital instruments in exchange for alternative capital of the issuer (stock settlement of principal). We recognise the benefits of this feature: it should not result in a reduction in the quantity of capital and, when exercised, could improve the quality of capital.
- 3.23 However, the number of shares that would have to be issued to redeem the principal amount of a preference share or capital instrument would probably be large enough to create investor expectations that the bank would exercise its call, thus creating a synthetic maturity. This pressure to call could be exacerbated at a time of financial stress, when the bank's access to the capital market may already be restricted.
- 3.24 In addition, principal stock settlement of an issue of preference shares or capital instruments could have a substantial impact on the supply and demand for a bank's capital, and consequently on its cost of capital. Stock settlement of principal could result in the issue of new capital that is exchanged for the preference shares or capital instrument, with the bank using the proceeds of the issue to pay cash to the preference share or capital instrument holders. Issuing new capital, to redeem the preference shares or capital instruments, during a period of financial stress could lead to a further deterioration in the bank's ability to access the capital market.
- 3.25 We therefore propose that Tier 1 instruments that include limited principal stock settlement features should only be allowable for inclusion in Innovative Tier 1 subject to a redemption limit. This limit could take the form of a restriction on the percentage dilution (of capital), or of a fixed redemption ratio with a maximum allowable increase in the ratio set at the time of issue. We propose a limited increase of 200% in the redemption ratio set at the time of issue. For example, if the redemption ratio at the time of issue was 2:1 the maximum ratio on redemption would be 4:1. A worked example is included in Appendix 15 in Annex C.

3.26 It has also been our policy that where principal stock settlement features are included in Tier 1 capital, banks should ensure that they hold an appropriate buffer of authorised capital to fulfil their potential obligations under these issues. We propose to formalise this expectation by including guidance to this effect within IPRU (Banks). The resulting amendments to IPRU (Banks) can be found in Annex C, CA: Section 5.1.4(c)b)i).

**Question 3.3:** Is a fixed ratio a better means of limiting principal stock settlement in Innovative Tier 1 than percentage dilution; and is the suggested maximum amount that the redemption ratio (of 200%) can be exceeded at a level that does not create undue pressure to call? If not, please suggest specific alternatives.

3.27 Proposals that represent a *tightening* of existing policy.

**Tier 1 capital should consist predominantly of ordinary shares, associated reserves and retained earnings.**

3.28 To highlight the importance of the underlying principles of loss absorbency and permanence, we are proposing a new requirement that Tier 1 capital should consist predominantly of ordinary shares, associated reserves and retained earnings. In practice predominance will usually be taken to mean 50% or more of total Tier 1 capital (net of Tier 1 deductions). The resulting breakdown of total Tier 1 would therefore be:

- minimum 50% ordinary shares, associated reserves and retained earnings; and
- maximum 15% innovative instruments, for example, instruments with an allowable step-up.

3.29 The new minimum limit on ordinary shares, associated reserves and retained earnings could potentially restrict the issuance of Tier 1 preference shares for some banks. In the event that any bank is already in breach of the proposed limit, we would grandfather existing positions. To minimise any adverse impact on competition that this may have, we would only grandfather specific issues in excess of the limit, rather than the breach of the requirement itself. This would prevent banks from avoiding meeting the 50% limit indefinitely through the re-issuance of grandfathered preference shares.

3.30 On balance we believe that, given the dynamic nature of innovative and other capital instruments being developed, the minimum of 50% ordinary shares, associated reserves and retained earnings is prudent and outweighs the negative consequences. It meets industry requirements for flexibility while underlining the importance of the loss absorbency and permanence of Tier 1 capital. The remainder of Tier 1 capital may consist of preference shares, capital instruments and innovative instruments. This proposal is compliant

with Basel. The resulting amendments to IPRU (Banks) can be found in Annex C, CA: Section 5.1.3.

See Question A.5 in Annex A - Costs and benefits.

3.31 Proposals that represent a *relaxation* of existing policy.

**Reducing the Tier 1 limit that banks must meet before issuing innovative capital from 6% to 4%.**

- 3.32 Our current policy is that to prove that it is ‘well-capitalised’, a bank must have a Core Tier 1 ratio (solo and consolidated) of at least 6% before it is allowed to include Innovative Tier 1 capital as part of total Tier 1 capital.
- 3.33 We recognise that the UK is super-equivalent to other national supervisory authorities in imposing a 6% well-capitalised test, and that this test has proved to be a constraint in the context of acquisition and merger discussions. So, we propose to adjust the existing test by setting the Core Tier 1 threshold at the EU Directive 4% minimum. The focus will be on banks to ensure that they have a proper capital plan in place, which will include an appropriate Individual capital ratio (ICR), as outlined in our Policy Statement ‘Individual Capital Ratios for Banks’.
- 3.34 We consider that the basic 8% regulatory minimum capital requirement is only appropriate for a well diversified bank whose business, management, systems and controls are strong and where the risks that it is exposed to are captured adequately by the existing capital model. Where we consider that an institution does not satisfy these conditions, we determine an appropriate ICR above the 8% minimum to mitigate the additional risks.
- 3.35 The basis of this calculation is that the 4% Tier 1 ratio must be met using Core (non-innovative) Tier 1 capital net of Tier 1 deductions. Instruments that are accounted for as liabilities may not be included in Core Tier 1 for the purposes of meeting this limit, as explained in paragraphs 3.14 and 3.15 above.
- 3.36 A shortfall in the minimum 4% Core Tier 1 limit would result in a reduction in the amount of allowable Innovative Tier 1 to zero, as well as a reduction in allowable Tier 2 capital. Innovative Tier 1 capital that is disallowed, because of a reduction in Core Tier 1, could be moved into a reduced Upper Tier 2. Any resulting excess Tier 2 capital could not be included in the capital calculation (except for banks that are able to use Tier 3 capital to cover market risk). In the case of such a shortfall, we would require a bank to put in place an appropriate remedial plan to rectify the shortfall. Our focus will be on ensuring that the shortfall in the 4% minimum Core Tier 1 ratio, and any shortfall in the ICR, is made up. The resulting amendment to IPRU (Banks) can be found in Annex: C, CA: Section 5.1.5.

### **Eliminating the 60% Tier 1 repayment test.**

- 3.37 This test requires a bank to have enough Tier 1 capital to cover 60% of its individual capital ratio after any repayment of Tier 1 capital. The proposal to remove this test is in keeping with our emphasis on senior management responsibility for capital planning, rather than on prescriptive tests. In future, any repayment of Tier 1 capital will be assessed in the context of a bank's wider capital plan as required in IPRU (Banks). The resulting amendment to IPRU (Banks) can be found in Annex C, CA: Section 12.1.1.

### **Recognising that capital instruments that are economically equivalent to preference shares could be eligible for Core Tier 1 treatment.**

- 3.38 We recognise that there may be instruments that, while not accounted for as preference shares, are equivalent to preference shares in terms of subordination, permanence and ability to defer costs. So we propose that these capital instruments<sup>5</sup> be treated in the same way as preference shares for the purposes of classifying Tier 1 capital. The resulting amendment to IPRU (Banks) can be found in Annex C, CA: Section 5.1.4.

**Question 3.4:** Are the proposals to relax existing policy in paragraphs 3.32 to 3.38 appropriate?

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<sup>5</sup> Capital instruments may include instruments which are in all ways economically equivalent to preference shares. Such instruments need not be accounted for as preference shares.

# 4 Compatibility with our general duties

## Compatibility with the statutory objectives

### Introduction

- 4.1 The purpose of this section is to give a statement of our reasons for concluding that the proposed changes to IPRU (Banks) are compatible with our general duties under section 2 of the FSMA. The requirement for this statement is in sections 155(2)(c) and 157(3) of the FSMA, and the cost benefit analysis is set out in Annex A. One of the objectives of this CP is to provide clarification of the existing policy on Tier 1 capital, but we have also included several new proposals. In this section, and in our cost benefit analysis, we treat the clarification of existing policy and the new proposals as a package.

### Our statutory objectives

- 4.2 Our policy on Tier 1 capital is aimed principally at meeting our market confidence and consumer protection objectives.

### Market confidence

- 4.3 One of the key objectives of the guidance proposed in this CP is to reduce the probability of market disruption caused by the prudential failure of a single bank or a group of banks. It aims to achieve this by giving clear and transparent guidance that seeks to ensure that an appropriate proportion of a bank's capital is held in a form that provides maximum protection in terms of loss absorbency and permanence. So it should reduce the probability that banks fail as a result of suffering unexpected losses. Also, the increased clarity about how our policy applies in this area should facilitate smoother operations in the relevant capital markets. In this context it is important to note that we do not have a zero failure policy and that any proposals must be proportionate to the risks.

### **Consumer protection**

- 4.4 The second key objective of the proposed guidance is to reduce the probability of consumers suffering losses because of prudential failure. Similar to the market confidence objective, the guidance seeks to ensure that banks hold an appropriate, high quality buffer of capital to absorb unexpected losses without depositors being adversely affected. It is also intended to provide a degree of consumer protection in the event that a bank does fail, since the holders of those capital issues are the last to be paid out in a liquidation.
- 4.5 Our proposals are aimed at improving the quality of capital, thereby offering extra protection to depositors and other consumers in the case of a prudential failure. We believe that our proposals, which focus on the quality rather than the quantity of capital, are proportionate to the risks to consumers of not implementing the framework outlined in this CP.
- 4.6 Section 5(2) of the FSMA requires us to have regard to the differing degree of risk to consumers involved in different kinds of investments or transactions, their differing degree of experience and expertise, their need for advice and information as well as their responsibility for their own decisions. Material about the make-up of capital is not the type of material that distinguishes between different types of consumer of the same firm. Our proposals do not distinguish between firms with different types of customers as the proposals represent basic standards that we think should apply to all firms to which the IPRU (Banks) applies.

### **Public awareness**

- 4.7 Our proposals are not specifically aimed at increasing public awareness; however we believe that they will provide increased clarity for banks and their advisers as to how our policy applies in this area.

### **Reduction of financial crime**

- 4.8 We do not believe that our proposals have any material impact on this objective.

### **Compatibility with the need to consider the principles of good regulation**

- 4.9 Section 2(3) of the FSMA requires us to consider certain principles when carrying out our general functions.

### **The need to use our resources in the most efficient and economic way.**

- 4.10 Our proposals aim to provide a transparent framework that builds on the underlying principles, or characteristics, of Tier 1 capital. We have tried to

strike the correct balance between prescription, which provides certainty but quickly becomes outdated, and flexibility to accommodate market developments. We believe that the proposed framework should provide consistent outcomes, but will not provide a definitive answer in every situation.

**The responsibility of those who manage the affairs of authorised persons.**

- 4.11 The increased transparency resulting from these proposals should enable senior management to make informed choices in their capital planning. Reducing the Tier 1 limit that banks must meet before issuing innovative capital and eliminating the 60% Tier 1 repayment test highlights senior management responsibility for capital planning.

**The principle that a burden or restriction, which is imposed on a person or on the carrying out of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from imposing of that burden or restriction.**

- 4.12 We have an obligation under sections 155 (2)(a) and 157(3) to publish a cost benefit analysis (CBA) when proposing new guidance. The CBA in Annex A to this paper shows that overall the burdens or restrictions arising from these proposals are proportionate to the benefits.

**The desirability of facilitating innovation connected with regulated activities.**

- 4.13 We recognise the importance of facilitating innovation in Tier 1 capital and this has been one of the key considerations in developing these proposals. Capital products of this sort are constantly evolving, and any framework that is highly prescriptive or reactive would restrict innovation and, potentially, limit access to good quality capital and quickly become outdated. As noted above, we have tried to design a framework to recognise innovation in Tier 1 capital. By avoiding excessive detail in the decision chart we believe that the proposed framework will better stand the test of time in an evolving market. In designing the framework we have attempted to counterbalance the need to facilitate innovation by making sure that the quality of Tier 1 capital is not diluted.

**The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom.**

- 4.14 Although EU directives and Basel set out certain requirements that govern our approach in this area, there remains a need for interpretation at the detailed level. So in developing our approach, we have drawn on those adopted by overseas regulators. For historical and legislative reasons, certain types of instruments are allowed for inclusion in Tier 1 in some countries and disallowed in others. Our proposals are more restrictive than certain regulators in some respects. For example, our proposal that indirect issues

through Special Purpose Vehicles (SPVs) should not be included in Core Tier 1 reflects our concerns about the additional operational risks, especially legal risks, these structures involve.

- 4.15 The proposals are less restrictive in other areas. For example, where an instrument is accounted for as a liability, but economically equivalent to preference shares, we would not automatically classify it as Innovative Tier 1.
- 4.16 Our proposals would remove two areas of UK super-equivalence, in the reduction of the Tier 1 limit required prior to issuing innovative instruments and the elimination of the (60%) Tier 1 repayment test.
- 4.17 So, on balance, we believe that our approach will maintain the competitive position of the UK, taking into account both international regulatory requirements and the particular characteristics of the Tier 1 capital market.

**The need to minimise the adverse effects on competition that may arise from anything done in the discharge of our functions.**

- 4.18 The proposals in this CP are designed to provide greater clarity and transparency about classifying Tier 1 capital for regulatory purposes, while avoiding a purely prescriptive approach. This should facilitate a more level playing field among banks wishing to bring new or innovative Tier 1 instruments to the market. Although issuers may still need to discuss the specifics of certain instruments with us, the increased clarity in our approach should give all banks equal access to the information needed to develop instruments that are likely to meet our requirements. In our view, the potential benefits of the increased scope to issue higher quality and cost efficient Tier 1 capital justifies a less prescriptive approach.

**The desirability of facilitating competition between those who are subject to any form of regulation by us.**

- 4.19 The current lack of clarity about how new or innovative capital products should be treated for regulatory purposes may impede competition in the capital markets. Stating our expectations clearly should allow the industry to develop capital plans in an efficient manner and with confidence that our guidelines apply equally to all banks. The decision chart included in our proposals will be widely circulated and has already been reviewed by the industry during the pre-consultation phase. We believe that our proposals provide greater clarity, so facilitating competition between regulated banks.
- 4.20 An advantage of a less prescriptive approach is that competition between issuers becomes focussed on the characteristics of the issue rather than on particular features that technically meet our requirements. This emphasis on the quality of capital (loss absorbency or permanence), rather than on the technical details of the structure, will help to promote equal access to Tier 1

capital markets for all UK banks.

- 4.21 Although at this stage these requirements will only apply to banks, we propose to consult on their inclusion within the PSB<sup>1</sup> in due course, so ensuring, as far as appropriate, the same approach across all sectors.

**The most appropriate way to meet our objectives.**

- 4.22 We are required to set out clearly why we think our proposed standards are not just one way to meet our obligations, but are the most appropriate way.

- 4.23 In developing our approach we considered three key options:

- Maintaining the status quo. Rather than updating IPRU (Banks), we could continue to advise banks of how our policy applies in this area through individual guidance. Given market developments in this area over recent years, our stated policy (as reflected in IPRU(Banks)) is already outdated. To continue to rely on individual guidance lacks transparency and is potentially anti-competitive. As such, this approach would not be in keeping with our objective of including all guidance of a continuing nature in the Handbook.
- Developing detailed prescriptive standards. As explained above, this approach would provide clarity and transparency, and should ensure consistent outcomes. However, given the pace of market innovation in this area, a detailed prescriptive approach could quickly become outdated and could therefore impede market developments, so limiting banks' access to good quality capital markets.
- Developing a framework that builds on the underlying principles, or characteristics, of Tier 1, while avoiding being overly prescriptive.

These options are discussed further in Annex A: Costs and benefits.

- 4.24 In our view, this third option is the most appropriate way to meet our objectives because it:

- maintains the integrity of good quality Tier 1 capital;
- provides increased clarity and transparency;
- enables banks to raise cost efficient Tier 1 capital;
- should help to ensure consistent outcomes; and
- keeps enough flexibility to facilitate innovation.

- 4.25 For these reasons, we believe our proposals are compatible with our regulatory objectives and represent the most appropriate way of meeting them.

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1 See CP97 issued June 2001



# Costs and benefits

## Introduction

- A.1 Section 157 of the FSMA requires us to undertake a cost benefit analysis of our proposed general guidance and to publish the results. Under section 155(8), this analysis is not required if the costs arising from the proposed guidance would be no more than those arising from the existing requirements, or if any cost increase is of minimal significance.
- A.2 We believe that overall the benefits arising from our proposals outweigh the costs. The following discussion outlines the costs and benefits to the extent that they are quantifiable. Compliance costs and benefits are dealt with from the point of view of banks. Benefits to the capital market and consumers are also dealt with, but not quantified.
- A.3 The principal cost arising from these proposals could be an increased cost of capital, primarily for those UK banks that are active in the Tier 1 market. Although our proposal for a predominance of ordinary shares, associated reserves and retained earnings could potentially affect all UK banks, we have focussed on the 10 UK banks most active in this market in attempting to quantify the cost of our proposed:
- requirement for a predominance of ordinary shares, associated reserves and retained earnings in Tier 1; and
  - limit on the capital issues or instruments, which could qualify for Core Tier 1 treatment.
- A.4 All costs, however, are estimates based on broad assumptions about the amount of innovative instruments banks would choose to issue and that the market would be able to absorb. Neither the individual capital needs of banks nor market conditions are fixed, limiting our ability to derive an exact number.
- A.5 The benefits of our proposals are largely unquantifiable, although we believe that the clarity and transparency of a flexible framework to classify Tier 1 issues could result in an overall increase in the Tier 1

capitalisation of UK banks. The benefits of increased issuance of higher quality capital depends on the capital requirements of individual banks and the receptivity of the market to new issues.

- A.6 Any cost benefit analysis of Tier 1 capital relies on striking a balance between increasing the absolute amount of Tier 1 capital (strengthening the UK banking system), and the risk of diluting the quality of Tier 1 capital (possibly weakening the capital position of UK banks).

## Policy goals

- A.7 Our aim is to provide a clear framework for Tier 1 capital, without constricting issuance of new capital, and to ensure that Tier 1 capital retains the highest level of loss absorbency and permanence without unduly limiting product innovation. Requiring a predominance of ordinary shares, associated reserves and retained earnings, and limiting the instruments that receive Core Tier 1 treatment, could result in a higher cost of funds for the industry. The benefit is high quality Tier 1 capital that promotes confidence in UK banks and protects consumers.

## Policy options

- A.8 In developing these proposals, we have considered three key options.
- First, we could do nothing and continue to assess Tier 1 instruments on a case-by-case basis as we do currently.
  - Second, we could develop prescriptive and inflexible guidelines that would provide the maximum amount of clarity but would be likely to restrict innovation.
  - Third, we could aim to develop a middle ground approach that aims to provide clarity while avoiding detailed prescriptive requirements.
- A.9 The first option is the status quo. Not introducing the proposal in this CP could result in the overall quality of Tier 1 capital suffering. Without the clarity and transparency of the proposed framework, raising capital could become a longer and more cumbersome process as issuers, their advisers and we would have to assess each proposed instrument case-by-case.
- A.10 As discussed earlier in Chapter 2, we believe our stated policy (as reflected in IPRU (Banks)) is already outdated. Continuing to rely on individual guidance lacks transparency and does not serve the interests of either the industry or us. Such an approach is not in keeping with our objective of including all guidance of a continuing nature in the Handbook.
- A.11 The second option of a prescriptive, and so more inflexible, set of guidelines would provide the highest level of clarity. It is possible that a prescriptive framework would in the short run, benefit those issuers with the resources to use

advisers to develop structures that incorporate the specific features outlined in the framework, but nevertheless do not meet the characteristics of Tier 1 capital. The effect could be a bias to structure technically correct (Tier 1) instruments that do not provide the degree of loss absorbency and permanence required in the highest form of capital.

- A.12 Another disadvantage of a prescriptive set of guidelines is that issuance of Tier 1 capital may be reduced because of the restrictive nature of the framework. Although this option might maintain a high quality of capital in Tier 1, it could not accommodate new and innovative structures that provide the required loss absorbency and permanence but were not envisaged at the time of developing these proposals. As markets develop, it is important that the guidance included in IPRU (Banks) is flexible enough to encompass new structures, without the need for continuous revision. Furthermore, we intend that in due course our proposed framework will be applied to insurers, investment firms and building societies. A more prescriptive framework is not likely to be easily applicable to a diverse range of firms.
- A.13 In this CP, we have attempted to strike a balance that gives us the flexibility to assess Tier 1 capital issues on an individual basis when required, yet gives the clarity and transparency that are inherent in the statutory objectives and the principles of good regulation. We believe that the third option provides the best solution to the problems presented by assessing issues on a case-by-case basis, and those posed by a set of prescriptive guidelines.
- A.14 When assessing instruments on a case-by-case basis, each feature of the issue must be considered in terms of its implications within that particular structure, as well as compared to previous instruments, for both positive and negative precedents. With an agreed framework in place, the parameters are narrowed and it becomes easier for us and issuers to focus on the features that are required in a Tier 1 instrument. However, we recognise that the resulting clarity in the definition of Core and Innovative Tier 1 may result in a higher cost of funds for some issuers, as certain instruments are clearly excluded from Core Tier 1.
- A.15 With highly prescriptive guidelines, the focus would shift to technical structures that are devised to meet the short-term needs of a particular issuer. Decisions on one particular structure could create a negative precedent for future instruments developed for a different issuer. In both cases (case-by-case assessment or prescriptive guidelines), the final result could be policy by precedent. Developing policy by precedent tends to favour the ‘first mover’, while a transparent framework is more likely to result in a level playing field.
- A.16 We believe that our proposed framework will result in an environment that encourages a qualitative rather than a quantitative approach to Tier 1 capital. As a result, we do not believe that super-equivalent requirements such as the 6% minimum requirement for Core Tier 1 prior to issuing innovative instruments, or the 60% repayment test are required. Due to the requirements imposed by Individual Capital Ratios, banks are not likely to start issuing innovative instruments with only 4% in Core Tier 1, resulting in minimal impact on their cost of funds. In addition, our emphasis on capital planning provides, we believe, a better means of ensuring the quality of Tier 1 capital than the 60% repayment test.

## Compliance costs

A.17 The cost analysis focuses on the costs arising as a result of our proposals.

### *Cost of funds - 50% ordinary shares, associated reserves and retained earnings requirement*

A.18 We have estimated the potential cost to issuers of our proposal to require a predominance of ordinary shares, associated reserves and retained earnings in total Tier 1, net of Tier 1 deductions. To do this we have used the Tier 1 capital of the 10 UK banks most active in the market, although this proposal could affect all UK banks. We focused on the 10 UK banks that would be primarily affected because of their ability to access the Innovative Tier 1 market. We also worked out the cost of issuing ordinary shares. To do this we used industry estimates of a 225 basis point increase in cost for ordinary shares over traditional preference shares, resulting in an annual cost of £2.25 million for each additional £100 million of ordinary shares issued. The present value of an annual cost of £2.25 million discounted at a rate of 8% over 10 years is £15.1 million.

A.19 However, we believe that our requirement for a predominance of ordinary shares, associated reserves and retained earnings in Tier 1 would not currently oblige banks to issue additional ordinary shares. The total Tier 1 capitalisation of all UK banks is approximately £118 billion and the 10 UK banks most active in the market account for about £88 billion, or 76% of the total. As this requirement is calculated based on Tier 1 net of Tier 1 deductions, all 10 of these UK banks currently have well over 50% of Tier 1 in ordinary shares, associated reserves and retained earnings.

A.20 This cost estimate is based on the assumption that 100% of any requirement to increase ordinary share capital would be met by issuing ordinary shares and that none of the increase would be derived from increased reserves or retained earnings. Also, it is our understanding that market forces would ensure that banks' ordinary shares did not fall below 50% of Tier 1 capital, as credit rating agencies expect no more than a certain amount of preference shares in a bank's capital structure. So, we believe that this proposal will result in significantly lower costs for banks than the estimates given in paragraph A.18.

**Question A.5:** Do you agree that our proposal for a predominance of ordinary shares, reserves and retained earnings would not result in significant additional costs for banks?

## Benefits

A.21 The benefits analysis focuses on the benefits arising from our proposals.

### *Lower cost of funds - capital instruments*

A.22 We have allowed for the possibility that capital instruments that are economically equivalent to preference shares but treated as a liability on the balance sheet, could be treated as Core Tier 1 capital. So we have estimated the benefits for the 10 UK banks most active in the market as in the Compliance costs section above. This treatment could allow banks to issue more cost efficient instruments without

using an indirect structure and so price the instrument at a lower cost. We used industry estimates of an 85 basis point difference in cost of funds between Core and Innovative Tier 1 instruments as a proxy for the cost saving to the industry of issuing capital instruments. The result is an annual benefit of £850,000 per £100 million Core Tier 1 issued. The present value of the annual benefit discounted at 5.75% over 10 years is £6.3 million.

### *Quality*

A.23 Our proposals maintain the integrity of good quality Tier 1 capital. The focus on the high level principles, in particular loss absorbency and permanence in Tier 1, should reduce the probability of market disruption and consumer loss because of prudential failure. Our proposed requirement for a predominance of ordinary shares, associated reserves and retained earnings in Tier 1 should require banks to maintain the integrity of Tier 1 capital. By using a framework that accommodates innovation while maintaining adherence to the high level principles, capital market participants will be more confident that UK banks will be able to respond to both systemic and issuer specific downturns.

### *Provides increased clarity and transparency*

A.24 A clear and transparent framework for classifying Tier 1 capital will allow banks and their advisers to bring new issues to the market with increased certainty as to their capital treatment. In time critical situations such as mergers and acquisitions, this framework should provide increased certainty that proposed structures will meet Tier 1 requirements.

### *Efficiency of competition*

A.25 Our proposals enable banks to raise cost efficient Tier 1 capital. In most cases, the proposed framework will enable issuers and their advisers to ascertain readily the capital treatment of a Tier 1 instrument and therefore bring Tier 1 instruments to the market in a timely manner. This creates a level playing field, allowing all banks to assess well in advance the likelihood of Core Tier 1 treatment of a new issue.

### *Should help to ensure consistent outcomes*

A.26 The decision chart (Appendix 14 in Annex C) should help to ensure consistent outcomes as it is based on the proposed framework outlined in this CP. Assessment on a case-by-case basis or a highly prescriptive approach can both result in policy by precedent. Following a precedent set on a particular instrument issued by one bank may not result in a consistent outcome if decisions are not based on the high level principles. This decision chart will be included in IPRU (Banks) as Appendix 14 to the CA chapter.

### *Retains sufficient flexibility to facilitate innovation*

A.27 A flexible framework should encourage issuance of Core Tier 1 capital. Greater flexibility in Core Tier 1 treatment will make it easier for banks to broaden their capital base by providing access to a wider investor base. This should increase the diversity and overall amount of capital in the system. Better capitalised UK banks increase confidence in the financial system, and benefit consumers.

## **Conclusions of cost benefit analysis**

A.28 Promoting consistency of treatment among issuers of Tier 1 capital should result in overall benefits to the industry. A more prescriptive framework than the one we are proposing might be more efficient as it would leave less room for interpretation. However, we believe that by adopting a flexible framework innovation will be facilitated and both the quality and quantity of Tier 1 capital will benefit. In summary, we believe that our framework is most likely to help us meet the statutory objectives of consumer protection and market confidence.

**Question A.6:** Do you agree with the costs and benefits of our proposals?

# List of questions in this CP

**Question 3.1:** Is assessing the features of specific instruments against the required characteristics of Tier 1 capital in the form of a decision chart a realistic and efficient way to classify capital within Tier 1?

**Question 3.2:** Are there any additional features that would have the same effect on permanence as an issuer call, step-up or increase in coupon and should be included in our framework?

**Question 3.3:** Is a fixed ratio a better means of limiting principal stock settlement in Innovative Tier 1 than percentage dilution; and is the suggested maximum amount that the redemption ratio (of 200%) can be exceeded at a level that does not create undue pressure to call? If not, please suggest specific alternatives.

**Question 3.4:** Are the proposals to relax existing policy in paragraphs 3.32 to 3.38 appropriate?

**Question A.5:** Do you agree that our proposal for a predominance of ordinary shares, reserves and retained earnings would not result in significant additional costs for banks?

**Question A.6:** Do you agree with the costs and benefits of our proposals?



## Annex C

### Amendments to material in the Interim Prudential Sourcebook: Banks

## 2 THE NATURE OF CAPITAL

### 2.1 The role of capital

1 From a **supervisory** perspective capital provides a buffer that enables a bank to absorb losses without the interests of the depositors being adversely affected.

2 For a **bank** the different forms of capital offer a flexible source of funding, since most elements include either a statutory or a contractual right to cancel or defer dividend (or interest) payments on share (or loan) capital. In difficult times, therefore, capital can be a comparatively cheap funding source; though to compensate for this, shareholders will expect a higher dividend when a bank is doing well.

### 2.2 The nature of capital

3 In order to perform this role, capital should have the following characteristics:

(a) It should be able to **absorb losses** before, or instead of, general creditors. ~~This can be done in two ways: (i) Where the bank has ceased to be a going concern, the holders of capital instruments are the last to be paid out in a liquidation.~~

~~(i) The bank can have negative reserves, as long as these do not exceed the book value of the shares issued, while the bank continues to trade and remains solvent.~~

(b) ~~The core elements of capital (Tier 1) capital~~ should have **no fixed costs**, i.e. there should be no contractual obligation to pay dividends on equity, and there may be a contractual right to defer interest payments ~~on subordinated loan capital.~~

a) The FSA does not generally allow banks to count as supervisory capital issues where the interest rate paid on subordinated debt increases when a bank becomes less creditworthy, e.g. after a credit rating downgrade.

(c) Capital should be **fully paid up**, i.e. the bank should be in possession of the funds. Guarantees and other forms of contingent liabilities should not be included in capital.

See s5.1

(d) A bank should not normally purchase and hold its own capital, or subsidise its capital holders (e.g. through soft loans or swaps).

See s10.2 & 10.3

a) In certain circumstances a bank may purchase its own capital, e.g. through trading activities, or through buy-back schemes sanctioned by the FSA. Such holdings should be deducted from capital, except where a trading book concession has been granted.

### 2.3 Types of capital

4 For supervisory purposes capital is split into three categories: Tier 1, (core and innovative) Tier 2 (upper and lower) and Tier 3. These categories represent different instruments' quality as capital, i.e. the degree to which each type of capital fulfils the characteristics stated above.

See s5

5 **Tier 1 capital forms** is a bank's core highest quality capital. ~~It takes two forms~~– It is divided into Core Tier 1 and Innovative Tier 1 capital. Instruments that meet all of the characteristics set out in paragraph 1 of Section 4.2 will normally be classified as Core Tier 1. Features that weaken these characteristics in any way would usually lead to classification as Innovative Tier 1 (or Tier 2).

(a) Examples of features that may lead to classification as Innovative, rather than Core Tier 1 include: indirect issuance, step-ups (increases in the coupon paid) and stock settlement of principal.

6 Tier 1 may be issued ~~capital and~~ or internally generated capital.

(a) Issued capital (e.g. share capital) is *perpetual* and returns are *non-cumulative*, as well as having the characteristics detailed above.

a) The *perpetual* (i.e. undated) nature of Tier 1 capital ensures that it can provide an on-going source of funding to the bank until the point where the bank becomes insolvent, or ceases trading.

b) *Non-cumulative* means that should the bank decide not to make a dividend payment, the dividend is not deferred, but cancelled. This ensures that the capital has no fixed costs.

(b) Internally generated capital arising from accruing profit to reserves, or by capitalising dividends.

*(With the exception of the change to the numbering of headings, the remainder of CA: Section 2 is unchanged.)*

## 4 ELEMENTS OF A BANK'S CAPITAL BASE

### 4.1 Introduction

This section summarises the constituent elements of the various tiers of capital which a bank may include in its *capital base* for supervisory purposes. Explanations and details of the constituent elements are given in the following sections.

See ch LE s4

The information below relates to the calculation of a bank's *capital base* for capital adequacy purposes. The differences in the calculation of the large exposures capital base are covered in the chapter on large exposures.

a) A bank's *capital base* is the total of Tiers 1, 2 and 3 capital available for fulfilling capital requirements after all necessary deductions have been made, subject to the various limits that apply to the different tiers.

See ch CO

b) The calculation of a bank's capital adequacy is covered in the overview chapter.

### 4.2 Tier 1 —~~core~~ capital

#### 1 High level principles underlying Tier 1 capital

Tier 1 capital must be able to absorb losses and be available permanently. In order to meet these underlying principles Tier 1 capital should have the following characteristics:

(a) it should be subordinated (e.g., all Tier 1 instruments whether Core or Innovative are expected to be fully subordinated to absorb losses on a going concern basis);

(b) it should be perpetual (e.g., it should be undated); and

(c) it should be non-cumulative (e.g., there should be no obligation to make coupon payments).

See s5

12 Core Tier 1 (~~or core~~) capital consists of:

See s5.1

(a) Permanent share capital:

(i) Allotted, called up and fully paid ordinary share capital/~~common stock~~.

See s10.1

a) This should be net of any own shares held.

(ii) Perpetual non-cumulative ~~preferred (or preference)~~ shares and capital instruments, including such shares redeemable at the option of the issuer but with the FSA's prior consent, and such shares convertible into ordinary shares.

a) Capital instruments include instruments which are in all ways economically equivalent to preference shares. These capital instruments should be equivalent to preference shares in

terms of subordination, permanence and the ability to defer costs. Such instruments need not be accounted for as preference shares.

See s5.2

- (b) Reserves in the form of general and other reserves created by appropriations of retained earnings, share premia and other surpluses.

See s5.3

- (c) Retained profit and loss arising during the course of the current year where verified by a bank's external auditors.

- a) This should be net of tax, anticipated dividends and other appropriations.

See s5.4

- (d) Minority interests arising from consolidation in permanent shareholders' equity.

- a) This applies, where there are minority interests, in the calculation of the solo-consolidated and consolidated capital base only.

3 Innovative Tier 1 capital consists of instruments which incorporate certain features, the effect of which is to weaken (but only marginally) the key characteristics of Tier 1 capital. Innovative Tier 1 capital is subject to a limit of 15% of total Tier 1 capital after Tier 1 deductions.

See s10.1

24 In calculating a bank's capital base, a number of deductions should be made from Tier 1:

- (a) All holdings of own shares.
- (b) Goodwill and other intangible assets.
- (c) Current year's unpublished net losses on the banking and trading books when taken together.

- a) For non-CAD banks the deduction is current year's unpublished net losses.

- (d) Fully paid shareholders' equity issued after 1 January 1992 by the capitalisation of property revaluation reserves.

*(The remainder of CA: Section 4 is unchanged.)*

## 5 TIER 1 CAPITAL

This section provides detail on the constituent elements of Tier 1 capital. The decision chart provided in Appendix 14 is designed to assist in the classification of instruments between Core and Innovative Tier 1 and between Innovative Tier 1 and Upper Tier 2 capital.

### 5.1 Permanent ~~share~~ capital

1 There are two types of ~~share~~ permanent capital eligible for Tier 1 capital:

(a) Ordinary shares, i.e. allotted, called up and fully paid share capital/~~common stock~~.

See s10.1

a) This should be net of any of its own shares that a bank holds.

(b) Perpetual non-cumulative ~~preferred~~ preference shares and capital instruments, including such shares and capital instruments redeemable at the option of the issuer and with the FSA's prior consent; and such shares and capital instruments convertible into ordinary shares.

2 Ordinary ~~S~~share capital is the strongest form of capital in terms of insulating depositors from credit risk. This is because:

(a) There is statutory subordination through the Companies Act and the Insolvency Act. Shareholders are the last to be paid in the event of the liquidation of a bank.

(b) Dividends are discretionary and non-cumulative - they need only be paid when the bank has sufficient distributable reserves.

(c) Ordinary ~~S~~share capital absorbs losses while the bank is still trading as a bank can have negative reserves, as long as these do not exceed the book value of the shares issued.

(d) It is undated.

3 Tier 1 capital should be predominantly in the form of ordinary shares, associated reserves and retained earnings.

(a) Predominantly will normally be interpreted as 50% or more of total Tier 1 capital after Tier 1 deductions.

34 Preference (or ~~preferred~~) shares and capital instruments are ~~shares~~ instruments where the holders rank before ordinary shareholders in claims on a bank, but where typically the shares or capital instruments carry no (or limited) voting rights. Preference shares and capital instruments may take

several forms, being either perpetual or dated, and cumulative or non-cumulative.

In order to be eligible for inclusion in Tier 1 capital, preference shares and capital instruments should have the following characteristics:

(a) the bank should be able to eliminate the dividend on the shares;

a) Where a tier 1 instrument includes a step-up in dividends, it is regarded as 'innovative' under Basel guidelines. An explanation of the policy on step-ups can be found in Appendix 15, paragraphs C.30 to C.34. ~~A one-off step-up in dividend from the tenth anniversary of issue associated with a call is permissible as long as the whole dividend can be waived. The dividend step-up should be no greater than either (i) 100bp, less the swap spread between the initial index basis and the stepped up index basis or (ii) 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped up index basis.~~ A bank wishing to include such an option should consult its line supervisor ahead of issue.

b) ~~Following Basel, the FSA therefore applies a limit of 15% of total tier 1 capital to any tier 1 issues that incorporate a step-up and/or are indirectly issued. There may be other instances where a tier 1 structure involves some innovative feature where the FSA will discuss with the issuer whether the 15% limit is also relevant.~~

(b) the dividend should be non-cumulative, i.e. if the dividend is missed it cannot be rolled up;

a) It is acceptable to pay the dividend in scrip if a cash dividend is withheld, as this is merely the conversion of one type of capital into another. However, to qualify for Tier 1 an obligation to pay in cash ~~the missed cash dividend~~ should not cumulate.

i) *Scrip dividends* are dividends that convert reserves into shares via a balance-sheet change. Shareholders are often given the option to receive a scrip as opposed to a cash dividend. The benefit of scrip dividends is that they preserve the capital base of the bank, through the conversion of one type of capital into another, as opposed to paying out the dividend.

ii) Where provision is made for missed dividends to be settled by issuing shares, the timing of this settlement is relevant to the classification of the instrument. Details can be found in Appendix 14, paragraphs C.17 to C.20.

(c) the shares should not be redeemed at the option of the holder;

a) Call options subject to supervisory consent are permissible; these should be at the option of the issuer and are subject to a five-year minimum for the first call. Thereafter, the issuer may have more frequent calls for market access purposes.

b) Where the call is accompanied by any feature, the effect of which is to increase investor expectations that the call will be exercised, the instrument would normally be classified as Innovative Tier 1 capital.

i) An example is, where there is an issuer call accompanied by a principal stock settlement feature, allowing holders to elect to redeem preference shares or capital instruments for an alternative Tier 1 instrument in the event the call is not exercised. Details can be found in Appendix 14, paragraphs C.13 to C.15 and Appendix 15, paragraphs C.35 to C.37.

(d) the shares have no other provisions which require future redemption of the issue; ~~and~~

(e) the shares are perpetual, i.e. they have no maturity date; ~~and~~

(f) in the case of Core Tier 1 only, the shares are directly issued.

(i) Where a Tier 1 instrument is indirectly issued, for example, via a special vehicle company, (SPV), it would normally be classified as Innovative Tier 1 capital. ~~To fulfil these criteria,~~ The issue should offer a level of loss absorbency analogous to a directly-issued preference share. The issuer should, inter alia, have an independent legal/accounting opinion to this effect. Details can be found in Appendix 14, paragraphs C.10 to C.12.

(g) The marketing of Tier 1 instruments should be in line with their prudential treatment and features that alter the economic substance of the instrument as a result of market pressure to call or redeem the issue would not be eligible.

See s6.5

Preference shares and capital instruments which do not fulfil all these conditions should be classed as Tier 2.

45 Non-cumulative undated preference shares or capital issued by vehicle companies as well as directly issued 'innovative' instruments may count as Core Tier 1 or Innovative ~~Tier 1~~ capital under limited the conditions above. In addition, this route is available only where innovative instruments may be included in the calculation of the Tier 1 ratio only when:

(a) the issuer has a Core Tier 1 ratio, consisting of share capital and reserves (excluding any instruments accounted for as a liability), of at least 64% of total Tier 1 capital (after deductions) to risk weighted assets at and immediately after issue. Similarly, the issuer must be able to meet the requirement for a capital ratio of 8% while excluding from Tier 1 anything other than share capital or reserves (e.g., excluding any instruments accounted for as a liability). An issuer must meet the 64% ratio as defined above (excluding existing 'innovative' Innovative Tier 1 instruments) before it can raise additional 'innovative' Innovative Tier 1 capital;

(b) the 64% ratio applies at both the solo and consolidated level. Therefore, even if the capital were being raised for the solo entity, it would not be acceptable for the

~~64~~% ratio to be met at the solo level but not at the consolidated level; and

(c) the sum of ~~'innovative'~~ Innovative Tier 1 capital instruments does not exceed 15% of ~~overall total~~ Tier 1.

(i) Total Tier 1 comprises Core Tier 1 plus Innovative Tier 1 less Tier 1 deductions.

(ii) Examples of how the various limits apply are given in the worked examples in Appendix 15.

Any bank wishing to undertake ~~such~~ Innovative Tier 1 issues should consult their supervisor ahead of making an issue.

*(The remainder of CA: Section 5 is unchanged.)*

## 12 REPAYMENT OF CAPITAL

### 12.1 Repayment of Tier 1 capital

~~5 In general a bank should only repay or return Tier 1 capital where it has sufficient remaining Tier 1 to cover 60% of its target capital requirement. This test applies to external repayments (but not intra-group capital repayments by FSA-regulated consolidated banking groups) and should be passed at both the solo and the consolidated level.~~

~~a) In this context the target capital requirement is defined as the bank's target RAR multiplied by weighted risk assets, plus supervisory deductions.~~

~~b) The reason for defining the capital requirement in this way (as opposed to simply referring to 60% of the bank's target RAR) is to ensure that the bank has sufficient Tier 1 to cover 60% of the capital needed to cover all parts of the group, including those where the FSA's supervisory treatment is capital deduction (e.g. life assurance companies) rather than line by line consolidation.~~

~~6 Subject to a bank satisfying the above test the FSA will only agree to the repayment or return of Tier 1 capital where a bank provides a capital plan covering its capital position for two years after the capital repayment. The plan should:~~

1 No repayment of Tier 1 capital should be made without the FSA's prior agreement. Any repayment should be part of a bank's capital plan that should:

- (a) demonstrate that the bank will remain in excess of its (group and solo) individual capital target ratios ~~(as defined above)~~ for two years without relying on new capital issues;
- (b) be consistent with the bank's strategic and operating plans; and
- (c) take account of any possible acquisitions, locked-in capital in subsidiaries and the possibility of exceptional losses.

a) The degree to which a worst case view will need to be included in the plan will depend on :

- i) the size of the institution;
- ii) the historic volatility of profitability and asset growth;
- iii) confidence in the calculation of assets; and
- iv) the quality of management and systems.

b) ~~For repayment of intra-group capital it is normally sufficient for a bank to be above its target ratio immediately after repayment, i.e. the need to remain above the target ratio for at least two years does not apply.~~

## **12.2 Repayment of Tier 2 capital**

See s12.1

7 No early repayment of Tier 2 capital should be made without the FSA's prior agreement. The FSA will only agree to early repayment where a bank produces a capital plan, as described in the section on repayment of Tier 1 capital that shows that the bank will remain above its ~~target~~ individual capital ratio for at least two years after the repayment.

a) ~~As with Tier 1, for r~~Repayment of intra-group capital it is normally sufficient for a bank to be above its ~~target~~ individual capital ratio immediately after repayment, i.e. the need to remain above the target ratio for at least two years does not apply.

See s8.2

8 Conditions which should be met for the repayment of Tier 2 subordinated debt are given under the section on general conditions for subordinated debt.

See s6.6 & s7.2

9 Specific conditions which should be met for the repayment of Upper and Lower Tier 2 subordinated debt are given under the sections on Upper and Lower Tier 2 capital.

*(The remainder of CA: Section 12 is unchanged)*

## **Appendix 14 -Decision chart**

### **Decision chart analysis**

- C.1 The decision chart is based on the high level principles and characteristics of Tier 1 capital used in our framework. These are represented by the headings across the top of the chart. The shaded boxes are decision points that result in classification as a lower form of Tier 1 capital.
- C.2 The decision chart is intended to help banks assess new Tier 1 instruments. The features that will result in classification of instruments as Core or Innovative Tier 1 can be linked to trigger events. These trigger events are generally defined in the terms and conditions of issuance and the decision chart is designed to allow classification as Core or Innovative based on the specific features of an instrument. We intend the features discussed below to be used as examples of how the framework would be applied in classifying Tier 1 instruments.
- C.3 A specific feature (for example, issuer call or step-up) may result in classification as a core or innovative instrument, but it is expected that the instrument meets all the other conditions for inclusion in Core or Innovative Tier 1. For example, an issuer call over five years from the date of issue will not result in Tier 1 treatment on that basis alone if all the other conditions (for example subordination) are not also met.
- C.4 However, a combination of several of the features in our framework (for example, an issuer call with principal stock settlement and coupon stock settlement) may increasingly lead us to question whether an instrument still conforms to the underlying principles and characteristics of Tier 1 capital. In addition, we expect that the marketing of Tier 1 instruments is in line with the prudential treatment and would not approve features which alter the economic substance of an instrument as a result of market pressure to call or redeem.
- C.5 Starting in the top left hand corner, the decision chart should be used in the following way.

### **Loss absorbency**

- C.6 The ability to absorb losses on a gone concern basis (for example liquidation) should be a feature of both Tier 1 and Tier 2 capital. To ensure loss absorbency on a going concern basis, all Tier 1 instruments (whether Core or Innovative) are expected to be fully subordinated. This applies to ordinary shares, preference shares, capital instruments and innovative instruments.

### **Permanence/dating**

- C.7 The second step is to determine whether there is an issuer call which could create investor expectations that may lead a bank to come under pressure to call the preference share or capital instrument at a time of

financial stress. For example, if there is an issuer call a minimum of five years after issue, the instrument could be classified as a preference share, capital instrument or innovative instrument, but not as an ordinary share. An issuer call beyond five years from the date of issue would not preclude an instrument from being included in the EU Directive 4% minimum. A forced call (an investor put) is disallowed because the issuer does not have control over the timing of the redemption. An issuer call before five years and one day from the date of issue is also disallowed.

- C.8 The third step is to determine whether there is a step-up (increase in the coupon rate) as defined by the Basel Committee on Banking Supervision, in conjunction with an issuer call, which could create an incentive for the bank to call the preference share or capital instrument. Step-ups of up to 100 basis points, or 50% of the initial credit spread, ten years or more after the date of issue, are permitted in Innovative Tier 1. Any step-up will result in classification as an innovative instrument, and any step-up resulting in an increase in the coupon rate greater than 100 basis points or 50% of the initial credit spread should not be included Tier 1. (See Appendix 15, paragraphs C.30 to C.34)
- C.9 Other increases in the amount paid to the investor that are the economic equivalent of a step-up and create a synthetic maturity, or incentive for the bank to call the preference share or capital instrument, would normally result in classification as Innovative Tier 1 capital. For example, an increase in the coupon rate triggered by there being a particular credit spread in the market at the relevant time would be considered the economic equivalent of a step-up.

#### **Indirect issues**

- C.10 The fourth step is to determine whether the instrument is directly or indirectly issued. The legal and documentary cross-jurisdictional risk in indirectly issued instruments could result in the issuer's inability to access funds at a time of financial stress. For example, the possibility that funds might not be upstreamed from the Special Purpose Vehicle (SPV) to the bank when required, because of documentary or legal complications, will result in indirect issues being classified as innovative instruments.
- C.11 Indirect issues are generally based on an SPV issuing preference shares or capital instruments to third party investors; the SPV then uses the funds to make a deeply subordinated debt investment in the parent bank. For the capital raised by the SPV to count as Innovative tier 1 for the parent bank, the parent bank must demonstrate to the FSA that the SPV meets the criteria for solo consolidation as set out in chapter CS Section 9.
- C.12 Any indirect issue should offer a level of loss absorbency analogous to a directly issued preference share or capital instrument. The issuer should, inter alia, have an independent legal/accounting opinion to this effect.

### **Principal costs**

- C.13 The fifth step is to determine whether investor expectations may cause the bank to come under pressure to call the preference share or capital instrument at a time of financial stress, creating a synthetic maturity through the use of stock settlement of principal with an issuer call. Where an issuer call is accompanied by principal stock settlement, the instrument would normally be classified as Innovative Tier 1.
- C.14 Limited principal stock settlement, for example, will be allowed in Innovative Tier 1 up to a redemption ratio (alternative Tier 1 instrument to preference shares or capital instruments) of up to 200% of the redemption ratio at the time of issue. The redemption value of the alternative Tier 1 instrument should not exceed the issue price of the original preference share or capital instrument. Appendix 15, paragraphs C.35 to C.37 contain a worked example.
- C.15 Where principal stock settlement features are included in Innovative Tier 1 capital, banks should ensure that they hold an appropriate buffer of authorised and unissued capital to fulfil their potential obligations under such issues.

### **Ability to defer costs**

- C.16 The sixth step is to determine whether the issuer has the ability to defer coupon costs. Tier 1 capital should have no fixed costs as cash cumulative coupons can quickly deplete reserves. So cash cumulative coupons may not be included in either Core or Innovative Tier 1.

### **Deferral mechanism**

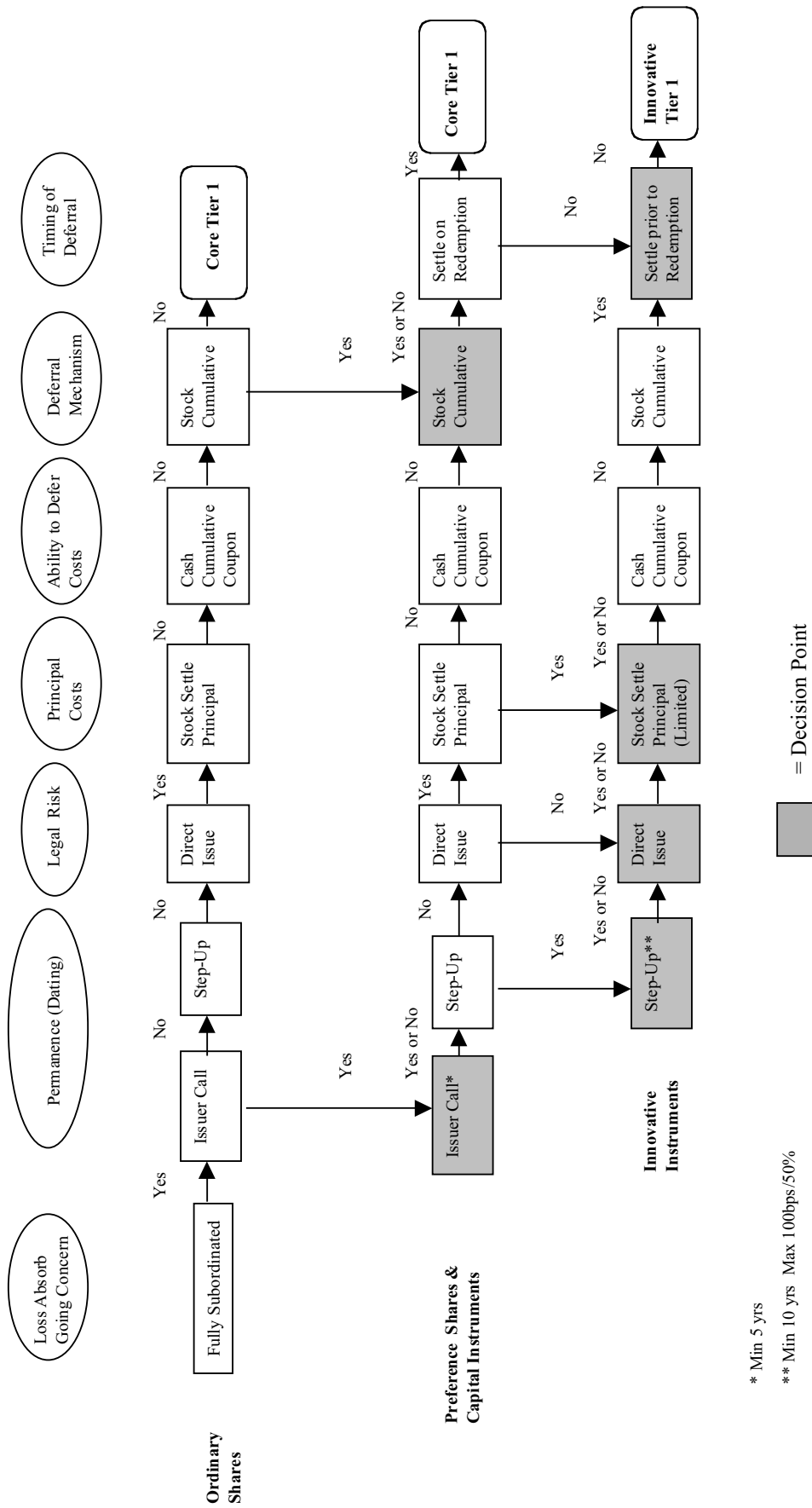
- C.17 The seventh step is to determine if the issuer has the option of deferring costs by paying a stock cumulative coupon. If so, the issue may be classified as a preference share, capital instrument or innovative instrument. Whether the instrument is treated as Core or Innovative Tier 1 depends on the timing of the deferral as outlined in the following paragraphs.

### **Timing of deferral**

- C.18 The final step is to determine the timing of the repayment of a deferred coupon as this can affect the cost of resuming coupon payments. The timing of the repayment of a deferred coupon could create investor expectations that may lead a bank to come under pressure to call the preference share or capital instrument at a time of financial stress. For example, stock settlement of a deferred coupon would normally result in classification as a Core Tier 1 instrument if the missed coupon is settled on redemption only. When deferred coupons become due only upon redemption, the issuer has more latitude to pay the deferred coupon at a time of financial strength.

- C.19 If cumulative coupons are stock settled before redemption, for example, this would normally result in classification as an innovative instrument.
- C.20 Where coupon stock settlement features are included in Tier 1 capital, banks should ensure that they hold an appropriate buffer of authorised and unissued capital to fulfil their potential obligations under such issues.

# Decision chart



\* Min 5 yrs  
 \*\* Min 10 yrs Max 100bps/50%

## Appendix 15 -Worked examples

### Core/Innovative calculation

C.21 To calculate the amount of allowable Innovative Tier 1 capital the amount of Core Tier 1 capital is multiplied by 17.65%. This number is derived by dividing 15% (allowable Innovative capital) by 85%. If a bank has issued £100 of Core Tier 1 they would be allowed to include £17.65 of Innovative Tier 1 capital.

C.22 A 10% reduction in Core Tier 1 would have the following effect on Innovative Tier 1 and Tier 2. For simplicity the assumption is that Core Tier 1 is composed entirely of instruments that meet the EU Directive 4% requirements and that the bank does not have any Tier 1 deductions.

	<u>Initial Core Tier 1</u>	<u>10% Reduction in Core Tier 1</u>
Core Tier 1	£100.00	£90.00
Innovative Tier 1	£17.65	£15.89
Tier 2	£117.65	£105.89

C.23 The core/innovative calculation is completed using Core Tier 1 plus Innovative Tier capital less Tier 1 deductions. The following example illustrates the effect of Tier 1 deductions on the core/innovative calculation. For simplicity the assumption is that Core Tier 1 is composed entirely of instruments that meet the EU Directive 4% requirements.

Core Tier 1	£100.00
Innovative Tier 1	£10.00
Total Tier 1	£110.00
Tier 1 Deductions	£12.00
Net Tier 1	£98.00

#### Effect of Tier 1 Deductions

Core Tier 1	£83.30 (Net Tier 1 of £98.00 x 85%)
Innovative Tier 1	£14.70 (Net Tier 1 of £98.00 x 15%)
Tier 2	£98.00 (equals Net Tier 1)

C.24 Although banks are free to issue innovative instruments in excess of the 15% limit, these will not be counted in the Tier 1 capital calculation.

### Shortfall in the EU Directive 4% Tier 1 limit

C.25 The EU Directive 4% Tier 1 Limit may only be met by instruments that are accounted for as share capital or reserves under national law. This could include ordinary shares and associated reserves and retained earnings, and certain preference shares. A reduction in instruments that are eligible for the 4% Tier 1 requirement would result in a decrease in allowable Innovative Tier 1 and Tier 2 capital. If, however, a bank's eligible Core Tier 1 fell below 4%, no innovative instruments could be

counted as Tier 1 capital. Assuming that a bank's 4% Tier 1 requirement was £80.00, the bank's capital requirement would be:

Core Tier 1	£80.00
Innovative Tier 1	£0
Tier 2	£80.00

- C.26 A shortfall in the minimum 4% Core Tier 1 limit would result in a reduction in the amount of allowable Innovative Tier 1 to zero, as well as a reduction in allowable Tier 2 capital. Innovative Tier 1 capital that is disallowed, because of a reduction in Core Tier 1, could be moved into a reduced Upper Tier 2. Any resulting excess Tier 2 capital could not be included in the capital calculation (except for banks that are able to use Tier 3 capital to cover market risk).
- C.27 The focus will be on banks to ensure that they have a proper capital plan in place, which will include an appropriate individual capital ratio (ICR), as outlined in our Policy Statement 'Individual Capital Ratios for Banks'. The focus will be on ensuring that the shortfall in the 4% minimum Core Tier 1 ratio, and any shortfall in the ICR, is made up, as the bank would be inadequately capitalised.

#### **Minimum equity requirement**

- C.28 The minimum equity requirement is calculated after Tier 1 deductions. For example if a bank has total Tier 1 capital of £100 composed of:

Ordinary shares	£60
Preference shares, capital and innovative instruments	£40
Tier 1 deductions	£20

- C.29 They would be required to hold a minimum of £40 of ordinary shares to show the predominance of ordinary shares and associated reserves and retained earnings. In the event that any bank is already in breach of the proposed limit, we would grandfather existing positions.

#### **Step-up calculation**

- C.30 Step-ups (an increase in the coupon rate) of up to 100 basis points or 50% of the Initial Credit Spread after 10 years are allowed in Innovative Tier 1. The calculations illustrated below are based on the formula specified by the Basel Committee on Banking Supervision, which says that the step-up should be no greater than either:

"100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or

50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis".

***Example 1 – Maximum step-up of 100 basis points***

C.31 The example below illustrates the calculation of the maximum permitted increase in the coupon rate of 100 basis point step-up after 10 years. It assumes that the initial index basis is 5.5%, based on 10 Year Gilts, and that the stepped-up index basis at the time of issue is 5.9%, based on 10 Year LIBOR.

10 Year Gilts at 5.5% (initial index basis) + 200 basis points (the Initial Credit Spread) = 7.5% (Initial Coupon Rate)

equivalent to

10 Year LIBOR at 5.9% (stepped-up index basis) + 160 basis points (to arrive at the 7.5% Initial Coupon Rate)

The result is the “swap spread” for the purpose of the next part of the calculation.

The maximum ‘New Index Basis’ for the purpose of the last part of the calculation is derived as follows:

$$\begin{aligned} (10 \text{ Year LIBOR} - \text{swap spread}) + 100 \text{ basis point step-up} &= \text{New Index Basis} \\ &= \\ (590 - 40) + 100 &= 650 \end{aligned}$$

C.32 When the Initial Credit Spread of 200 basis points is added to the result of the equation above, this results in a 100 basis point step up over the Initial Coupon Rate.

***Example 2 – Maximum step-up of 50% of the initial credit spread***

C.33 The example below illustrates the calculation of the maximum permitted increase in the coupon rate of 50% of the Initial Credit Spread, after 10 years. It assumes that the initial index basis is 6.2%, based on 10 Year Gilts, and that the stepped-up index basis at the time of issue is 6.6%, based on 10 Year LIBOR.

10 Year Gilts at 6.2% (initial index basis) + 180 basis points (the Initial Credit Spread) = 8% (Initial Coupon Rate)

equivalent to

10 Year LIBOR at 6.6% (stepped-up index basis) + 140 basis points (to arrive at the 8% Initial Coupon Rate)

The result is the “swap spread” for the purpose of the next part of the calculation.

The maximum 'New Index Basis' for the purpose of the last part of the calculation is derived as follows:

(10 Year LIBOR - swap spread) + (50% x Initial Credit Spread) = New Index Basis

$$= (660 - 40) + (0.5 \times 180) = 710$$

C.34 When the Initial Credit Spread of 180 basis points is added to the result of the equation above this results in a step up of 50% (90 basis points) of the Initial Credit Spread of 180 basis points.

#### **Limited principal stock settlement calculation**

C.35 The calculation is based on the redemption ratio at the date of issue. This is calculated by comparing the issue price of the original preference share or capital instrument in question against the market price of the alternative Tier 1 instruments at the date of issue. This is then compared against the market value of the number of alternative Tier 1 shares or capital instruments into which one of the original preference shares or capital instrument is exchanged for on redemption as against the original issue price of the preference share or capital instrument.

C.36 If the alternative Tier 1 instrument is not outstanding at the time of issue of the preference share or capital instrument, the redemption value of the alternative Tier 1 instrument may not be greater than the issue price of the original preference share or capital instrument being redeemed.

C.37 Assuming the following prices at the time of issue, and the maximum allowable increase in the redemption ratio of 200%, this is how limited principal stock settlement would apply.

Value of original preference share or capital instrument:	£10
Value of the alternative Tier 1 instruments at time of issue:	£5
Redemption ratio set at time of issue:	2:1

- If the value of the alternative Tier 1 instrument at the time of redemption was £5.00, the redemption ratio would remain at 2:1.
- If the value of the alternative Tier 1 instrument fell to £2.50, holders of the original preference share or capital instrument would receive the cash equivalent of the value of the original preference share or capital instrument on redemption using the maximum allowable increase in the redemption ratio of 200%. The redemption ratio would rise to 4:1.
- If the value of the alternative Tier 1 instrument fell below £2.50, or a decrease of greater than 50%, holders of the original preference share or capital instrument would not recoup the full value of the original preference share or capital instrument.

- If the value of the alternative Tier 1 instrument increased above £5.00 holders of the original preference share or capital instrument would only recoup the value of the original preference share or capital instrument. For example, if the alternative Tier 1 instrument was £6.00 at the time of redemption, holders of the original preference share or capital instrument would only receive the cash equivalent of 83% of the value of the alternative Tier 1 instrument.



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