THE CENTRAL BANK OF THE BAHAMAS

Consultation Paper on the Definition of Capital

Bank Supervision Department
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INTRODUCTION

The Central Bank has fully embarked on a Basel program that comprises elements of Basel II and III frameworks. In December 2010, the Basel Committee on Banking Supervision (BCBS) issued a reform package in response to the 2007-2009 financial crisis entitled *"Basel III: A global regulatory framework for more resilient banks and banking systems"* ("BCBS June 2011"). The reform measures aim to improve the banking sector's ability to absorb shocks arising from financial and economic stress, improve risk management and governance and strengthen banks' transparency and disclosures.

While adhering to the spirit and letter of the new standards, the Central Bank is also cognizant that the Basel III reforms are to be implemented with due recognition to national priorities, resources and in the context of our unique banking industry and risk characteristics. In preparation for these changes, the Central Bank has already implemented some aspects of the Basel III capital framework with respect to its domestic systemically important banks (i.e. the Commercial Banks), with effect from January 1, 2013. Specifically, the commercial banks have been subject to the phasing-in of the new capital definition for Common Equity Tier 1 (CET1), Additional Tier 1 (AT1) and Tier 2 and the phasing-out of capital instruments that no longer qualify as CET1, AT1 or Tier 2.

PURPOSE

The purpose of this paper is to present the Central Bank's new standard and definition of capital in line with Basel III requirements. The aim of which, is to further strengthen the overall framework adopted by the Central Bank for assessing the adequacy of a bank's capital. Specifically, this paper outlines the characteristics that an instrument must have in order to qualify as regulatory capital, and the various adjustments that have to be made in determining the regulatory capital of a bank. These requirements will apply to banks, and banks & trust companies incorporated in the Bahamas. Not included are Pure Trust Companies and Foreign Branches of Banks &/or Trust Companies. In this regard, we invite comments and/or questions from our various industry stakeholders.

Consultative Period

To make an informed and impartial decision on this topic, the Central Bank wishes to obtain comments from its licensees and other interested parties. The consultative period will run for sixty (60) days from 12th December, 2014 to 12th February, 2015 and we welcome your comments on these proposals.

Questions and/or Comments

You are encouraged to submit any questions and/or comments relative to this consultation paper to the Policy Unit, Bank Supervision Department, via postal mail or email.

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1. OVERVIEW

1.1. Characteristics of Capital

The first Basel Capital Accord which was developed by the Basel Committee in 1988 required banks to hold sufficient capital to support the risks that arise from their business. This requirement is still being pursued under the new capital adequacy framework. In order to be eligible for inclusion in regulatory capital, a bank's capital should have the following characteristics:

(a) Provide a permanent and unrestricted commitment of funds;
(b) Be freely available to absorb losses;
(c) Not impose any unavoidable servicing charges against earnings; and
(d) Rank behind the claims of depositors and other creditors in the event the bank is wound up.

1.2. Components of Capital

Total regulatory capital shall consist of the sum of the following elements:

(a) Tier 1 Capital (going-concern capital[1]), which will comprise

i. Common Equity Tier 1 (CET1) capital
ii. Additional Tier 1 capital (AT1)

(b) Tier 2 Capital (gone-concern capital[2])

Note that for each of the three categories above, there is an individual set of criteria that the instruments are required to meet before they can be included in the relevant category.

1.3. Limits and Minima

The licensee shall, at all times (in the periods specified) maintain the minimum ratio as follows:

(a) Common Equity Tier1 capital must be at least 4.5% of risk-weighted assets[3];
(b) Tier 1 capital must be at least 6.0% of risk-weighted assets[4];
(c) Total Capital (Tier 1 Capital + Tier 2 Capital) must be at least 8% of risk weighted assets at all times.

For the purpose of determining the capital adequacy ratio of a bank, the capital base of the licensee shall be the sum of Tier 1 and Tier 2 Capital net of regulatory adjustments applied.

1.4. Minimum Capital Adequacy Requirement

The Central Bank will require all banks to maintain a capital adequacy ratio of at least 8% (exclusive of the capital conservation buffer) at all times. The capital adequacy ratio is calculated by dividing a licensee's total eligible capital base by its total risk-weighted exposures.

[1] 'Going-concern capital' refers to capital against which losses can be written off while the bank continues to operate.
[2] 'Gone-concern capital' refers to capital that would not absorb losses until such time as a bank is wound up or the capital is otherwise written off or converted to ordinary shares.
[3] Applicable to all banks based on the phase-in arrangements under Basel III.
[4] Applicable to all banks based on the phase-in arrangements under Basel III.

1.5. Capital Consolidation

The Central Bank supervises the capital adequacy of locally incorporated banks (i.e. subsidiaries and stand-alone entities) on both a stand-alone (“solo”) and consolidated (“group”) basis, covering the global operations of the bank and its subsidiaries. Generally, a bank should consolidate the financial statements of all of its subsidiaries in accordance with International Financial Reporting Standards for capital adequacy purposes. Exceptions should be approved by the Central Bank.

(a) Ordinary Shares issued by consolidated subsidiaries

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

(i) The instrument giving rise to the minority interest would, if issued by the bank, meet all the criteria for classification as ordinary shares for regulatory capital purposes; and
(ii) The subsidiary that issued the instrument is itself a bank.

(b) Tier 1 qualifying capital issued by consolidated subsidiaries

Tier 1 capital instruments issued by a fully consolidated subsidiary of the bank to third party investors may receive recognition in Tier 1 capital only if the instruments would, if issued by the bank; meet all of the criteria for classification as Tier 1 capital. The amount of this Tier 1 capital that will be recognized in Additional Tier 1 capital will exclude amounts recognized in Common Equity Tier 1 capital.

(c) Tier 1 and Tier 2 qualifying capital issued by consolidated subsidiaries

Total capital instruments (i.e. Tier 1 and Tier 2 capital instruments) issued by a fully consolidated subsidiary of the bank to third party investors may receive recognition in Total Capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 or Tier 2 capital. The amount of this Total Capital that will be recognized in Tier 2 will exclude amounts recognized in Common Equity Tier 1 capital and amounts recognized in Additional Tier 1 capital.

2. DEFINITION OF CAPITAL

A licensee must ensure that any component of capital included in its capital base satisfies, in both form and substance, all applicable requirements in this paper for the particular category of capital in which it is included.

2.1. Common Equity Tier 1 (CET1)

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

(a) Common shares issued by the bank that meet the criteria for classification as common shares for regulatory purposes (see section 2.2 below);

(b) Stock surplus (share premium) resulting from the issue of instruments included in Common Equity Tier 1 capital;

(c) Retained earnings, after deducting any interim or final dividends which have been declared by the Board of the reporting bank or banking group entity on any class of shares and any interim losses incurred since the end of the last financial reporting period;

(d) Accumulated other comprehensive income and other disclosed reserves[5];

(e) Common shares issued by consolidated subsidiaries of the bank and held by third parties (i.e. minority interest) that meet the criteria for inclusion in Common Equity Tier 1 capital; and

(f) Regulatory adjustments applied in the calculation of Common Equity Tier 1 (see section 2.3 below).

2.2. Criteria for classification as common shares issued by the bank directly

An instrument must satisfy all of the following criteria to be classified as ordinary shares:

1. Represents the most subordinated claim in liquidation of the bank.

2. The investor is entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).

3. The principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).

4. The bank does not, in the sale or marketing of the instrument, create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.

5. Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).

6. There are no circumstances under which the distributions are obligatory. Nonpayment is therefore not an event of default.

7. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.

8. It is the form of issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others.

9. The paid-in amount is recognized as equity capital (i.e. not recognized as a liability) for determining balance sheet insolvency.

10. The paid-in amount is classified as equity under the relevant accounting standards.

11. It is directly issued and paid-in[6] and the bank cannot directly or indirectly have funded the purchase of the instrument.

[5] There is no adjustment applied to remove from Common Equity Tier 1 unrealized gains or losses recognized on the balance sheet. Unrealized losses are subject to the transitional arrangements set out in paragraph 94 (c) and (d). The Committee will continue to review the appropriate treatment of unrealized gains, taking into account the evolution of the accounting framework.

[6] Paid-in capital generally refers to capital that has been received with finality by the institution, is reliably valued, fully under the bank's control and does not directly or indirectly expose the bank to the credit risk of the investor.

12. The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity[7] or subject to any other arrangement that legally or economically enhances the seniority of the claim.

13. It is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorized by the owners.

14. It is clearly and separately disclosed as equity on the bank's balance sheet prepared in accordance with the relevant accounting standards.

2.3. Regulatory Adjustments in the Calculation of CET1 Capital

A licensee must make the following regulatory adjustments to determine CET1 capital at the solo or consolidated level, as the case may be, in accordance with the transitional arrangements set out in the BCBS June 2011. **Assets deducted from CET1 capital should not be included in risk-weighted assets.**

Goodwill and other intangibles

(a) Goodwill, including any goodwill included in the valuation of capital investments in unconsolidated major stake companies, shall be deducted in the calculation of CET1 capital. The full amount shall be deducted, net of any associated deferred tax liability that would be extinguished if the goodwill becomes impaired or derecognized under the Accounting Standards.

(b) Intangible assets[8], including but not limited to copyright, patents and other intellectual property, shall be deducted in the calculation of CET1 capital. The full amount shall be deducted, net of any associated deferred tax liability that would be extinguished if the intangible assets become impaired or derecognized under the Accounting Standards.

Deferred tax assets

(c) Deferred tax assets (DTAs) that rely on future profitability of the bank to be realized are to be deducted in the calculation of CET1 capital. Deferred tax assets may be netted with associated deferred tax liabilities (DTLs) only if the DTAs and DTLs relate to taxes levied by the same taxation authority and offsetting is permitted by the relevant taxation authority. Where these DTAs relate to temporary differences (e.g. allowance for credit losses) the amount to be deducted is set out in the "threshold deductions" section below. All other such assets, e.g. those relating to operating losses, such as the carry forward of unused tax losses, or unused tax credits, are to be deducted in full net of deferred tax liabilities as described above. The DTLs permitted to be netted against DTAs must exclude amounts that have been netted against the deduction of goodwill, intangibles and defined benefit pension assets, and must be allocated on a pro rata basis between DTAs subject to the threshold deduction treatment[9] and DTAs that are to be deducted in full.

(d) DTAs arising from any other source will be required to be deducted from CET1 capital as a prudent measure.

Cash flow hedge reserve

(e) The amount of the cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) shall be derecognized in the calculation of CET1 capital. In this regard, positive amounts shall be deducted and negative amounts shall be added back. This treatment specifically identifies the element of the cash flow hedge reserve that is to be derecognized for prudential purposes.

[7] A related entity can include a parent company, a sister company, a subsidiary or any other affiliates. A holding company is a related entity

[8] Intangible assets include but are not limited to copyright, patents, intellectual property and capitalized information technology software costs.

[9] Refer to paragraph 87 of the BCBS June 2011.

Gain on sale related to securitization transactions

(f) Increases in equity capital resulting from securitization transactions (e.g., capitalized future margin income, gains on sale) should be deducted in the calculation of CET 1 capital.

Cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities

(g) Derecognize in the calculation of CET1 capital, all unrealized gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk.

Defined benefit pension fund assets and liabilities

(h) Any defined benefit pension fund liabilities, as included in the balance sheet, shall be fully recognized in the calculation of CET1 Capital. That is, it cannot be increased through derecognizing these liabilities.

(i) For each defined benefit pension fund that is an asset on the balance sheet, the asset shall be deducted in the calculation of CET1 Capital net of any associated deferred tax liabilities which would be extinguished if the asset becomes impaired or derecognized under the Accounting Standards. Assets in the fund to which the licensee has unrestricted and unfettered access may, with the prior approval of the Central Bank, offset the deduction. Such offsetting assets shall be given the risk weight they would receive if they were owned directly by the bank.

Investment in own shares (treasury stock)

(j) All of a licensee's investments in its own common shares (treasury stock), whether held directly or indirectly, will be deducted in the calculation of CET1 capital (unless already derecognized under IFRS). In addition, any own stock which the institution could be contractually obliged to purchase should be deducted in the calculation of CET1 capital. The treatment described will apply irrespective of the location of the exposure in the banking book or the trading book.

Reciprocal cross holdings in the capital of banking, financial and insurance entities

(k) Reciprocal cross holdings in common share capital (e.g. Bank A holds shares of Bank B and Bank B in return holds shares of Bank A) that are designed to artificially inflate the capital position of the bank shall be fully deducted in the calculation of CET1 capital.

Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity

(l) The regulatory adjustment described in this section applies to investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than **10% of the issued common share capital of the entity**. In addition:

- Investments include direct, indirect and synthetic holdings of capital instruments. For example, banks should look through holdings of index securities to determine their underlying holdings of capital.

- Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (e.g. subordinated debt). It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year); and

- Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included.

- If the capital instrument of the entity in which the bank has invested does not meet the criteria for CET1, AT1, or Tier 2 capital of the bank, the capital is to be considered common shares for the purposes of this regulatory adjustment.

- The licensee may, with the prior approval of the Central Bank, temporarily exclude certain investments where these have been made in the context of resolving or providing financial assistance to reorganize a distressed institution.

- If the total of all holdings listed in paragraph (l) above in aggregate exceed 10% of the bank's common equity (after applying all other regulatory adjustments in full) then the amount above 10% is required to be deducted, applying a corresponding deduction approach. This means the deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself. Accordingly, the amount to be deducted is to be calculated as follows:

  Aggregate all of the bank's holdings which in aggregate exceed 10% of the bank's common equity (as per above) multiplied by the common equity holdings as a percentage of the total capital holdings (i.e. Common Equity Tier 1 capital).

- The same approach is to be applied for a bank's non-significant capital investments in financial sector entities that are to be deducted from Additional Tier 1 capital and Tier 2 capital.

- If a licensee is required to make a deduction from a particular tier of capital and it does not have sufficient capital to make that deduction, the shortfall will be deducted from the next higher tier of capital (for example, if an institution does not have sufficient Additional Tier 1 capital to satisfy the deduction, the shortfall will be deducted from Common Equity Tier 1 capital).

- The amounts of such capital investments that are below the threshold (i.e. do not exceed the 10%) and are not deducted shall continue to be risk weighted according to the banking and trading book rules.

Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation

(m) The regulatory adjustment described in this section applies to investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation where the bank **owns more than 10% of the issued common share capital of the issuing entity or where the entity is an affiliate[10] of the bank**. In addition:

- Investments comprise:

  a. Direct, indirect and synthetic holdings of capital instruments. For example, banks should look through holdings of index securities to determine their underlying holdings of capital.

  b. Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (e.g. subordinated debt). It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year).

  c. Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included.

[10] An affiliate of a bank is defined as a company that controls, or is controlled by, or is under common control with, the bank. Control of a company is defined as (1) ownership, control, or holding with power to vote 20% or more of a class of voting securities of the company; or (2) consolidation of the company for financial reporting purposes.

d. If the capital instrument of the entity in which the bank has invested does not meet the criteria for Common Equity Tier 1, Additional Tier 1, or Tier 2 capital of the bank, the capital is to be considered common shares for the purposes of this regulatory adjustment.

e. Licensees may, with the prior approval of the Central Bank, temporarily exclude certain investments where these have been made in the context of resolving or providing financial assistance to reorganize a distressed institution.

- All investments included above that are not common shares must be fully deducted from the corresponding tier of capital. This means the deduction should be applied to the same tier of capital for which the capital would qualify if it were issued by the institution itself (e.g. investments in the Additional Tier 1 capital of other entities must be deducted from the institution's Additional Tier 1 capital).

- If a licensee is required to make a deduction from a particular tier of capital and it does not have sufficient capital to make that deduction, the shortfall will be deducted from the next highest tier of capital (e.g. if an institution does not have sufficient Additional Tier 1 capital to satisfy the deduction, the shortfall will be deducted from Common Equity Tier 1 capital).

- Investments included above that are common shares will be subject to the threshold deductions as described in the next section (n).

(n) The following items will be subject to the capital deductions described in this section:

(i) All of the licensee's holdings in entities where the bank owns more than 10% of common equity (i.e. significant investments in the common shares of unconsolidated financial institutions) of the individual entity will each receive limited recognition when calculating Common Equity Tier 1. The recognition will be capped at 10% of the bank's common equity;

(ii) Mortgage servicing rights (MSRs), including those related to consolidated subsidiaries, subsidiaries deconsolidated for regulatory capital purposes, and the proportional share of MSRs in joint ventures subject to proportional consolidation or equity method accounting.; and

(iii) Deferred tax assets arising from temporary differences.

- The amount of the three items that are not deducted in the calculation of Common Equity Tier 1 capital will be risk weighted at 250%.

- On 1 January 2013, a bank must deduct the amount by which the aggregate of the three items above exceeds 15% of its common equity component of Tier 1 capital (calculated prior to the deduction of these items but after application of all other regulatory adjustments applied in the calculation of Common Equity Tier 1 capital). The items included in the 15% aggregate limit are subject to full disclosure.

- As of 1 January 2018, the calculation of the 15% limit will be subject to the following treatment: the amount of the three items that remains recognized after the application of all regulatory adjustments must not exceed 15% of the Common Equity Tier 1 capital, calculated after all regulatory adjustments. See Annex 2 of the BCBS June 2011 for an example.

Other Adjustments

(o) A licensee shall make any other deductions required under any other guidelines and/or as may be required by the Central Bank.

2.4. Additional Tier 1 Capital (AT1)

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

(a) Instruments issued by the licensee that meet the criteria for inclusion in Additional Tier 1 capital (and are not included in Common Equity Tier 1);

(b) Stock surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital;

(c) Instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Additional Tier 1 capital and are not included in Common Equity Tier 1; and

(d) Regulatory adjustments applied in the calculation of Additional Tier 1 Capital.

2.5. Criteria for inclusion in Additional Tier 1 Capital

An instrument must satisfy the following criteria to be included in Additional Tier 1 Capital.

1. The instrument is issued and fully paid-in in cash;

2. Subordinated to depositors, general creditors and subordinated debt of the bank;

3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis the bank's depositors and/or creditors.

4. Is perpetual, i.e. there is no maturity date and there are no step-ups[11] or other incentives to redeem.

5. May be callable at the initiative of the issuer only after a minimum of five years from the issue date, subject to the following requirements:

    a. A call option can be exercised only with the prior approval of the Central Bank;
    b. The bank shall not create an expectation that the call option will be exercised; and
    c. The bank must not exercise a call option unless:

        i. The bank replaces the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; or
        ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

6. Any repayment of principal (e.g. through repurchase or redemption) must be with prior approval of the Central Bank and licensees should not assume or create market expectations that supervisory approval will be given;

7. With regard to dividend or coupon discretion;

    a. the bank must have full discretion at all times to cancel distributions/payments;
    b. cancellation of discretionary payments must not be an event of default;
    c. banks must have full access to cancelled payments to meet obligations as they fall due;
    d. cancellation of distributions/payments must not impose restrictions on the bank except in relation to distributions to common stockholders;

[11] A step-up is defined as a call option combined with a pre-set increase in the initial credit spread of the instrument at a future date over the initial dividend (or distribution) rate after taking into account any swap spread between the original reference index. Conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in credit spread would not constitute a step-up.

8. Dividends/coupons on the instrument must be paid out of distributable items;

9. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the credit standing of the bank or the group or any related party;

10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law governing the provisions of the capital instrument;

11. Where the instrument is classified as a liability for accounting purposes, it must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point; or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:

    a. It reduces the claim of the capital instrument in liquidation of the bank;
    b. It reduces the amount to be repaid when a call option is exercised; and
    c. It partially or fully reduces dividend or coupon payments on the capital instrument.

12. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.

13. The instrument cannot have any features that hinder recapitalization, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.

14. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity[12] or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in AT1 capital.

15. The main features of the capital instruments are disclosed clearly and accurately.

16. The agreement governing the issuance of the capital instrument shall not be changed without the prior approval of the Central Bank where such proposed changes could impact its eligibility as AT1 Capital.

2.6. Regulatory Adjustments to Additional Tier 1 Capital

A licensee shall apply the following regulatory adjustments in the calculation of AT1 Capital at the solo or consolidated level, as the case may be, in accordance with the transitional arrangements set out in the BCBS June 2011.

(a) Where the amount of AT1 Capital is insufficient to cover the amount of deductions required to be made from this category of capital, the shortfall must be deducted from CET1 Capital.

Investment in own Additional Tier 1 Capital

(b) Investments in the bank's own AT1 capital instruments, whether held directly or indirectly by the bank or any of its banking group entities, shall be deducted in the calculation of AT1 Capital. Any AT1 capital instruments, which the reporting bank or any of its banking group entities could be contractually obliged to purchase, shall also be included in the deduction. This adjustment shall apply to exposures in both the banking book and trading books.

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

Investments (significant and non-significant investments) in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation

(c) These comprise of:

(i) Direct, indirect and synthetic holdings of AT1 Capital instruments in banking, financial and insurance entities. This includes:

- Holdings of AT1 Capital instruments held in the banking book;
- Net long positions[13] in AT1 Capital Instruments[14] held in the trading book; and
- Underwriting positions in AT1 Capital instruments held for more than five working days.

(ii) The amount of such capital investments to be deducted in the calculation of AT1 Capital shall be in accordance with paragraph (l) above.

(d) If the bank does not have sufficient Tier 2 capital needed to make the required deductions from Tier 2 capital, the shortfall must be deducted from Additional Tier 1 capital.

2.7. Tier 2 Capital

Tier 2 Capital includes other components of capital that, to varying degrees, fall short of the quality of Tier 1 Capital, but nonetheless contribute to the overall strength of a bank and its capacity to absorb losses. Tier 2 capital (prior to regulatory adjustments) consists of the sum of the following elements:

(a) Instruments issued by the bank that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital);

(b) Contributed surplus (share premium) resulting from the issue of instruments included in Tier 2 capital;

(c) Instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital.

(d) Certain loan loss provisions such as general provisions/general loan-loss reserve; and

(e) Regulatory adjustments applied in the calculation of Tier 2 Capital.

2.8. Criteria for inclusion in Tier 2 Capital

The objective of Tier 2 is to provide loss absorption on a gone-concern basis. The following sets out the minimum set of criteria for an instrument to meet or exceed in order for it to be included in Tier 2 capital.

1. The instrument should be issued by the bank and fully paid-in in cash.

2. The instrument is subordinated to depositors and general creditors of the bank.

[13] 'Net long positions' are the gross long positions net of short positions in the same underlying exposures where the maturity of the short positions either match the maturity of the long positions or have residual maturities of at least one year. They include netting positions in physical instruments and derivatives over the same underlying exposure (including those associated with looking through holdings of index securities).

[14] This includes investments in capital instruments resulting from the holdings of index securities. Financial institutions are permitted to net long short positions in the same index security subject to maturity matching provisions.

3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general bank creditors.

4. The instrument must have a Minimum original maturity of at least five years and here are no step-ups or other incentives to redeem.

5. The amount of the instrument that will be eligible for inclusion in Tier 2 capital shall be amortized on a straight line basis as follows:

Years to Maturity	**Amount Eligible for Inclusion in Tier 2 Capital**
5 years or more	100 percent
4 years and less than 5 years	80 percent
3 years and less than 4 years	60 percent
2 years and less than 3 years	40 percent
1 year and less than 2 years	20 percent
Less than 1 year	0 percent

6. The instrument may be callable at the initiative of the issuer only after a minimum of five years, subject to the following requirements:

   a. To exercise a call option a bank must receive approval of the Central Bank;
   b. A bank must not do anything that creates an expectation that the call will be exercised; and
   c. Banks must not exercise a call unless:
      i. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; or
      ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

7. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.

8. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the credit standing of the bank, or the group or any related party.

9. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.

10. If the instrument is not issued out of an operating entity[15] or the holding company in the consolidated group (e.g. a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 Capital.

Contributed/Stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital;

11. Contributed/Stock surplus (i.e. share premium) that is not eligible for inclusion in Tier 1, will only be permitted to be included in Tier 2 capital if the shares giving rise to the contributed/stock surplus are permitted to be included in Tier 2 capital.

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

General provisions/general loan-loss reserves (for banks using the Standardized Approach for credit risk)

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

2.9. Regulatory Adjustments to Tier 2 Capital

Net Tier 2 Capital is defined as Tier 2 capital including all regulatory adjustments, but may not be lower than zero. If the total of all Tier 2 deductions exceeds Tier 2 Capital available, the excess must be deducted from Tier 1 Capital.

A licensee shall apply the following regulatory adjustments in the calculation of Tier 2 Capital at the solo or consolidated level, as the case may be, in accordance with the transitional arrangements set out in the BCBS June 2011.

Investment in own Tier 2 Capital

(a) Investments in the bank's own Tier 2 capital instruments, whether held directly or indirectly by the bank or any of its banking group entities, shall be deducted in the calculation of Tier 2 Capital. Any own Tier 2 capital instruments, which the reporting bank or any of its banking group entities could be contractually obliged to purchase, shall also be included in the deduction. This adjustment shall apply to exposures in both the banking book and trading books.

Investments (significant and non-significant investments) in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation

(b) These comprise of:

  a. Direct, indirect and synthetic holdings of Tier 2 Capital instruments in banking, financial and insurance entities. This includes:

    i. Holdings of Tier 2 Capital instruments held in the banking book;
    ii. Net long positions in Tier 2 Capital Instruments held in the trading book; and
    iii. Underwriting positions in Tier 2 Capital instruments held for more than five working days.

  b. The amount of such capital investments to be deducted in the calculation of Tier 2 Capital shall be in accordance with paragraph (l) in section 2.3 above.

3. ADDITIONAL REPORTING REQUIREMENTS

1. A licensee must ensure that any component of capital included in its capital base satisfies, in both form and substance, all applicable requirements prescribed for the relevant category of capital, in which it is included.

2. The Central Bank may, in writing, require a bank to:

  a. Exclude from its regulatory capital any component of capital that in the opinion of the Central Bank does not represent a genuine contribution to the financial strength of the bank; or
  b. Reallocate to a lower category of capital any component of capital that in the opinion of the Central Bank does not fully satisfy the requirements for the category of capital to which it was originally allocated.

3. A licensee must provide the Central Bank, as soon as practicable, with copies of documentation associated with the issue of Tier 1 and Tier 2 capital instruments and provide a description of the main features of the capital instrument issued.

4. A licensee must immediately notify the Central Bank prior to any subsequent modification of the terms and conditions of an instrument that may affect its eligibility to continue to qualify as regulatory capital.