

EXTRACT FROM
**BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR
MORE RESILIENT BANKS AND BANKING SYSTEMS**

DEFINITIONS OF COMMON EQUITY TIER 1, ADDITIONAL TIER I AND TIER II CAPITAL

I. Common Equity Tier 1 (CET1)

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

- Common shares issued by the bank that meet the criteria for classification as common shares for regulatory purposes (or the equivalent for non-joint stock companies);
- Stock surplus (share premium) resulting from the issue of instruments including CET1;
- Retained earnings;
- Accumulated other comprehensive income and other disclosed reserves;¹
- 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 CET1; and
- Regulatory adjustments applied in the calculation of CET1

Common shares issued by the bank

For an instrument to be included in CET1 capital it must meet all of the criteria that follow.

Criteria for classification as common shares for regulatory capital purposes²

1. Represents the most subordinated claim in liquidation of the bank.
2. Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e., has an unlimited and variable claim, not a fixed or capped claim).
3. Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).
4. The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.

¹ There is no adjustment to remove from CET1 unrealized gains or losses recognized on the balance sheet. Unrealized losses are subject to the regulatory adjustments.

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

5. Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).
6. There are no circumstances under which the distributions are obligatory. Non payment is therefore not an event of default.
7. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.
8. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur³. 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 recognised as a liability) for determining balance sheet insolvency.
10. The paid in amount is classified as equity under the relevant accounting standards.
11. It is directly issued and paid-in and the bank can not directly or indirectly have funded the purchase of the instrument.
12. The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity⁴ 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 on the bank's balance sheet.

II. Additional Tier 1 capital

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

- Instruments issued by the bank that meet the criteria for inclusion in Additional Tier 1 capital (and are not included in CET1);
- Stock surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital;
- 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. See section 4 for the relevant criteria; and
- Regulatory adjustments applied in the calculation of Additional Tier 1 Capital

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

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

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

Instruments issued by the bank that meet the Additional Tier 1 criteria

The following box sets out the minimum set of criteria for an instrument issued by the bank to meet or exceed in order for it to be included in Additional Tier 1 capital.

Criteria for inclusion in Additional Tier 1 capital

1. Issued and paid-in
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 bank creditors
4. Is perpetual, i.e., there is no maturity date and there are no step-ups or other incentives to redeem.
5. May be callable at the initiative of the issuer only after a minimum of five years:
 - a. To exercise a call option a bank must receive prior supervisory approval; and
 - b. A bank must not do anything which 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 bank⁵; or
 - ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.⁶
6. Any repayment of principal (e.g., through repurchase or redemption) must be with prior supervisory approval and banks should not assume or create market expectations that supervisory approval will be given
7. Dividend/coupon discretion:
 - a. the bank must have full discretion at all times to cancel distributions/payments⁷
 - b. cancellation of discretionary payments must not be an event of default

⁵ Replacement issues can be concurrent with but not after the instrument is called.

⁶ Minimum refers to the regulator's prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.

⁷ A consequence of full discretion at all times to cancel distributions/payments is that "dividend pushers" are prohibited. An instrument with a dividend pusher obliges the issuing bank to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term "cancel distributions/payments" means extinguish these payments. It does not permit features that require the bank to make distributions/payments in kind.

- 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.
8. Dividends/coupons must be paid out of distributable items
9. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organization's credit standing.
10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.
11. Instruments classified as liabilities for accounting purposes must have 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. Reduce the claim of the instrument in liquidation;
 - b. Reduce the amount re-paid when a call is exercised; and
 - c. Partially or fully reduce coupon/dividend payments on the 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 entity⁸ or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital

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

Stock surplus (i.e., share premium) that is not eligible for inclusion in CET1, will only be permitted to be included in Additional Tier 1 capital if the shares giving rise to the stock surplus are permitted to be included in Additional Tier 1 capital.

III. Tier 2 capital

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

- Instruments issued by the bank that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital);
- Stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital;

⁸ An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

- 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;
- Certain loan loss provisions such as general provisions/general loan-loss reserve; and
- Regulatory adjustments applied in the calculation of Tier 2 Capital.

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

Instruments issued by the bank that meet the Tier 2 criteria

The objective of Tier 2 is to provide loss absorption on a gone-concern basis. Based on this objective, the following box 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.

Criteria for inclusion in Tier 2 Capital

1. Issued and paid-in
2. Subordinated to depositors and general creditors 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 depositors and general bank creditors
4. Maturity:
 - a. minimum original maturity of at least five years
 - b. recognition in regulatory capital in the remaining five years before maturity will be amortized on a straight line basis
 - c. there are no step-ups or other incentives to redeem
5. May be callable at the initiative of the issuer only after a minimum of five years:
 - a. To exercise a call option a bank must receive prior supervisory approval;
 - b. A bank must not do anything that creates an expectation that the call will be exercised;⁹ 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 bank¹⁰; or
 - ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.¹¹

⁹ An option to call the instrument after five years but prior to the start of the amortization period will not be viewed as an incentive to redeem as long as the bank does not do anything that creates an expectation that the call will be exercised at this point.

¹⁰ Replacement issues can be concurrent with but not after the instrument is called.

¹¹ Minimum refers to the regulator's prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.

6. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.
7. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organization's credit standing.
8. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument
9. 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 entity¹² 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

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

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 stock surplus are permitted to be included in Tier 2 capital.

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

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 risk assets calculated under the standardized approach.

Excess of total eligible provisions under the Internal Ratings-based Approach

Where the total expected loss amount is less than total eligible provisions, banks may recognize the difference in Tier 2 capital up to a maximum of 0.6% of credit risk-weighted assets calculated under the Internal ratings-based approach.

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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.