BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Publication

Supervisory Statement | SS7/13

Definition of capital (CRR firms)

(Updating ~~November 2021~~ September 2022)

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AUTHORITY

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Contents

1 Introduction

1.1 This statement is relevant to PRA-authorised firms to which the Capital Requirements Regulation (CRR) applies.[1]

1.2 It sets out the Prudential Regulation Authority's (PRA's) expectations on the quality of regulatory capital resources that firms are required to hold under the CRR. This statement complements the requirements set out in ~~Part 2 of the CRR~~the Own Funds (CRR) Part of the PRA Rulebook, in the Definition of Capital Part of the PRA Rulebook and the high-level expectations on capital as outlined in 'The PRA's approach to banking supervision'.[2]

2 Quality and composition of capital

2.1 As set out in 'The PRA's approach to banking supervision', the PRA expects the most significant part of a firm's capital to be ordinary shares and reserves. These are the highest-quality form of capital, as they allow firms to absorb losses unambiguously on a going concern basis.

2.2 When assessing firms, the PRA will be mindful of the fact that quality of capital is not purely about whether a firm meets each sub-tier of the capital rules. For example, even if two firms have identical Common Equity Tier 1 (CET1) positions, the PRA may view the quality of their capital differently due to the nature of the items underlying their CET1 position.

2.3 As set out in 'The PRA's approach to banking supervision', the PRA also expects firms to comply with the clearly stated internationally agreed criteria around the definition of capital, in spirit as well as to the letter, when structuring capital instruments. ~~CRR II (Article 79a)~~Own Funds (CRR) Article 79a requires that institutions have regard to the substantial features of instruments and consider all arrangements related to the instruments to determine that the combined economic effects of such arrangements are compliant with the objective of the relevant provisions. Additionally, the PRA expects firms to consider any such arrangement that the firm is aware of, including the use of side agreements,[3] regardless of whether the firm is a party to such an arrangement.

2.4 With that purpose in mind, the PRA's preference is for firms to adopt simple, plain vanilla CET1 share structures consisting of only one class of share that is fully subordinated to all other capital and debt, that has full voting rights and equal rights across all shares with respect to dividends and rights in liquidation. The PRA expects firms to refrain from features that may be ineffective (or less effective) in absorbing losses. For the avoidance of doubt, this expectation also applies to Additional Tier 1 (AT1) and Tier 2 capital instruments. For example, the PRA would expect firms to refrain from complex CET1 share structures, including transactions involving several legs or side agreements, where the same prudential objective can be achieved more simply. Complex features and structures complicate the prudential assessment and may also undermine instruments' loss-absorbing properties and ~~CRR~~ compliance with relevant provisions of the Own Funds (CRR) Part. Complexity can arise, for instance, when CET1 shareholders have different rights and entitlements, including preferential realisation provisions or other features that guarantee a distribution to CET1 shareholders. Multiple classes of shares, whereby some are classed as CET1 instruments and others are not, could result in the entirety of the CET1 instruments becoming ineligible as regulatory capital. Some instruments may include preferential realisation provisions which grant priority or higher amounts to certain shareholders when allocating the proceeds from share sales, or other preferential terms such as anti-dilution clauses. These arrangements may

1 These firms include banks, building societies and PRA UK designated investment firms. For avoidance of doubt, these expectations apply at both the individual and UK consolidated level. SS7/13 was updated and renamed in March 2020. See the annex for a summary of changes.
2 Available at 'the PRA's approach to supervision of the banking and insurance sectors'.
3 The Glossary Part of the PRA Rulebook states that a side agreement 'means any document containing an agreement or other arrangement, including a proposed agreement or other arrangement, related to the capital instrument (whether or not explicitly referred to in the instrument) which could affect the assessment of compliance of the instrument with Part Two of CRR'.

represent barriers to recapitalisation, especially in a stressed environment, as they could deter new investors from investing in the firm unless they receive similar preferential or superior rights as other shareholders. This results in uncertainty regarding the ability of the firm to raise capital quickly when needed, which in turn undermines the firm's primary recovery option of recapitalisation. The PRA notes the prudential risks arising from such features and expects firms to avoid them.

2.5 The PRA expects the relevant Senior Management Function (SMF) to take responsibility for ensuring the quality of the capital structure overall. This includes being accountable for the quality of notifications to the PRA under Definition of Capital 7A to 7D, acknowledging that the act of signing and submitting any notification form may be delegated. In a relatively rare case where it may be necessary for a firm to include complex feature(s) in its CET1 instruments, the PRA expects the relevant SMF to inform the firm's board in advance of the issuance, evidencing why the instrument cannot be issued without the proposed complex feature(s) and that, notwithstanding the proposed complexity, they consider the instrument compliant with the objective of the ~~CRR~~Own Funds (CRR) Part. For the purpose of this paragraph and paragraph 2.6, the relevant SMF means the individual with:

(a) responsibility for managing the allocation and maintenance of the firm's capital, funding and liquidity (Allocation of Responsibilities 4.1(7) – PR O); or

(b) responsibility for managing the firm's financial resources (Allocation of Responsibilities 5.2(5) – PR CC) (small firms only).

2.6 The PRA expects the SMF's proposal, in turn, to be subject to appropriate board-level review and discussion and the board should consider and suggest ways to minimise any proposed complexity. In cases where the board does adopt the SMF's proposal and complex features are included in CET1 instruments, notwithstanding the PRA's preference for simplicity (paragraph 2.4), the PRA expects the board to discuss whether the continued inclusion of the complex features within the share structure is necessary, at least annually as part of its Internal Capital Adequacy Assessment Process (ICAAP).[4] The PRA also expects firms to try to simplify the structure where possible.

3 Additional Tier 1 instruments

3.1 ~~CRR~~Own Funds (CRR) Articles 52 and 54 require~~s~~ AT1 instruments to contain a trigger of at least 5.125% CET1, but allow~~s~~ firms to select a higher trigger. ~~It~~They also recognise~~s~~ that the terms of an AT1 instrument may provide for a write-down that is either temporary or permanent, and that the amount converted or written down may be limited to that necessary to restore the firm's CET1 ratio to 5.125% or may be greater.

3.2 Depending on the circumstances, an instrument with a trigger of 5.125% CET1 may not convert in time to prevent the failure of a firm. A temporary write-down may make it more difficult for the firm to re-establish its capital position following a stress. Also, conversion or write-down that only restores the firm's CET1 ratio to 5.125% may leave the firm close to a second trigger event.

3.2A ~~CRR~~Own Funds (CRR) Article 52 is indifferent to the equity or liability accounting classification of an AT1 instrument. Most of the AT1 instruments issued by UK firms are accounted for as equity, but in some cases, firms may prefer to issue liability-accounted AT1 instruments with certain features or other arrangements to manage certain market risks, such as currency risk, when issuing in currencies other than

4 SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)', January 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss.

in the reporting currency. Some of these features or arrangements could undermine the subordination of payments or give rise to other prudential concerns.

3.3 Firms will wish to consider these factors when deciding how to exercise the choices available to them under ~~CRR~~the Own Funds (CRR) Part. The PRA expects to discuss with firms their analysis on features of draft capital instruments that they submit for our review under the PRA pre-issuance notification rules (~~Rule 7B,~~ Definition of Capital ~~Part~~ 7B~~, PRA Rulebook~~). As noted in paragraph 2.4, the PRA expects firms to refrain from including features in capital instruments that may affect their ability to absorb losses.

4 Preference

4.1 Where possible, the PRA expects firms to meet their CET1 requirements entirely with voting common shares and associated reserves. The PRA strongly discourages firms from including non-voting shares in CET1, particularly if such shares have higher dividends than common shares. The main reason for the PRA's concern is that it is imperative that the composition of a firm's CET1 is as straightforward and transparent as possible. There should also be no doubt that a firm's CET1 only includes the highest quality capital. The inclusion of instruments other than voting common shares in CET1 could lead to concerns that such instruments may not have the same capital quality.

5 Subordination, remedies, events of default and set-off

5.1 Under ~~CRR~~the Own Funds (CRR) Part, all regulatory capital must be capable of absorbing losses either on a going or gone concern basis. Therefore, all capital instruments as a minimum must be subordinated to all senior creditors, including depositors. In particular, building societies must ensure that any capital instruments issued by them are subordinated to non-deferred shares (~~as~~ per ~~the rule in~~ Definition of Capital 10.2).

5.2 It is also important that subordination is not made less effective by granting additional rights to holders of subordinated instruments, for example in respect of events of default, remedies and rights of set-off. The PRA expects events of default to be restricted to non-payment of any amount falling due under the terms of the instrument or on the winding-up of the firm. This ensures that the subordinated creditor cannot force early repayment while the issuer may still be technically solvent. This is important so as not to hinder the efforts of the authorities in the context of recovery actions in relation to the issuer.

5.3 In the event that default occurs, the PRA expects remedies to be restricted, to the fullest extent permitted under the laws of the relevant jurisdictions, to petitioning for the winding-up of the firm or proving for the debt in liquidation or administration. Limiting remedies in this way prevents holders of subordinated instruments using other remedies to receive payment, potentially ahead of senior creditors. The expectations set out for restrictions on remedies are not intended to capture remedies for breaches of contract that do not relate to payment obligations, ie remedies that are not available for failure to pay any amount of principal, interest, expenses or in respect of any other payment obligation. Further, any damages or repayment obligation (arising, for example, because remedies could not be limited under applicable law) must be subordinated in accordance with the normal ranking of the instrument in insolvency.

5.4 Also, to the fullest extent permitted under the laws of the relevant jurisdictions, the PRA expects subordinated creditors to waive any rights to set off amounts they owe the issuer against subordinated amounts owed to them by the issuer. Waiving rights of set-off helps to maintain the creditor hierarchy so that subordinated creditors are not treated in the same way as senior creditors.

6 [DELETED]

7 Significant insurance holdings

7.1 As announced in the PRA statement on 29 June 2013 and reiterated in PS7/13, the PRA requires firms to ~~follow the default position in CRR Article 49(1). Firms are therefore required to~~ deduct holdings of own funds instruments issued by an insurer in which the firm has a significant investment.[5]

7.2 For the purposes of valuation, the PRA considers that the embedded value method is not appropriate for determining the value of firms' significant insurance holdings. This is because the embedded value method could have the effect of inflating banks' CET1 as it takes into account the present value of the expected future inflows from existing life assurance business.

8 Connected funding of a capital nature (CFCN)

8.1 ~~Chapter 4 of the PRA's~~ Definition of Capital ~~rules~~ Chapter 4 states that firms must treat all CFCN as a holding of capital of the connected party and apply to it the treatment under the ~~CRR~~Own Funds (CRR) Part applicable to such a holding. The CFCN rule applies on an ongoing basis. Therefore where a loan initially falls outside the definition of CFCN but later falls into it, the appropriate capital treatment should be applied immediately and the PRA should be notified. For example, if the initial lending to a connected party is subsequently downstreamed to another connected party, the relationship between the firm and the ultimate borrower may be such that, looking at the arrangements as a whole, the entity to which the firm lends is able to regard the loan as being capable of absorbing losses.

8.2 Firms should take account of contractual, structural, reputational or other factors when determining whether a transaction is a CFCN.

8.3 Lending to a connected party will not normally be considered CFCN where that party is acting as a vehicle to pass funding to an unconnected party and has no other creditors whose claims could be senior to those of the lender.

8.4 Additionally, for connected parties within the same consolidation group, it is likely that a loan is not CFCN if:

(a) it is secured by collateral that is eligible for the purposes of credit risk mitigation under the standardised approach to credit risk; or

(b) it is repayable on demand (and is treated as such for accounting purposes by the borrower and lender) and the firm can demonstrate that there are no potential obstacles to exercising the right to repay, whether contractual or otherwise.

9 Pre/post-issuance notification (PIN) requirements[6]

PRA's expectations in relation to pre/post issuance notifications

9.1 Firms are generally required to notify the PRA at least one month before the intended date of issuance or amendment or variation to the terms of each CET1 or AT1 capital instrument, and immediately after issuing or amending or varying the terms of each Tier 2 capital instrument, that will count towards regulatory capital resources or own funds, either at solo, sub-consolidated or group consolidated level or any combination of these.

5 Statement regarding the prudential treatment of banks' significant investments in insurance companies for firms that are regulated by the PRA

6 Rules 7A to 7D of Definition of Capital Part of the PRA Rulebook require pre-issuance notification for CET1 and AT1 issuances, and post-notification for Tier 2 issuances.

9.2 The PRA is likely to need more time to review a notified instrument with complex feature(s) (as set out in paragraphs 2.3 to 2.5 above), or issuances with new features, for example, instruments marketed as 'Green', 'Social', or 'Environmental, Social, Governance (ESG)'. The PRA expects the firm to engage with its usual supervisory contact as early as possible (for example, once the relevant terms and conditions including any side agreements are drafted) with a clear explanation of how the proposed features comply with the letter and objective of the ~~relevant CRR requirements, the~~ PRA~~'s~~ rules and supervisory expectations. Notwithstanding the post-issuance notification of Tier 2 instruments, the PRA expects firms to discuss Tier 2 instruments which include complex or new features that could affect their capital eligibility with the PRA prior to issuance.

9.3 The PRA expects the relevant SMF (as defined in paragraph 2.5 above) to ensure that the notified capital instrument complies with the letter and objective of the relevant ~~CRR requirements, the~~ PRA~~'s~~ rules and supervisory expectations.

9.4 In certain cases, as set out in Definition of Capital 7A – 7D, ~~T~~the PRA requires ~~all new issuances of~~ notified capital instruments to be accompanied by an independent legal opinion to confirm the instrument's eligibility as a capital instrument. The PRA expects the legal opinion to explain how the instrument complies with the respective ~~CRR~~ eligibility criteria set out in the Own Funds (CRR) Part, including the ~~CRR~~ Article 79a requirement that the combined economic effect of the substantial features of instruments and all arrangements related to the instruments are compliant with the objective of the ~~CRR~~ eligibility requirements.

9.5 The PRA may ask firms to provide additional information, for example in case of an incomplete notification, unclear terms and conditions, or changes to terms and conditions during the assessment period, which is likely to delay the PRA's assessment beyond the normal one month period. The PRA reserves the right to review any capital instrument at any time – particularly in light of international policy developments or lessons learnt from its own assessments.

Timing of notifications and definition of '~~s~~substantially the same' ~~and sufficiently in advance~~

9.6 ~~CRR II allows a firm to count any subsequent issuance of a form of CET1 instrument for which it has already received the PRA's permission (pursuant to CRR Article 26(3) (as amended)) towards its CET1 capital, provided the conditions set out in the second subparagraph of the amended Article 26(3) are met. These conditions are that:~~

9.7 The required timing of a PIN submission depends on the characteristics of the notified instrument. The following table summarises the notification requirements set out in Definition of Capital 7A – 7D:

Table 1: summary of PIN requirements

Capital instruments	**Comparison to terms previously reviewed by the PRA**	**Notification requirements**
CET1	Identical	No notification requirement
	Substantially the same	As soon as possible after issuance/amendment
	Not substantially the same	At least one month in advance
AT1	Substantially the same	As soon as possible after issuance/amendment
	Not substantially the same	At least one month in advance
Tier 2	Substantially the same	As soon as possible after issuance/amendment
	Not substantially the same	

~~(a) the provisions governing those subsequent issuances are substantially the same as the provisions governing those issuances for which the firms have already received permission from the PRA; and~~

~~(b) firms have notified those subsequent issuances to the PRA sufficiently in advance of their classification as CET1 instruments.~~

9.8 ~~CET1 issuances whose terms and conditions (including any side agreements) are identical to those of an issuance for which a firm has already received the PRA's permission would satisfy the conditions for being 'substantially the same' as the previous issuance. For subsequent issuances of CET1 instruments on such identical terms, firms may notify the PRA no later than the intended date of the subsequent issuance.~~ [Deleted.]

9.9 ~~However, a~~A CET1 ~~issuance~~instrument will normally not be considered substantially the same as one previously reviewed by the PRA ~~as a previous issuance~~ if:

(a) there is any change to provisions governing voting rights, subordination, or distributions; or any feature that might be considered a potential barrier to recapitalisation;

(b) there is material change to other provisions governing the instrument; or

(c) the transaction involves new side agreements or material amendments to an existing side agreement which were not considered in the PRA's previous assessment.

9.10 ~~In any such cases, firms should notify the PRA at least one month in advance of the intended date of issuance.~~[Deleted.]

9.11 ~~Similarly, a firm may count an issuance of an AT1 instrument towards its AT1 capital provided that the AT1 instrument will be issued on substantially the same terms as a previously notified AT1 issuance.~~The PRA considers an AT1 instrument to be substantially the same as one previously reviewed

by the PRA if its terms and conditions (including any side agreements) are identical to a previous AT1 instrument except for the issue date, the amount of issuance, the currency of issuance or the rate of interest payable by the issuer.

9.12 ~~For subsequent issuances of AT1 instruments on such terms, firms may notify the PRA no later than the intended date of the subsequent issuance.~~

9.13 ~~However, a~~An AT1 ~~issuance~~instrument will normally not be considered substantially the same as one previously reviewed by the PRA ~~as a previous issuance~~ if:

(a) there is any change to provisions governing subordination, conversion or write-down mechanism, call option, frequency or amount of distributions; or any feature that might be considered a barrier to recapitalisation or an incentive to redeem; or

(b) there is material change to any other provision governing the instrument.

9.14 ~~In such cases, the PRA expects firms to notify the PRA at least one month in advance of the intended date of issuance.~~[Deleted.]

9.15 ~~For issuances of Tier 2 instruments, firms need not submit a legal opinion provided that the Tier 2 instrument was issued on substantially the same terms as a previously notified Tier 2 issuance. Similar to AT1 instruments, t~~The PRA considers a Tier 2 instrument to be substantially the same if its terms and conditions (including any side agreements) are identical to a previous Tier 2 instrument except for the issue date, the amount of issuance, the maturity, the currency of issuance or the rate of interest payable by the issuer.

9.16 However, a Tier 2 ~~issuance~~instrument will normally not be considered substantially the same as one previously reviewed by the PRA ~~as a previous issuance~~ if:

(a) there is any change to provisions governing subordination, conversion or write-down mechanism, call option, frequency or amount of distributions; or any feature that might be considered a barrier to recapitalisation or an incentive to redeem; or

(b) there is material change to any other provision governing the instrument.

9.18 ~~In such cases, the PRA expects firms to submit a legal opinion in accordance with Definition of Capital 7C.2.~~[Deleted.]

9.17 ~~Further, an AT1 or Tier 2 instrument would be considered substantially the same if, following an amendment to the terms of the instrument, it remains identical other than in respect of the issue date, the amount of issuance, or the currency of issuance. However, it will normally not be considered substantially the same as the existing instrument if:~~[Deleted.]

~~(a) there is any change to provisions governing subordination, conversion or write-down mechanism, call option, frequency or amount of distributions; or any feature that might be considered a barrier to recapitalisation or an incentive to redeem; or~~[Deleted.]

~~(b) there is material change to any other provision governing the instrument.~~[Deleted.]

10 Publication of ~~P~~permissions for reduction of own funds instruments and share premiums

10.1 ~~CRR Article 77(1)(c) requires firms to seek the PRA's prior permission to effect the call, redemption, repayment or repurchase of Additional Tier 1 instruments or Tier 2 instruments as applicable, prior to the date of their contractual maturity.~~[Deleted.]

10.2 ~~For clarity, the PRA expects firms to seek prior permission for any forms of reductions of own funds instruments, including cancellation or conversion of a capital instrument (except for conversions of AT1 instruments at a predetermined automatic trigger, or conversion of capital instruments at the point of non-viability), de-recognising an instrument as own funds, or any transactions that would have the effect of reducing a firm's own funds instruments and related share premiums.~~ [Deleted.]

10.3 The PRA has a statutory duty to publish all permissions, including permissions granted to firms to reduce own funds instruments, unless the PRA considers such publication unnecessary or inappropriate. The PRA generally accepts firms' requests to co-ordinate this publication with a firm's announcement of the capital reduction transaction. As such, the PRA expects firms to inform their usual supervisory contact as soon as there is sufficient certainty regarding the capital reduction transaction to enable the PRA to publish the relevant permissions accordingly. For general prior permissions granted under ~~CRR Article 78(1)~~Own Funds (CRR) Article 77, the PRA expects firms to notify the PRA every quarter regarding transactions taken under the permission.

Annex – SS7/13 updates

This annex details the changes that have been made to this SS following its initial publication in December 2013:

2026

XX [month] 2026

SS7/13 was revised as follows after PSXX/XX:

- Chapter 9 was updated to remove the requirement for firms to submit a notification when issuing CET1 on terms identical to those the PRA has reviewed in the past; and to require firms to notify the PRA of CET1 orAT1 transactions where the instrument is 'substantially the same' as soon as possible *after* they have taken place, rather than in advance.

- Paragraph 10.2 was deleted as there is now a PRA rule requiring firms to firms seek prior PRA permission for any forms of reduction to own funds instruments.

- Miscellaneous changes were made throughout to aid readability.

2022

26 September 2022

SS7/13 was revised as follows after PS8/22:[7]

- Chapter 2 was updated to further clarify PRA expectations regarding the complexity of CET1 instruments, based on supervisory experience, including the implications of non-CET1 shares on the eligibility of CET1 shares; the use of side-agreements; and the risks of barriers to recapitalisation from preferential distribution of share sales proceeds amongst shareholders or anti-dilution clauses.

- Chapter 3 was updated to clarify PRA expectations on liability-accounted AT1 instruments which could include certain features or arrangements that may undermine the subordination of payments and increase the complexity of the instrument or the firm's capital structure.

- Chapter 5 was updated to clarify that the Bank, as UK resolution authority, is not affected or limited in the actions it can undertake, as a result of the actions of subordinated creditors.

- Chapter 6 was deleted to remove the expectation that the value of a subordinated hedging instrument could be included in the value of the hedged capital instrument. The PRA considers that this expectation is not relevant as the CRR does not provide for it.

- Chapter 9 was updated to introduce an expectation that, notwithstanding the post-issuance notification requirement for Tier 2 instruments, firms should discuss with the PRA prior to issuing Tier 2 instruments with new or complex features.

- Chapter 10 was introduced to set out the PRA's expectations on permissions for reduction of own funds instruments and share premiums, including an expectation that firms seek prior PRA permission for any forms of reduction to own funds instruments, and an expectation that firms

7 September 2022: https://www.bankofengland.co.uk/prudential-regulation/publication/2022/february/definition-of-capital-updates.

inform their usual supervisory contact as soon as there is sufficient certainty regarding a capital reduction transaction.

The SS was also updated with minor changes to improve accessibility and rectify typographical errors.

2021

8 November 2021

SS7/13 was revised as follows following PS25/21 'Responses to CP13/21 Occasional Consultation Paper':[8]

- Chapter 8 (Connected funding of a capital nature (CFCN)) was updated to replace 'bank' with 'firm'. This minor amendment follows similar change to the scope of Chapter 4 of the Definition of Capital Part of the PRA Rulebook, to refer to CRR firms rather than UK banks.

2020

10 March 2020

SS7/13 was revised as follows after a public consultation in September 2019 (Consultation Paper (CP) 20/19):[9]

- SS7/13 was renamed 'Definition of capital (CRR firms)' from 'CRD IV and capital';

- Chapter 2 (Quality and composition of capital) was updated to clarify the PRA's expectations on simple capital structures and the role of senior management and the firm's board in relation to quality of the firm's regulatory capital resources; and

- Chapter 9 (Pre/post-issuance notification (PIN) requirements) was introduced to set out the PRA's expectations in relation to PIN requirements. This section clarifies two subjective terms, namely 'substantially the same' and 'sufficiently in advance', in relation to subsequent issuances of or amendments to the terms of regulatory capital instruments. These terms should support firms' compliance with Article 26(3) of CRR (as amended) and the PIN requirements under Definition of Capital 7A to 7D.

This SS was also updated to simplify the formatting and language where helpful to aid readability.

8 November 2021: https://www.bankofengland.co.uk/prudential-regulation/publication/2021/june/occasional-consultation-paper-june-2021.
9 September 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/regulatory-capital-instruments-update-to-pin-requirements.