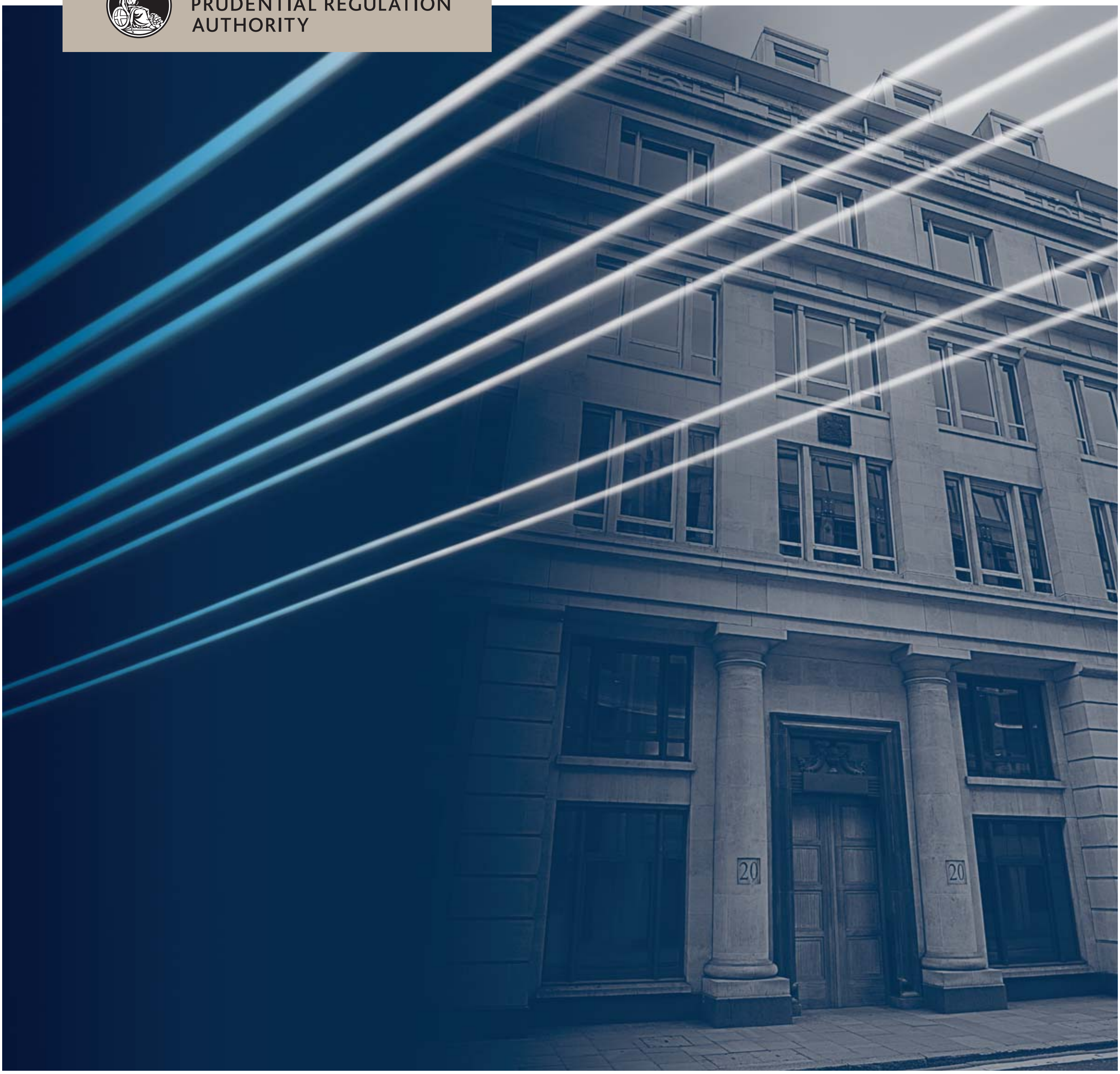
Supervisory Statement | SS7/13

CRD IV and capital

December 2013

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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1 Introduction

1.1 This statement is aimed at firms to which CRD IV applies.

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 CRD and the CRR. This statement complements the requirements set out in Part 2 of the CRR, in the Capital rules of the PRA Rulebook and the high-level expectations on capital as outlined in *The PRA's approach to banking supervision*.[1]

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. This includes an expectation that firms ensure their marketing of proposed capital instruments does not undermine their compliance with the spirit of these criteria. The PRA expects firms to refrain from innovation to structure new capital instruments if these may be ineffective (or less effective) in absorbing losses. For example, the PRA would expect firms to refrain from complex structures, including transactions involving several legs or side agreements, where the same prudential aim can be achieved more simply.

3 Additional Tier 1 Triggers

3.1 CRR requires AT1 instruments to contain a trigger of at least 5.125% CET1, but allows firms to select a higher trigger. It also recognises 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. Firms will wish to consider these factors when deciding how to exercise the choices available to them under CRR. The PRA expects to discuss with firms their analysis on features of draft capital instruments that they submit for our review.

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, 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 retail depositors (as per the rule in 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 or resolution 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

(1) www.bankofengland.co.uk/pra/Pages/supervision/approach/default.aspx.

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 Regulatory capital and subordinated swaps

6.1 CRR requires that the full amount of regulatory capital is subordinated. If a firm chooses to hedge the valuation volatility associated with a capital instrument that it has issued under fair value hedge accounting, then to maintain consistency with the CRR capital regime the PRA expects the hedging instrument also to be subordinated. For example, if the value of a subordinated debt instrument falls from 100 to 90, then the hedge must also be subordinated in order to continue to count 100 of subordinated debt as regulatory capital. If the hedge is not subordinated, then only 90 of subordinated debt would be eligible to count as regulatory capital. This is because the ten contributed by the swap would not be subordinated and therefore would not meet the minimum eligibility criteria specified in CRR.

7 Significant insurance holdings

7.1 As announced in the PRA statement on 29 June 2013 and reiterated in CP5/13, 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.

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 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 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 bank and the ultimate borrower may be such that, looking at the arrangements as whole, the entity to which the bank lends is able to regard the loan as being capable of absorbing losses.

8.2 Banks 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 bank can demonstrate that there are no potential obstacles to exercising the right to repay, whether contractual or otherwise.