BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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Supervisory Statement | SS7/13

Definition of capital (CRR firms)

(Updating March 2020)

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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

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, 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) 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.

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. 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.

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

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 https://www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-approach-documents-2018.

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. 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).[3] The PRA also expects firms to try to simplify the structure where possible.

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.

3 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.

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 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 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 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 firm and the ultimate borrower may be such that, looking at the arrangements as 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[4]

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

9.1 Firms are 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.

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). 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

4 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.

comply with the letter and objective of the relevant CRR requirements, the PRA's rules and supervisory expectations.

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 The PRA requires all new issuances of 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, 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.

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:

(c) 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

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

9.7 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.

9.8 However, a CET1 issuance will normally not be considered substantially the same as a previous issuance if:

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

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

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

9.9 In any such cases, firms should notify the PRA at least one month in advance of the intended date of issuance.

9.10 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 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.

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

9.12 However, an AT1 issuance will normally not be considered substantially the same as a previous issuance if:

(h) 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

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

9.13 In such cases, the PRA expects firms to notify the PRA at least one month in advance of the intended date of issuance.

9.14 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, 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.

9.15 However, a Tier 2 issuance will normally not be considered substantially the same as a previous issuance if:

(j) 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

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

9.16 In such cases, the PRA expects firms to submit a legal opinion in accordance with Definition of Capital 7C.2.

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:

(l) 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

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

Annex – SS7/13 updates

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

2021

8 November 2021

SS7/13 was revised as follows following PS25/21 'Responses to CP13/21 Occasional Consultation Paper':[5]

- 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):[6]

- 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.

5 https://www.bankofengland.co.uk/prudential-regulation/publication/2021/june/occasional-consultation-paper-june-2021.

6 September 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/regulatory-capital-instruments-update-to-pin-requirements.