TIER ONE CAPITAL FOR BANKS INSTRUMENT 2003

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the power in section 157(1) (Guidance) of the Financial Services and Markets Act 2000.

Commencement

B. This instrument comes into force on 1 January 2004.

Amendments to the Interim Prudential sourcebook for banks

C. IPRU(BANK) is amended in accordance with the Annex to this instrument.

Citation

D. This instrument may be cited as the Tier One Capital for Banks Instrument 2003.

By Order of the Board
20 November 2003

ANNEX

Amendments to IPRU(BANK)

In this Annex, underlining indicates new text and striking through indicates deleted text. Where the numbering of a section has changed but the text is otherwise unamended, this is indicated but the text is not reproduced.

Volume 1

...

CA: Section 2

2 THE NATURE OF CAPITAL

2.1 The role of capital

1 From a **supervisory** perspective capital provides a buffer that enables a bank to absorb losses without the interests of the depositors being adversely affected.

2 For a **bank** the different forms of capital offer a flexible source of funding, since most elements include either a statutory or a contractual right to cancel or defer dividend (or interest) payments on share (or loan) capital. In difficult times, therefore, capital can be a comparatively cheap funding source; though to compensate for this, shareholders will expect a higher dividend when a bank is doing well.

2.2 The nature of capital

3 In order to perform this role, capital should have the following characteristics:

(a) It should be able to **absorb losses** before, or instead of, general creditors. ~~This can be done in two ways:~~ Where the bank has ceased to be a going concern, the holders of capital are the last to be paid out in a liquidation.

See s5.1

~~(i) The bank can have negative reserves, as long as these do not exceed the book value of the shares issued, while the bank continues to trade and remains solvent.~~

~~(ii) Where the bank has ceased to be a going concern, the holders of the capital instruments are the last to be paid out in a liquidation.~~

(b) ~~The core elements of capital (tier 1)~~ Good quality capital should have **no fixed costs**, i.e. there should be no contractual obligation to pay dividends on equity, and there ~~may~~ should be a contractual right to defer interest payments ~~on subordinated loan capital~~.

…

2.3 Types of capital

4 For supervisory purposes capital is split into three categories: Tier 1 (core and innovative),Tier 2 (upper and lower) and Tier 3. These categories represent different instruments' quality as capital, i.e. the degree to which each type of capital fulfils the characteristics stated above.

See s5

5 **Tier 1 capital** ~~forms~~ is a bank's ~~core~~ highest quality capital. ~~It takes two forms - issued capital and internally generated capital.~~ It is divided into Core Tier 1 and Innovative Tier 1 capital. Instruments that meet all of the characteristics set out in paragraph 1 of Section 4.2 will normally be classified as Core Tier 1. Features that weaken these characteristics in any way would usually lead to classification as Innovative Tier 1 (or Tier 2).

(a) Examples of features that may lead to classification as Innovative, rather than Core Tier 1 include: indirect issuance, step-ups (increases in the coupon paid) and stock settlement of principal.

6 Tier 1 may be issued or internally generated capital.

(a) Issued capital includes ordinary share capital and preference share capital. ~~(e.g. share capital) is *perpetual* and returns are non-*cumulative*, as well as having the characteristics detailed above.~~

~~a) The *perpetual* (i.e. undated) nature of Tier 1 capital ensures that it can provide an on-going source of funding to the bank until the point where the bank becomes insolvent, or ceases trading.~~

~~b) *Non-cumulative* means that should the bank decide not to make a dividend payment, the dividend is not deferred, but cancelled. This ensures that the capital has no fixed costs.~~

(b) Internally generated capital arises~~ing~~ from accruing profit to reserves, or by capitalising dividends.

In the remainder of Section 2 of Chapter CA, the numbering of each paragraph numbered with an Arabic numeral is increased by one, so that the existing paragraph 6 becomes 7 and so on. Subject to that, the remainder of that section is unchanged.

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4 ELEMENTS OF A BANK'S CAPITAL BASE

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4.2 Tier 1 ~~– core~~ capital

<u>**1 Principles underlying Tier 1 capital**</u>

<u>Tier 1 capital should be able to absorb losses to allow a bank to continue trading, despite suffering losses up to the value of that capital and the capital should be permanently available for that purpose. In order to meet these principles Tier 1 capital should have the following characteristics:</u>

<u>(a) it should be subordinated</u>

<u>a) Subordination should be effective not only so that the holders of the capital are repaid after ordinary creditors on a winding up, but also so that there are no obligations that could result in the bank ceasing to trade normally and no obligations the breach of which could have that effect or provide grounds for the taking of winding up, administration or other insolvency proceedings against the bank.</u>

<u>(b) it should be perpetual (e.g., it should be undated); and</u>

<u>a) The *perpetual* (i.e. undated) nature of Tier 1 capital ensures that it can provide an on-going source of funding to the bank until the point where the bank becomes insolvent, or ceases trading.</u>

<u>(c) it should be non-cumulative (e.g., there should be no obligation to make coupon payments.</u>

<u>a) *Non-cumulative* means that should the bank decide not to make a dividend payment, the dividend is not deferred, but cancelled. This ensures that the capital has no fixed costs.</u>

See s5

~~1~~<u>2</u> <u>Core</u> Tier 1 ~~(or core)~~ capital consists of:

See s5.1

(a) Permanent share capital:

(i) Allotted, called up and fully paid ordinary share capital~~/common stock~~.

See s10.1

a) This should be net of any own shares held.

b) “Fully paid” means that the proceeds of the issue have been received by the bank and are available to absorb losses. This is stricter than the Companies Act definition of fully paid, which only requires an undertaking to pay.

(ii) Perpetual non-cumulative ~~preferred~~ ~~(or~~ preference~~)~~ shares including such shares redeemable at the option of the issuer but with the FSA’s prior consent, and such shares convertible into ordinary shares.

(b) …

(c) …

See s5.4

(d) Minority interests arising from consolidation in permanent shareholders’ equity subject to sections 5.4(10) and (11).

a) This applies, where there are minority interests, in the calculation of the solo-consolidated and consolidated capital base only.

3 Innovative Tier 1 capital consists of instruments which incorporate certain features, the effect of which is to weaken (but only marginally) the principles of Tier 1 capital. Innovative Tier 1 capital is subject to a limit of 15% of total Tier 1 capital after Tier 1 deductions.

See s10.1

~~2~~4 In calculating a bank’s capital base, a number of deductions should be made from Tier 1:

(a) All holdings of own shares.

(b) Goodwill and other intangible assets.

(c) Current year’s unpublished net losses on the banking and trading books when taken together.

a) For non-CAD banks the deduction is current year’s unpublished net losses.

(d) Fully paid shareholders’ equity issued after 1 January 1992 by the capitalisation of property revaluation reserves.

In the remainder of Section 4 of Chapter CA, the numbering of each paragraph numbered with an Arabic numeral is increased by two, so that the existing paragraph [3] becomes [5] and so on. Subject to that, the remainder of that section is unchanged.

…

5 TIER 1 CAPITAL

This section provides detail on the constituent elements of Tier 1 capital other than accumulated profit and loss reserves.

5.1 Core and Innovative Tier 1 ~~Permanent~~ ~~share~~ capital

1 There are ~~two~~ three types of ~~share~~ capital instruments eligible for Tier 1 capital: ordinary shares, preference shares, and other capital instruments. The only capital instruments that may be eligible for Core Tier 1 are those described in paragraphs (a) and (b) below. Other capital instruments may be eligible as Innovative Tier 1.

(a) Ordinary shares, i.e. allotted, called up and fully paid share capital~~/common~~ ~~stock~~.

See s10.1

a) This should be net of any of its own shares that a bank holds.

b) "Fully paid" means that the proceeds of the issue have been received by the bank and are available to absorb losses. . This is stricter than the Companies Act definition of fully paid, which only requires an undertaking to pay.

(b) Perpetual non-cumulative ~~preferred~~ preference shares, including such shares redeemable at the option of the issuer and with the FSA's prior consent; and such shares convertible into ordinary shares.

2 Ordinary ~~S~~share capital is the strongest form of capital in terms of insulating depositors from credit risk. This is because:

(a) There is statutory subordination through the Companies Act and the Insolvency Act. Shareholders are the last to be paid in the event of the liquidation of a bank.

(b) Dividends are discretionary and non-cumulative - they ~~need~~ can only be paid when the bank has sufficient distributable reserves.

(c) Ordinary ~~S~~share capital absorbs losses while the bank is still trading as a bank can have negative reserves, as long as these do not exceed the book value of the shares issued.

(d) It is undated.

3 Tier 1 capital should be predominantly in the form of ordinary shares and retained earnings.

(a) Predominantly will normally be interpreted as 50% or more of total Tier 1 capital after Tier 1 deductions.

~~3~~4 ***Preference ~~(or preferred)~~ shares and Innovative Tier 1 instruments*** are ~~shares where the holders~~ subordinated to ordinary creditors and rank before ordinary shareholders in claims on a bank in a liquidation, but~~where~~ typically ~~the shares~~ carry no (or limited) voting rights. ~~Preference shares may take several forms, being either perpetual or dated, and cumulative or non-cumulative~~.

5.1 (4) only applies to directly issued Tier 1. Indirect issued Tier 1 is dealt with in 5.4.

In order to be eligible for inclusion in Tier 1 capital, ~~preference~~ the shares and instruments should have the following characteristics:

(a) the bank should be able to eliminate the interest or dividend on the shares;

a) Where a tier 1 instrument includes a step-up in interest or dividends, it is regarded as ‘innovative’ provided no step-up occurs before the tenth anniversary of the date of issue. If the step-up occurs before the tenth anniversary of the date of issue, then the instrument is not eligible for Tier 1 capital. ~~A one-off step-up in dividend from the tenth anniversary of issue associated with a call is permissible as long as the whole dividend can be waived. The dividend step up should be no greater than either (i) 100bp, less the swap spread between the initial index basis and the stepped up index basis or (ii) 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis.~~ A bank wishing to include such an option should consult its line supervisor ahead of issue.

~~b) Where a tier 1 instrument includes a step-up in interest or dividends, it is regarded as ‘innovative’ under Basel guidelines. Following Basel, the FSA therefore applies a limit of 15% of total tier 1 capital to any tier 1 issues that incorporate a step-up and/or are indirectly issued. There may be other instances where a tier 1 structure involves some innovative feature where the FSA will discuss with the issuer whether the 15% limit is also relevant.~~

(b) the interest or dividend should be non-cumulative, i.e. if the interest payment or dividend is missed it cannot be rolled up;

a) It is acceptable to pay the interest or dividend in *scrip* if a cash dividend is withheld, as this is merely the conversion of one type of capital into another and provided this does not result in issuing lower quality capital. However, to qualify for Tier 1 an obligation to pay in cash ~~the missed cash dividend~~ should not accumulate.

i) Scrip dividends are dividends that convert reserves into shares via a balance-sheet change. Shareholders are often given the option to receive a scrip as opposed to a cash dividend. The benefit of scrip dividends is that they preserve the capital base of the bank, through the conversion of one type of capital into another, as opposed to paying out the dividend.

b) Where coupon stock settlement features are included in Tier 1 capital, banks should ensure that they have an appropriate buffer of authorised capital to fulfil their potential obligations under such issues.

(c) the shares and instruments should not be redeem~~ed~~able at the option of the holder;

a) Call options subject to supervisory consent are permissible; these should be at the option of the issuer and are subject to a five-year minimum for the first call. Thereafter, the issuer may have more frequent calls for market access purposes.

b) Where the call is accompanied by any feature, the effect of which is to increase investor expectations that the call will be exercised, the instrument would normally be classified as Innovative Tier 1 capital.

i) An example is where there is an issuer call accompanied by a principal stock settlement feature allowing holders to elect to redeem Tier 1 instruments in exchange for ordinary shares in the event the call is not exercised.

(d) the shares and instruments have no other provisions which require future redemption of the issue; ~~and~~

(e) the shares and instruments ~~are~~should be perpetual, i.e. they have no maturity date~~.~~;

(f) the marketing of Tier 1 instruments should be in line with their prudential treatment. Therefore if an instrument that would otherwise qualify as Core Tier 1 is marketed as if it were an instrument that would only qualify for a lower level of capital (e.g. if marketed as dated) or on the basis that investing in it is like investing in a lower level instrument, it should be treated as an instrument falling into that lower level of capital for prudential purposes as well;

(g) in deciding whether an instrument is eligible as Tier 1 capital or Core Tier 1 capital, its economic substance should also be taken into account. Therefore, any feature of an instrument that results in the economic substance of the instrument being inconsistent with the features of Tier 1 capital or Core Tier 1 capital will result in its being ineligible as Tier 1 capital or, as the case may be, Core Tier 1 capital. Any feature of a Tier 1 instrument that creates or increases market expectations of or pressure for redemption makes the instrument innovative;

(h) the shares and instruments should be available to absorb losses on a going concern basis;

(i) to count as Core Tier 1, there should be no doubt that the instrument is available to absorb losses to allow an issuer to continue trading, despite suffering losses up to the value of that capital. The FSA considers that only directly issued ordinary shares, and directly issued non-cumulative undated preference shares meet these criteria. Any other instrument, if it is eligible Tier 1 capital, should be classified as Innovative.

An instrument may only be included in Innovative Tier 1 capital if it meets the criteria on loss absorbency in paragraph (ii);

(ii) the bank's obligations under the capital instrument should either not constitute a liability (actual, contingent or prospective) under section 123(2) of the Insolvency Act 1986 or, if they do, the conditions in paragraph (iii) should be met;

(iii) if the bank's obligations do constitute liabilities under paragraph (ii), the terms of the capital instrument should be such that:

- those liabilities should not be relevant for the purposes of deciding whether the bank is unable to pay its debts, whether it is likely to become unable to pay its debts or whether its liabilities exceed its assets;

- no creditor (including but not limited to holders of the instrument) should be able to petition for the winding up or administration of the bank on the grounds that the bank is or may become unable to pay any liabilities under the capital instrument;

- the bank should not have to take into account those liabilities for the purposes of deciding whether or not the bank is or may become insolvent for the purposes of section 214 of the Insolvency Act 1986 (wrongful trading);

(iv) therefore, if the capital instrument does constitute a liability, this should only be the case when the bank is perfectly able to pay that liability but chooses not to do so. As Tier 1 capital should be undated, this will generally only be relevant on a solvent winding up of the bank;

a) A bank wishing to issue a capital instrument should obtain an opinion from Queen's Counsel, or where the opinion relates to the law of a jurisdiction

outside the UK, from a lawyer in that jurisdiction of equivalent status, confirming that these criteria are met.

b) For the purpose of (iii) above, the holder should agree that the bank has no liability (including any contingent or prospective liability) to pay any amount to the extent to which that liability would cause the bank to become insolvent if it made the payment or to the extent that its liabilities exceed its assets or would do if the payment were made. The terms of the instrument should be such that the directors can continue to trade in the best interests of the senior creditors even if this prejudices the interests of the holders of the instrument.

(i) where an issuer call is accompanied by principal stock settlement, the instrument is classified as Innovative Tier 1:

(i) limited principal stock settlement will be allowed in Innovative Tier 1 subject to a redemption limit of an increase of 200% in the redemption ratio (alternative Tier 1 instrument to preference shares) set at the time of issue. The redemption value of the alternative Tier 1 instrument should not exceed the issue price of the original preference share or capital instrument;

(ii) where principal stock settlement features are included in Innovative Tier 1 capital, banks should ensure that they hold an appropriate buffer of authorised share capital to fulfil their potential obligations under such issues.

a) The redemption ratio is calculated as follows. The issue price of the original preference shares or capital instruments is compared with the market price (as at the date of issue of the preference share or capital instrument) of the Tier 1 instruments that will be issued on their redemption. The ratio between those two prices is calculated. Then the original issue price of the original preference shares or capital instruments is compared with the market price (as at the date of the redemption) of the Tier 1 instruments issued on their redemption. The ratio between those two prices is calculated. Those two ratios are then compared.

b) If the alternative Tier 1 instrument is not outstanding at the time of issue of the preference share or capital instrument, the redemption value of the alternative Tier 1 instrument should not be greater than the issue price of the original preference share or capital instrument being redeemed.

i) Assuming the following prices at the time of issue, and the maximum allowable increase in the redemption ratio of 200%, this is how limited principal stock settlement would apply:

Value of original preference share or capital instrument: £10

Value of the alternative Tier 1 instruments at time of issue: £5
Redemption ratio set at time of issue: 2:1

c) If the value of the alternative Tier 1 instrument at the time of redemption was £5.00, the redemption ratio would remain at 2:1. If the value of the alternative Tier 1 instrument fell to £2.50, holders of the original preference share or capital instrument would receive the cash equivalent of the value of the original preference share or capital instrument on redemption using the maximum allowable increase in the redemption ratio of 200%. The redemption ratio would rise to 4:1.

d) If the value of the alternative Tier 1 instrument fell below £2.50, or a decrease of greater than 50%, holders of the original preference share or capital instrument would not recoup the full value of the original preference share or capital instrument.

e) If the value of the alternative Tier 1 instrument increased above £5.00 holders of the original preference share or capital instrument would only recoup the value of the original preference share or capital instrument. For example, if the alternative Tier 1 instrument was £6.00 at the time of redemption, holders of the original preference share or capital instrument would only receive the cash equivalent of 83% of the value of the alternative Tier 1 instrument.

See s6.5

Preference shares and other instruments which do not fulfil all these conditions should be classed as Tier 2.

45 ~~Non-cumulative undated preference shares issued by vehicle companies as well as directly-issued 'innovative' instruments may count as tier 1 capital under limited conditions. To fulfil these criteria, the issue should offer a level of loss absorbency analogous to a directly-issued preference share. The issuer should, inter alia, have an independent legal/accounting opinion to this effect.~~ In addition, ~~this route is available only where~~ the following provisions apply where innovative instruments are included in the calculation of the Tier 1 ratio:

(a) ~~The issuer has a Tier 1 ratio of at least 6% at and immediately after issue. An issuer must meet the 6% ratio (excluding existing 'innovative' instruments) before it can raise additional 'innovative' capital;~~ The issuer should be able to meet the requirement at all times for a capital ratio of 8% while excluding from Tier 1 anything other than Core Tier 1;

(b) Only Core Tier 1 capital can count towards the €5mn minimum capital requirement.

(c) ~~(b) the 6% ratio~~ Paragraph (a) applies at both the solo and consolidated level. Therefore, even if the capital were being raised for the solo entity, it would not be acceptable for those

requirements the 64% ratio to be met at the solo level but not at the consolidated level; and

(d) (c) Tthe sum of 'innovative' Innovative Tier 1 capital instruments does should not exceed 15% of overall total tTier 1.

(i) Total Tier 1 comprises Core Tier 1 plus Innovative Tier 1 less Tier 1 deductions.

(e) For the purpose of calculating the capital available to meet the Individual Capital Ratio, a breach of the 8% ratio in (a) does not result in an exclusion of the amount of Innovative Tier 1 capital already issued, or a reduction in the amount of allowable Tier 2 capital.

a) The 8% capital requirement in paragraph 5.1(5)(a) above includes all the requirements in the Banking Consolidation Directive about how to calculate capital. One of those requirements is the limit on Tier 2 capital to 100% of Tier 1 capital. Given that anything other than Core Tier 1 must be excluded from Tier 1 to meet the 8%, this means that a bank should have a minimum Core Tier 1 ratio of 4%.

b) The FSA considers that the breach of the 4% Core Tier 1 ratio, like the breach of the Individual Capital Ratio is a breach of the obligation to have adequate capital as set out in, for example, rule 3.3.13 of Chapter GN. In that situation, a bank should promptly submit to the FSA an appropriate remedial plan, addressing the breaches.

c) If a bank considers a breach of its 4% ratio or its Individual Capital Ratio is likely, it should submit a remedial plan well before the breach occurs.

Any bank wishing to undertake such Innovative Tier 1 issues should consult their supervisor ahead of making an issue.

…

5.4 Indirectly issued Tier 1 capital and Minority Interests

10 *Minority interests* arising from consolidation in permanent shareholders' equity may be included in Tier 1 capital.

a) *Minority interests* arise when a company has a subsidiary which it does not wholly own. The company's consolidated accounts usually include all of the assets of the subsidiary so it would be misleading to include only that part of its share capital and reserves that is owned by the company. The capital subscribed by the minority shareholders is therefore included in the consolidated capital base.

See s6.3 & s9.4

b) Where a Tier 1 instrument is indirectly issued via a special purpose vehicle, it would be classified as Innovative Tier 1 capital.

c) To minimise the risk that the capital may not be available to absorb losses, a bank should have an obligation to substitute the indirectly issued capital with directly issued Core Tier 1 capital upon a breach of the 8% capital ratio and the bank should take all reasonable steps to ensure it has, at all times, sufficient headroom and corporate authorisations to be able to directly issue Core Tier 1 capital if necessary.

d) If a bank considers raising capital through a subsidiary that the bank wants to treat as Tier 1 capital, it should seek individual guidance on whether the capital qualifies as Core or Innovative Tier 1.

11 Minority interests arising from ~~Tier 2 and 3~~ preference shares classified as Tier 2 and 3 for the issuing bank's solo requirements may be included in consolidated Tier 2 and 3 capital for the group's capital requirements.

5.5 Deductions from Tier 1 capital

See s10.1

12 Details of the items that should be deducted from Tier 1 capital are given below.

6 UPPER TIER 2 CAPITAL

This section provides detail on the constituent elements of Upper Tier 2 capital.

…

6.5 Hybrid capital instruments

a) 5

…

6 Upper Tier 2 capital instruments therefore include:

(a) Perpetual cumulative preferred shares, including:

(i) such shares redeemable at the option of the issuer and with the prior consent of the FSA; and

(ii) such shares convertible into ordinary shares. The shares should not be included within Tier 1 capital until the conversion has taken effect.

See s5.1

a) These shares are included in Tier 2 capital because they are cumulative. Non-cumulative perpetual preference shares ~~are~~ may be included in Tier 1.

…

6.6 Criteria for subordinated debt to be included in Upper Tier 2

See s8.2

7 In order to qualify as a hybrid capital instrument, and to therefore be eligible for inclusion in Upper Tier 2 capital, subordinated debt

should satisfy the conditions listed below, **as well as the general conditions for subordinated debt detailed under the section on subordinated debt below**:

(a) The debt should be perpetual, i.e. undated.

a) This is not a requirement under the ~~OFD (now replaced by The~~ Banking Consolidation Directive~~)~~.

(b) …

…

See s8.2

(c) **Deferral of interest**: The debt agreement should provide for the institution to have the option to defer any interest payment on the debt.

a) It is acceptable for deferred interest to bear interest, provided that it is not at a penal rate, i.e. provided that it is not materially different from the market rate.

(d) The debt agreement should provide for the debt and unpaid interest to be able to absorb losses, whilst leaving a bank able to continue trading. ~~This can be achieved in two ways:~~ For that purpose, a debt agreement should meet the criteria on loss absorbency set out in 5.1(4)(h).

~~(i) The debt agreement can provide for automatic conversion of the perpetual debt, and unpaid interest, into share capital where a *capital reconstruction* has not been undertaken and reserves become negative. In such cases the bank should maintain a sufficient margin of authorised but unissued share capital in order to allow a conversion of the debt into equity at any time.~~

~~e) A *capital reconstruction* is the conversion of one type of capital into another, e.g. reserves into share capital.~~

~~(ii) The debt agreement can specifically provide for the principal and interest on the debt to absorb losses where the bank would not otherwise be solvent, and for the subordinated creditors to be treated as if they were holders of a specified class of share capital in any liquidation of the bank~~

~~In this case the debt agreement provides for the debt to be treated as if it will be converted into share capital either on the day immediately preceding the presentation of a petition for the commencement of a winding-up of the bank, or on the date of the creditors' or shareholders' meeting at which the~~

~~relevant resolution for a winding-up is passed. The debt agreement should contain an explicit warning to lenders that the debt can be treated in this way.~~

…

6.7 Convertible loanstock

8 *Convertible loanstock* is loanstock which may be converted into another form of capital. Conversions may be mandatory, or at the investors' or issuers' option~~, providing the following criteria are met~~. In addition to the criteria listed in 6.6, a convertible loanstock can be included in Upper Tier 2 providing it also meets the following criteria:

…

~~**6.8 Repackaging perpetual debt**~~

~~9 In order to improve the market for perpetuals some schemes have been proposed which involve the creation of an off-shore vehicle to hold the perpetuals which then issues securities of its own. Since these securities are not classified as holdings of bank capital, they are not required to be deducted from a bank's capital base and therefore are more attractive for other banks to hold. This is called *repackaging*.~~

~~10 In order to accept repackaged debt as capital the FSA would need to be satisfied on two counts:~~

~~(a) the scheme should preserve the quality of capital for the issuer; and~~

~~a) This prevents the issuing bank from giving any new undertakings which might reduce the value of the perpetual as capital. For example, the issuer should continue to be able to suspend servicing the debt where necessary.~~

~~(b) the scheme should remove any exposure to the bank's creditworthiness from the instrument held by the investor.~~

~~a) This means that the principal and interest on the security issued by the vehicle should be protected from any risk attached to the underlying perpetual. This can be achieved, for example, if the vehicle also holds other assets of sufficient quality to cover the full face value of the perpetuals in its portfolio and if the interest payments are protected by an insurance scheme). The FSA should be satisfied that there is sufficient distance between the perpetuals and the securities for the securities to be considered non-deductible.~~

11 Such schemes are applicable only to perpetuals that are already being traded. Under the terms of the Basel agreement, perpetuals should not be issued in a repackaged form ("*instantly repackaged perpetuals*").

…

8 GENERAL CONDITIONS FOR SUBORDINATED DEBT

…

8.3 Step-ups

2 Issues of subordinated debt can contain options for the bank to repay the debt (in the case of perpetual debt), or prepay the debt prior to its maturity date (in the case of term debt). Failure to exercise the option sometimes leads to an increase in the interest rate paid on the debt. This is called a *step-up*.

3

…

4 The limits on step-ups are cumulative and apply to the all-in cost of the debt to the bank.

a) The FSA considers that the inclusion of a step-up in a debt agreement signals the intention to repay the debt, as the inclusion of a large step-up will make the repayment of the debt preferable to paying a penal interest rate.

b) The FSA objects to high step-ups, as they can make a bank's capital expensive at a time when the reason that the issue has not been called is that alternative sources of finance are not readily available.

c) Where a step-up arises through a change from paying a coupon on a debt instrument to paying a dividend on a share issued in settlement of the coupon, then any cost to the bank arising from the tax treatment of the dividend may be excluded.

…

12 REPAYMENT OF CAPITAL

12.1 Repayment of Tier 1 capital

1 In general a bank should only repay or return Tier 1 capital where it has sufficient remaining Tier 1 to cover 60% of its target capital requirement. This test applies to external repayments (but not intra-group capital repayments by FSA-regulated consolidated banking

~~groups) and should be passed at both the solo and the consolidated level.~~

a) ~~In this context the individual capital requirement is defined as the bank's individual capital ratio multiplied by weighted risk assets, plus supervisory deductions.~~

b) ~~The reason for defining the capital requirement in this way (as opposed to simply referring to 60% of the bank's individual capital ratio) is to ensure that the bank has sufficient Tier 1 to cover 60% of the capital needed to cover all parts of the group, including those where the FSA's supervisory treatment is capital deduction (e.g. life assurance companies) rather than line by line consolidation.~~

~~2 Subject to a bank satisfying the above test the FSA will only agree to the repayment or return of Tier 1 capital where a bank provides a capital plan covering its capital position for two years after the capital repayment. The plan should:~~

1 No repayment of Tier 1 capital should be made without the FSA's prior agreement. Any repayment should be part of a bank's capital plan that should:

(a) demonstrate that the bank will remain in excess of its (group and solo) ~~capital~~ individual capital ratios ~~(as defined above)~~ for two years without relying on new capital issues;

(b) be consistent with the bank's strategic and operating plans; and

(c) take account of any possible acquisitions, locked-in capital in subsidiaries and the possibility of exceptional losses.

a) …

b) ~~For repayment of intra-group capital it is normally sufficient for a bank to be above its individual capital ratio immediately after repayment, i.e. the need to remain above the individual capital ratio for at least two years does not apply.~~

12.2 Repayment of Tier 2 capital

See s12.1

2 ~~3~~ No early repayment of Tier 2 capital should be made without the FSA's prior agreement. The FSA will only agree to early repayment where a bank produces a capital plan, as described in the section on repayment of Tier 1 capital that shows that the bank will remain above its individual capital ratio for at least two years after the repayment.

a) ~~As with Tier 1, for~~ For repayment of intra-group capital, it is normally sufficient for a bank to be above its individual capital ratio immediately after repayment, i.e. the need to remain above the target ratio for at least two years does not apply.

See s8.2

3 Conditions which should be met for the repayment of Tier 2 subordinated debt are given under the section on general conditions for subordinated debt.

See s6.6 & s7.2

4 Specific conditions which should be met for the repayment of Upper and Lower Tier 2 subordinated debt are given under the sections on Upper and Lower Tier 2 capital.

In the remainder of Section 12 of Chapter CA, the numbering of each paragraph numbered with an Arabic numeral is decreased by one, so that the existing paragraph 6 becomes 5 and so on. Subject to that, the remainder of that section is unchanged.

…