Policy Statement

10/19

Financial Services Authority

# Strengthening Capital Standards 3

## Feedback and final rules for CP10/17 (chapters 11–13) and CP10/22 (chapter 3)

December 2010

FSA®

Financial Services Authority

# Contents


| | | |
|---|---|---|
| | List of acronyms used in this Policy Statement | 3 |
| 1 | Overview | 5 |
| | **PART I – FEEDBACK TO CP10/17** | |
| 2 | Response to CP10/17 | 8 |
| 3 | Core tier one capital | 9 |
| 4 | Operational risk | 15 |
| 5 | Large exposures | 17 |
| | **PART II – FEEDBACK TO CP10/22** | |
| 6 | Response to CP10/22 | 22 |
| 7 | Capital floors | 24 |
| 8 | Residential mortgage LGD floors | 26 |

**Annex 1:** List of non-confidential respondents to the questions in CP10/17, and Chapter 3 of CP10/22

**Appendix 1:** Final Handbook text



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This Policy Statement provides feedback to responses received from Consultation Paper 10/17 (chapters 11–13) and Consultation Paper 10/22 (chapter 3), and publishes final rules.

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# List of acronyms used in this Policy Statement

| | |
|---|---|
| ABCP | Asset Backed Commercial Paper |
| AMA | Advanced Measurement Approach |
| BCBS | Basel Committee on Banking Supervision |
| BCD | Banking Consolidation Directive |
| BIPRU | Prudential sourcebook for Banks, Building Societies and Investment Firms |
| CBA | Cost-Benefit Analysis |
| CEBS | Committee of European Banking Supervisors |
| CP | Consultation Paper |
| CRD | Capital Requirements Directive |
| FSA | The Financial Services Authority |
| GENPRU | General Prudential sourcebook |
| IRB | Internal Ratings Based approach to credit risk |
| LGD | Losses Given Default |
| ORTM | Other Risk Transfer Mechanism |
| PS | Policy Statement |
| TP | Transitional Provision |

# 1 Overview

### Introduction

1.1 This Policy Statement (PS) contains feedback on the responses to CP10/17 (chapters 11 –13) and our Quarterly Consultation Paper CP10/22 (chapter 3), and subsequent changes to our rules.

### Who should read this paper?

1.2 The contents of this PS apply principally to banks, building societies and certain investment firms caught by the CRD (see Chapter 2 of CP09/29, scope of application), and will be of particular interest to such firms and their advisers.

### Background

1.3 Various packages of changes are being made to the Capital Requirements Directive (CRD).[1] The European Commission (the Commission) has 'numbered' these packages to avoid confusion and for ease of reference. We have made the rules for the CRD2 package of changes (which will take effect from 31 December 2010), and will be performing further consultation on the CRD3[2] package in early 2011.

1.4 In CP10/17 we provided feedback on CP09/29, which consulted on CRD2, parts of CRD3 implementation and our proposals to give effect to certain CRD2-related Committee for European Banking Supervisors (CEBS) guidelines.[3] The CEBS guidance related to:

- core tier one capital (chapter 11);

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1 The CRD comprises two (amended) directives, the recast Banking Consolidation Directive 2006/48/EC (BCD) and the recast Capital Adequacy Directive 2006/49/EC (CAD). It was adopted by Council and European Parliament on 14 June 2006.

2 Commission Directive 2009/83/EC, Directive 2009/110/EC and Directive 2009/111/EC amending the CRD.

3 CP10/17 also consulted on changes to the rules for the credit risk 0% risk weight for intra-group exposures under the standardised approach. Feedback and rules for this were provided in *Handbook Notice* 103 – www.fsa.gov.uk/pubs/handbook/hb_notice103.pdf

- operational risk (chapter 12); and
- large exposures (chapter 13).

1.5 The consultation period for these chapters closed on 23 October 2010.

1.6 Then, in CP10/22 (chapter 3), we consulted on changes relating to covered bonds and capital floors. These changes were part of the CRD3 amendments package but, unlike most of the CRD3 amendments (excluding the 'Remuneration' changes), had to be put in place by 1 January 2011. The consultation period for these changes closed on 6 November 2010.

1.7 The new CRD2-related rules and guidance will come into force on 31 December 2010, and the CRD3 material on 1 January 2011.

1.8 The cost-benefit analysis and compatibility statement for the proposals remain unchanged from those published in CP10/17 and CP10/22 (Chapter 3).

## Structure of this paper

- Part I provides feedback for CP10/17.
- Part II provides feedback for CP10/22.
- Annex 1 lists the non-confidential respondents to both consultations.
- Appendix I contains the instrument made by our Board.

# Part I – Feedback to CP10/17

# 2 Response to CP10/17

2.1 We received ten responses from a mixture of banks, building societies, industry professionals and trade associations. The responses are summarised below.

### Core tier one capital

2.2 We received a mixed response to our proposal to implement the CEBS guidelines in relation to core tier one capital. While most respondents recognised that the changes were necessary, some felt that the requirements could have been extended in some areas (e.g. extending the criteria for core tier one capital to other types of subordinated instruments) and further exemptions provided in others (e.g. that the mutuals exemption be extended to banking subsidiaries owned by a mutual).

2.3 Some respondents asked for further clarification of the guidance, and also felt that we were being super-equivalent in our implementation. We look in more detail at these questions in Chapter 3.

### Operational risk

2.4 Our proposals for implementing the CEBS guidelines on operational risk received one substantive comment, which was a request for further guidance. We discuss this in Chapter 4.

### Large exposures

2.5 The consultation on the CEBS guidance on large exposures prompted several questions on the wider changes to the large exposures regime. Where practicable, we have attempted to answer these questions in Chapter 5.

# 3 Core tier one capital

3.1 We consulted in Chapter 11 of CP10/17 on implementing the guidance drawn up by CEBS as part of the CRD amendments on instruments referred to in Article 57(a) of the recast Banking Consolidation Directive (BCD)[4] or 'core tier one' instruments. We received eight formal written responses from banks, building societies and trade associations. We set out below a summary of the written replies to individual questions and how we intend to deal with the matters raised.

### Core tier one instruments for joint-stock companies restricted to ordinary shares

3.2 In CP10/17 we proposed to make ordinary shares the only instrument that joint stock companies can include within core tier one capital. We acknowledged that this was super-equivalent to the requirements of CRD2 and the CEBS guidelines. However, we noted that this restriction would provide certainty that instruments met the core tier one criteria and should restrict the possibility for financial engineering that may weaken the quality of core tier one capital. We also noted that the Basel Committee on Banking Supervision (BCBS) proposals[5] restrict joint stock companies' core tier one capital instruments to ordinary shares. We expect that the final Basel agreement will be implemented in the EU through further amendments to the CRD from 1 January 2013.

> Q4: Do you agree with our proposed restriction of core tier one instruments to ordinary shares?

3.3 There was a mixed response to this question. Some respondents agreed with our proposed restriction. They noted that joint stock companies were currently restricted to issuing ordinary shares in core tier one capital. And they acknowledged that, while this may temporarily create an 'unlevel playing field' for banks in the UK, this would be remedied when the EU adopts the BCBS's proposals as part of its proposed CRD4 amendments package.

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4 Implementation Guidelines regarding Instruments referred to in Article 57(a) of Directive 2006/48/EC recast, Committee of European Banking Supervisors, 14 June 2010 – www.c-ebs.org/Publications/Standards-Guidelines/CEBS-Guidelines-on-instruments-referred-to-in-Arti.aspx

5 Strengthening the resilience of the banking sector, Basel Committee on Banking Supervision, December 2009 – www.bis.org/publ/bcbs164.htm

3.4 Other respondents gave some specific reasons why they did not agree or did not fully agree with our proposed restriction:

- One respondent argued that, while instruments with preferential rights to ordinary shares should not be included within core tier one, instruments that are even more sub-ordinated than ordinary shares should be included within core tier one.
- Another respondent commented that the restriction represented an overemphasis on form over substance and other instruments that meet the eligibility criteria should be permitted if they are developed and that 'financial engineering' would not occur if there was a close exchange between banks and the regulator. The respondent also argued that the super-equivalence would disadvantage UK banks versus their European competitors.
- A further respondent asked us to take into account the BCBS's recent proposals on the definition of capital before finalising our rules.

**Our response:** We considered the issue of super-equivalence as part of our initial consultation. We continue to consider, as noted in CP10/17, that: the restriction provides certainty, as ordinary share capital is regarded as the highest form of capital by market participants; and the required loss absorbency is best achieved through the use of ordinary share capital. And, as we noted in our cost-benefit analysis, the opportunity costs of this restriction are likely to be minimal. This is because this restriction has been our policy for many years and there is no evidence that there is a higher cost of capital in the UK relative to European counterparts because of it. And any instrument that complies with the CEBS guidelines is likely to be priced identically to ordinary share capital by virtue of its loss-absorbency feature required for compliance. The restriction also removes potential firm and market uncertainty about whether an instrument complies with the guidelines.

We note the argument that joint stock companies should be allowed to include both ordinary shares and any instruments sub-ordinated to them within core tier one capital. However, we are unable to allow such a treatment. This is because a core tier one instrument must 'rank after all other claims' in a liquidation under the terms of Article 57(a) BCD – a point that is reinforced by the CEBS guidelines. We have made some small amendments to our draft rules to reflect this point. We have also amended our rules to make it clear that, in a liquidation, core tier one instrument holders must have a claim on the residual assets that is proportional to their holding and not a fixed claim for the nominal amount, a point that is also included within the CEBS guidelines.

The BCBS's Definition of Capital proposals will be implemented as part of the EU Commission's proposed 'CRD4' package of amendments, which have not yet been finalised.

### Preferential right to a dividend not permitted

3.5 We also proposed not to permit core tier one instruments to have a preferential right to a dividend. Our reasons for this were to further limit the instruments eligible as core tier one and to restrict any possibilities of 'financial engineering'. We also noted that the BCBS proposals would not permit a preferential right to a dividend.

Q5: Do you agree with our proposal to disallow a preferential right to a dividend in core tier one?

3.6 Most of the respondents to this question agreed with our proposals to disallow a preferential right to a dividend in core tier one. One noted that 'such instruments will eventually come to fall outside of the core tier one definition as the negotiations around CRD4 continue'. Two respondents did not agree: one noted that the approach was super-equivalent and would disadvantage UK banks; and another argued that such instruments should be allowed as long as 'any certain or required payment is deducted and the products are non-cumulative'.

**Our response:** We also considered super-equivalence as part of our initial consultation. The aim of our policy, as noted above, is to ensure that instruments are not financially engineered, which may lead to a weakening of core tier one capital and also to avoid different classes of preference between core tier one instruments with potentially different loss-absorbency capabilities. We also noted, as part of our cost-benefit analysis, that we were unaware of any instruments with a preferential right to a dividend within core tier one apart from ordinary shares used as part of state aid. This means that the immediate costs to firms of this policy will be low. We expect the opportunity cost from the loss of this option to also be low, as firms have not revealed any preference to date to issue instruments with such a preferential right. So, we have continued to disallow a preferential right to a dividend in our final rules.

### Exceptions for mutuals

3.7 In CP10/17 we proposed implementing the exception in the CEBS guidelines that would permit building societies to include in its core tier 1 capital an instrument which is subject to a cap on distribution, so long as the purpose of the cap was to protect the society's reserves. We required that any building society wishing to issue a core tier 1 instrument with a cap should give the FSA at least one month's prior notice and send us the terms of the proposed instrument and any other relevant documentation. We proposed not to implement other exceptions permitted in the CEBS guidelines for non-joint stock (NJS) companies on the basis that they were not applicable to mutuals in the UK due to the legislative framework supporting UK mutuals and the operating models currently in existence.

Q6: Do you agree with our proposed approach to implementing the exceptions for mutuals as permitted in the CEBS guidelines?

3.8 The responses received were supportive of our proposed approach but sought some clarification and, on some points, posed alternate interpretations of the Directive and CEBS guidelines:

- Two respondents sought clarification on the conditions for eligibility of capped distribution instruments, in particular in terms of where the cap is established.
- One respondent suggested that the CEBS guidelines could be interpreted as allowing an institution to have different levels of caps among individual capped distribution instruments.

- One respondent suggested an interpretation of the CEBS guidelines that would mean the exceptions for mutuals would apply to joint stock banking subsidiaries of cooperatives or mutuals, such as industrial and provident societies.

**Our response:** We continue to explore the issues raised here in bilateral conversations with mutuals and their representatives. However, we can provide some further clarity with regard to the implementation of CRD2 and the related CEBS guidelines.

The exceptions for mutuals in the CEBS guidelines permit a cap on payments where the cap is imposed by law or company statutes. We intend to implement the guidelines as stated by CEBS and the final rules reflect this intention.

The CEBS guidelines speak of a single cap. The guidelines do not state explicitly that only a single cap is permissible nor that an institution may have different levels of caps among its individual capped distribution instruments. We consider that applying the same cap to all of a society's capped distribution core tier one instruments is likely to best deliver the objective of the cap – the protection of reserves – and so is the prudent approach to implementing the guidelines.

The CEBS guidelines state explicitly that the exceptions are intended to apply to non-joint stock companies. Recital 4 of CRD2 refers to mutuals, cooperative societies and similar institutions. We consider that this is recognition of the fact that there are various types of non-joint stock institutions to which CRD2 applies. But in our view the use of the term 'similar institutions' does not create an opportunity to extend the application of the exceptions to institutions which are, in legal form, joint-stock companies. So, in the implementation of CRD2 and the CEBS guidelines, we do not intend to extend the application of exceptions for mutuals to joint-stock model banking subsidiaries of institutions that adopt a mutual model.

## General comments on rules

Q7: Are our proposed rules clear?

3.9 There was a mixed response to this question. Two respondents agreed that the proposed rules were clear, while two others outlined how they considered that their proposed core tier one instruments would meet the proposed rules. There were also some detailed comments on certain aspects of the rules:

- One respondent asked for further clarity in relation to the definition of 'preference'.
- One respondent noted that joint stock companies may be unable to fulfil General Prudential sourcebook (GENPRU) 2.2.83A (4), which requires holders of core tier one capital instruments to not be 'able to petition for the winding-up or administration of the firm or for any similar procedure in relation to the firm'. The respondent noted that under Section 124 of the Insolvency Act 1986, a contributory (a term that can include an ordinary shareholder) has the right to present a winding-up petition, unless the bank insolvency regime has already been triggered.
- One respondent argued that one month's notice of repurchase was not reasonable or practical and that there should be a carve-out for market-making activities. They also commented that deducting capital on notification was not

consistent with the risk position of the firm, particularly if repayment required regulatory consent.

- One respondent noted that a firm may have notified us of its intention to repurchase an instrument via its capital plan. The respondent suggested that this may be sufficient notification of its planned repurchase.

**Our response:** We will respond bilaterally to respondents who, as part of the feedback to the consultation, have given examples of proposed instruments that they consider meet the terms of our proposed rules.

We consider that a 'preference' relates to both the priority and level of payment. Particularly in relation to mutuals, preferences are likely to arise as a consequence of instruments that are subject to a coupon limit, and we have provided some guidance on this within the rules to provide clarity. When a capital instrument, subject to a cap ('coupon limit'), is included within the same stage of capital as an uncapped instrument, then a preference is likely to arise.

We have amended our proposed GENPRU rule to clarify that holders of core tier one instruments should not be able to petition for a winding-up due to the non-payment of a dividend or coupon or other sum payable under the instrument. We consider that this is the intention of the CEBS guidelines in this area and it should be consistent with the provisions of the Insolvency Act.

We continue to consider it appropriate for a firm to give us at least one month's notice of repurchase. The purpose of this requirement is to ensure that we have appropriate time to consider the proposed transaction before the repurchase is due to take place. However, as a firm giving notice is planning to repurchase an instrument, it is expecting that the capital will not be available to it within a short period of time. So, it is appropriate for it to be deducted from capital at the point of notification. (We would also note that this is consistent with our rule on giving notice of redemption.) If approval is not given, the capital can be reinstated.

We understand that some firms may wish to undertake market-making activity in their own shares. Firms planning to undertake or continue to undertake such activities should notify their supervisor at least one month in advance of their intentions. Their supervisors can then agree appropriate next steps for future notifications. We would also note that firms wishing to undertake market-making activities must have adequate policies in place, taking into account market abuse rules and regulations.

We note that a firm may include a proposed repurchase within its capital plan. However, as the timing of such a repurchase is unlikely to be clear at that stage, we would expect a firm to re-notify us of the planned repurchase at least one month in advance. This should not be onerous, as we would expect internal sign-off at a senior level to also be required for share buy-backs or similar repurchases.

### Cost-benefit analysis

> Q8: Have the relevant costs and benefits of our proposals been appropriately estimated?

3.10 There were two responses to this question. One respondent argued that mutuals were unable to issue core tier one capital, as there is no suitable instrument available. They considered that the fact this would hamper mutuals' ability to lend, and so provide competition to banks, had not been factored into the cost-benefit analysis.

3.11 Another respondent asked us to take into account the results of the Basel Committee's Quantitative Impact Survey, including potential knock-on effects on business and the real economy. The respondent also commented that 'there can be hidden costs when making the regulations uneven between jurisdictions', such as creating regulatory confusion (e.g. should capital in a subsidiary be permitted at a higher level in the group?).

**Our response:** We will continue to engage with mutuals regarding the challenges they face under these rules, which give effect to the CEBS guidelines. We would also note that our cost-benefit analysis (CBA) on these rules considered the costs and benefits of the areas of super-equivalence that we proposed. There was no additional adverse impact on mutuals over and above the rules that we have introduced in implementing CRD2 and the related CEBS guidelines.

Our CBA found that there were likely to be minimal costs in implementing our proposed rules, as we currently restrict joint stock companies to ordinary shares and the only core tier one instruments that include a preferential right to a dividend that we are aware of relate to ordinary shares issued as part of state aid.

There may be potential for regulatory confusion where we implement rules that are different from those in other jurisdictions. However, differences currently exist at the moment in tax, accounting and regulatory treatments between jurisdictions. And there is no evidence of additional material incremental costs as a result of our proposals differing from those of other member states.

# 4 Operational risk

4.1 In CP10/17 we consulted on our proposed approach adopting the CEBS guidelines[6] for the conditions for use of insurance and Other Risk Transfer Mechanisms (ORTM) by firms using the Advanced Measurement Approach (AMA) for calculating operational risk capital, and for the supervision of those firms.

4.2 Given the small number of firms for whom the guidelines were relevant, we did not copy-out the guidelines into the Handbook. Instead we proposed to insert guidance in the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU) 6.5, saying that firms should take into account the guidelines when considering their use of insurance and ORTM in AMA.

Q9: Are the references to CEBS guidelines clear?

4.3 We received three responses, all agreeing the referencing was clear. However, one respondent asked if we could clarify a couple of points of the CEBS guidelines, as set out below.

### *Haircuts for uncertainty of coverage*

4.4 The guidelines state: 'Institutions that use insurance instruments to transfer operational risk should analyse the various factors that create uncertainty in the effectiveness of the risk transfer. They should reflect these uncertainties in their capital calculations through appropriate haircuts'.

4.5 The respondent asks if the guidelines requiring haircuts for payment uncertainty[7] are required to be applied twice: firstly as part of the deduction for 'payment uncertainty' and secondly as a separate deduction for 'counterparty default'?

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6 Implementation Guidelines regarding Operational Risk mitigation techniques, Committee of European Banking Supervisors, 22 December 2009 –
www.c-ebs.org/documents/Publications/Standards---Guidelines/2009/Operational-risk-mitigation-techniques/Guidelines.aspx

7 Paragraph 21; CEBS guidelines

**Our response:** The guidelines say that 'Payment uncertainty is the risk that the insurance provider will not make the payments expected by the institution in a timely fashion. This can result, for example, from …counterparty default…'. Therefore, 'counterparty default' is taken to be a type of 'payment uncertainty' and so only one haircut should be applied for all 'payment uncertainties'.

4.6 The guidelines use the case of 'medium to large losses due to high deductibles' as an example of a coverage mismatch – for which a haircut should be applied for insurance coverage. The respondent suggests that deductibles should be treated separately from coverage mismatches, as they see coverage mismatch as losses that can't be recovered from insurance due to the restrictions in the coverage and deductibles as the amount deducted from any recovery.

**Our response:** Regards of the connection between deductibles and coverage mismatch, the intention of the guidelines is that haircuts should be applied in relation to both these events.

### *Specific conditions for the use of ORTM*

4.7 The guidelines recommend that institutions should have experience in using ORTM products before they are allowed to recognise these products in their AMA capital calculations. This requirement is intended to encourage institutions to collect data from internal and external sources on the probability of coverage and the timeliness of payment for ORTM instruments. This is particularly necessary for product types or classes with novel characteristics, and is not necessarily required for every product.

4.8 The respondent asked us to clarify the experience of ORTM products that firms should prove, and over what timescale, to enable them to recognise the products in their AMA capital.

**Our response:** The experience firms require of ORTM products to be able to use them in AMA capital calculations will vary from firm-to-firm, and the CEBS guidelines states that 'supervisors should assess the institution's use of ORTM in AMA capital calculations on a case by case basis', so it is not appropriate for us to produce a definitive list to capture all scenarios. It is also the responsibility of firm's senior management to be able to evidence and justify their decisions, if asked.

If firms seek further clarification on this issue, then they should get in touch with their regular supervisory contact.

4.9 The respondent also asked if regulators will have the resources and skills to closely monitor the features of insurance products and ORTM and their impact on the coverage of operational risk.

**Our response:** We can assure firms that the FSA will be allocating the necessary resource to meet our regulatory obligations.

# 5 Large exposures

5.1 In CP10/17 we consulted on our approach to adopting the CEBS guidelines[8] for exposures to groups of connected clients and exposures to underlying assets, and for certain short-term exposures arising from providing money transmission, correspondent banking, clearing and settlement and custody activities eligible to be exempted under Article 106(2)(c) and (d)[9] of CRD2.

5.2 At this stage, our proposed approach to implementation was to insert references to the CEBS guidelines in the text of BIPRU 10 so that firms will have due regard to the CEBS guidelines when considering their positions in the areas of the CRD2 contemplated under the guidelines. We plan to undertake a cost-benefit analysis of adopting a copy-out approach to the full CEBS guidelines in due course. At that point we will engage with the relevant stakeholders and consult on our proposed adoption approach. We now publish the guidance in BIPRU 10 that reference the CEBS guidelines.

5.3 We asked:

> Q10: Are the references to CEBS guidelines clear?

5.4 We received six responses that all agreed the referencing was clear. However, respondents had a number of questions on the CEBS guidelines and the large exposure regime in general and, where appropriate, we provide responses below.

### *Applying CEBS guidelines*

5.5 One respondent suggested that the CEBS guidelines do not address every potential variation or the impact of revised capital rules, and this should be taken into account when considering our local regulatory application.

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8 *CEBS Guidelines on the implementation of the revised large exposures regime,* Committee of European Banking Supervisors, 11 December 2009 – www.c-ebs.org/documents/Publications/Standards---Guidelines/2009/Large-exposures_all/Guidelines-on-Large-exposures_connected-clients-an.aspx

9 *CEBS Guidelines on Article 106(2) (c) and (d) of Directive 2006/48/EC recast*, Committee of European Banking Supervisors, 28 July 2010 – http://www.c-ebs.org/documents/Publications/Standards---Guidelines/2010/Article106(2)(c)(d)/GL_Article106(2).aspx

**Our response:** We recognise that the guidance is not intended by CEBS to be exhaustive, as particular circumstances will vary between firms. The guidelines are intended by CEBS as a guide, or further clarification, to firms about how they should be applying the provisions in CRD2 as best fits their particular circumstances.

We continue to be engaged with firms on how the guidelines are being applied in practice, and may consider making more detailed guidance where it is compatible with the future European regulatory framework.

5.6 The respondent also suggested that we should assess and have regard to the combined effects of the reduction in capital resources arising from the revised definitions, in conjunction with the reduced scale of permitted exposures, and complete systematic review of large exposures.

**Our response:** As CRD2 allows generous grandfathering of hybrid instruments, we do not believe that the combined effects of the changed rules concerning hybrid capital instruments, and of the changes in the large exposure regime, would create any significant additional costs.

We took into account in the CBA on large exposure, the fact that firms could choose to increase their capital if they wanted to keep the same level of exposure. However, as we mentioned in the CBA, no firms reported that they would do this in the survey we conducted before CP09/29.

Concerning the future changes to the definition of capital, we intend to consider in due course the effects of the new definition of capital on large exposures when the Basel 3 and CRD4 proposals are finalised.

The CBA to be conducted in due course regarding the CEBS guidance may provide a further opportunity to address this issue.

### *Securities settlement*

5.7 Institutions that provide services related to providing money transmission, clearing, settlement and asset servicing of financial instruments or securities financing services, deal with very large volumes of inflows and outflows within short timeframes. The cash activities related to these services are highly volatile, making the end-of-day positions uncertain and creating the possibility for large exposures to arise.

5.8 To facilitate the smooth functioning of financial markets, Article 106(2)(c) and (d) of the CRD provide an exemption to the large exposure regime for very short-term exposures arising from client activity (point (c)) and to institutions (point (d)) in providing services related to the provision of money transmission, clearing and settlement and correspondent banking.

5.9 The conditions for the exemption include a time element: for Article 106(2)(c) the exposure is exempted from the large exposure limit, as long as it does not last longer than the next business day. If it does, CEBS expects the exposure to be reduced below the large exposure limit as soon as possible within the next business day. For Article 106(2)(d), only exposures that are reduced below the large exposure limit within the same business day are covered by the exemption, in which case

CEBS expects the exposure to be reduced below the large exposure limit without delay, i.e. as soon as possible within the business day.

5.10 One respondent, referencing its response to the original CEBS consultation, asked for clarification around the point at which an exposure should be recorded for large exposures purposes.

5.11 Another respondent asked for clarification of the exemption, claiming that the one business day exemption for balances arising from late settlement of purchase transactions is inadequate.

**Our response:** In the case of transactions for the purpose or sale of securities, exposures incurred in the ordinary course of settlement are excluded from the basic large exposure limit during the five business days following payment or delivery of the securities, whichever is the earlier (see BIPRU 10.2.2R(3)).

An exposure to a counterparty is considered a large exposure where its value is equal or exceeds 10% of a firm's capital resources. Therefore, we expect a firm's internal systems and processes to record the existence of a large exposure as and when it arises and capital requirements are required to be held. The short-term exposure envisaged in Articles 106(2)(c) or 106(2)(d) are exempt from the large exposure regime within the time frame as prescribed. If the exposure is not reduced below the large exposure limit within the applicable time period allowed under the exemption in Articles 106(2)(c) or 106(2)(d), the exposure will no longer be exempted from the large exposure regime and a breach of the limit shall be reported.

That the exemption is available for one business day is a requirement of the CRD2, which we have copied out into BIPRU 10.2.2R(4) and (5).

### *Underlying assets*

5.12 Potential losses stemming from schemes with underlying assets can arise from the risk associated with the scheme itself and the risk associated with the underlying assets of the scheme. Article 106(3) of the CRD requires these two sources of risk to be taken into account in the determination of the existence of a group of connected clients: In CEBS's view: 'The different nature of the two sources implies that different factors should be taken into account when assessing the materiality of the risks stemming from each source, and therefore the need to apply look-through to cope with the risk stemming from the underlying assets or to limit the investment in a specific scheme to cope with the risk stemming from the scheme itself.'

5.13 CEBS provides a number of approaches for the treatment of exposures to schemes with underlying assets according to Article 106(3) for the purpose of determining the interconnections of the underlying assets in the scheme with other clients.

5.14 It also advises that 'institutions shall consider the risk arising from the scheme itself separately, in addition to the risk stemming from the underlying assets. Therefore, investments in single schemes …shall be limited to 25% of own funds according to Article 111(1) of Directive 2006/48/EC'.

5.15 One respondent suggested that the CEBS requirement to record exposures to both the underlying pool and to the scheme is super-equivalent to the CRD, and that they wished for more detailed guidance on the factors to determine the source of risk, whether it be the underlying assets, scheme or both.

**Our response:** Article 106(3) states that '…where there is an exposure to underlying assets, a credit institution shall assess the scheme or its underlying exposures, or both'. As the article makes it clear that a firm must assess the scheme and the underlying exposure as may be appropriate, given the economic substance and risks inherent in the structure of the transaction, we don't believe that the guidelines are being super-equivalent.

Firms are to assess for themselves the most appropriate approach for a specific scheme. However, the CEBS guidelines also contemplate that firms should, whenever feasible, use the more risk-sensitive approaches and should be able to demonstrate to the competent authorities that regulatory arbitrage considerations have not influenced their choice.

### *Economic interconnectedness*

5.16 Article 4(45) of Directive 2006/48/EC requires institutions to identify clients that are connected because of funding relationships, i.e. where the funding problems of one entity are likely to spread to another due to dependence on the same funding source.

5.17 One respondent asked whether the guidance is intended to treat all conduits to which firms provide liquidity as connected or whether it is intended to treat facilities to pools within a single conduit as connected. They suggest that a case-by-case approach should be taken to determine whether there is a concentrated credit risk.

5.18 Another respondent asked for our interpretation of a specific scenario on aggregating the exposures to their Asset Backed Commercial Paper (ABCP) conduit programmes.

**Our response:** The examples in paragraphs 46 to 49 of the CEBS guidelines clarify how the requirement to connect entities together as single risk applies to conduits because of funding relationships. A single risk shall be assumed if there is a risk of contagion or synchronic risk between the conduits.

Given the varying circumstances that apply to firms, we cannot provide an exhaustive list of examples that illustrate possible dependencies between entities that give rise to a single risk. Each case needs to be assessed on its specific facts and circumstances. We are unable to provide individual guidance in this feedback statement, and if firms have queries that are specific to their circumstances, then they should approach their normal supervisory contact.

# PART II – Feedback to CP10/22

# 6 Response to CP10/22

6.1 CP10/22 was the September FSA Quarterly Consultation Paper. It contained a number of consultations, including, in Chapter 3, CRD3 material related to covered bonds and capital floors, which must be implemented by 1 January 2011.

6.2 CP10/22 received numerous responses, and four of these made reference to Chapter 3. However, there were only two detailed responses – from a bank and a trade association.

## Capital floors

6.3 Our proposal for implementing the CRD3 concession for allowing firms switching to a modelled advanced approach to calculate their previous capital requirements on the basis of the CRD Standardised Approach, rather than Basel I, was by the use of a waiver. One respondent commented on this proposal and agreed that we had taken a pragmatic approach, although they suggested that firms already on an internal ratings-based (IRB) approach were at a competitive disadvantage as they still need to maintain Basel I systems.

6.4 Our proposals for extending the capital floors indefinitely was questioned by the respondents, who felt that we should consider limiting the extension to coincide with one of the earlier milestones in the implementation of the leverage ratio (e.g. from either 2011 when supervisory monitoring commences, or 2013 when parallel running starts). We set out our response to these comments in Chapter 7.

## Residential mortgage LGD floors

6.5 We proposed to copy-out into the handbook the CRD3 extension of the residential mortgage Losses Given Default (LGD) floor for a further two years, until 31 December 2012. One respondent agreed that the extension of the floor was 'clear, prudent and reasonable for the medium-term', but suggested we should be open to the 'acceptance of models that prove a lower LGD is more accurate' in certain conditions.

6.6 Another respondent asked about the calculation of the LGD floor, and we respond to this in Chapter 8.

### Covered bonds

6.7 We also took a copy-out approach to the CRD3 changes related to covered bonds. The one respondent on this topic agreed that our changes were clear. They also agreed it was unlikely that the types of assets affected by the change to the eligibility criteria were included in firms' collateral pools.

6.8 The respondent also agreed with our approach to implementing the reduction in the LGD value of covered bonds under the Foundation IRB approach.

6.9 We intend to implement our proposed changes in relation to covered bonds without further comment.

# 7 Capital floors

## Capital floors for firms using advanced approaches

7.1 Firms that use the Internal Ratings Based (IRB) approach for credit risk and/or the Advanced Measurement Approach (AMA) for operational risk, are limited in any resulting reduction in their capital requirements to a 'floor' set at 80% of the amount calculated on the basis of the previous Basel I regime.

7.2 Firms that moved onto the Basel II internal models advanced approaches when the new regime was initially applied have, therefore, been required to maintain the systems necessary to calculate capital requirements under the previous regime. However, firms that chose to use the non-modelled approaches would not have these systems, and so would find it difficult to calculate the 'floor' for their capital requirements on that basis.

7.3 To not discourage these firms from moving to the advanced approaches, the CRD has been amended to allow firms who are adopting this approach from 1 January 2010 onwards, subject to supervisory approval on an individual basis, to base their floor capital requirement on the amounts required by the non-modelled approaches under the CRD, as opposed to those of Basel I.

7.4 In CP10/22 we proposed to implement this change by allowing firms wishing to switch to a modelled advanced approach to calculate their previous capital requirements on the basis of the CRD, rather than Basel I, by using a waiver.

> Q4: Do you agree that the above proposal represents an appropriate implementation of the CRD-amended capital floors treatment?

7.5 Although the one respondent to this question was in general support of our approach, they noted that waiving the requirement to calculate the capital required under Basel I for those firms moving from a non-modelling approach to an IRB approach leaves those firms already on an IRB approach at a competitive disadvantage, as they must maintain systems to calculate the floor.

**Our response:** As we said in CP10/22, the IRB approach enables firms to closely align economic risks and regulatory capital, and we think it is desirable to allow firms that would like to switch to the IRB approach or the AMA to use a CRD non-modelling method to compute their capital floor, to do so without disproportionate costs.

Firms currently using the advanced modelled approaches will already have the systems in place to calculate the floors based on Basel 1 approaches. Firms switching to the new approach will avoid what we consider to be the disproportionate cost of setting up new systems to do so, but will still incur the costs of retaining a second set of systems to calculate a floor, which in their case would be that required by the non-modelled approaches of the CRD. We don't believe that there is a significant competitive advantage in one over the other. Furthermore, the way in which we apply this waiver will prevent it being used by a firm that obtains a significant reduction in capital requirements as a result of using a floor calculated on the alternative CRD basis.

7.6 The CRD requires the capital floor to be extended until 31 December 2011. However, to ensure that the Basel II minimum capital requirements continue to be underpinned by a non-risk based measure, we proposed in CP09/20 to extend the treatment indefinitely until an asset-based leverage ratio is implemented.

7.7 One respondent noted that supervisory monitoring of the leverage ratio will start in 2011, and we should consider whether an indefinite floor was required or whether it could fall away in 2013 when parallel running starts. Another respondent suggested that extending the capital floor past the start of supervisory monitoring of the leverage ratio on 1 January 2011, would result in burdensome additional costs to firms from running Basel I, Basel II and Basel III requirements simultaneously. They encouraged us to at least not be super-equivalent and extend the floors only to 31 December 2011.

**Our response:** We were not re-consulting on extending the capital floor in this CP, but only on the way in which it would be applied to later adopters of the modelled approaches. As we said in CP09/20, our intention is to extend the floor until an asset-based leverage ratio is implemented. We intend to gather data on the effect the leverage ratio has on capital standards and then give further consideration to removing the floor.

### Cost benefit analysis

Q5: Are there any other costs or benefits we should consider?

7.8 We have addressed questions on CBA in the two responses above.

# 8 Residential mortgage LGD floors

8.1 The CRD includes a transitional provision under which the exposure weighted average LGD for all retail exposures secured by residential properties may not be lower than 10%. This provision was originally due to expire at the end of this year but, following a review by the Basel Committee on Banking Supervision (BCBS), the CRD has been amended to extend the expiry of the LGD floor for retail exposures secured by residential properties for a further two years, until 31 December 2012.

8.2 We proposed to implement a 'copy out' into the BIPRU TP 11.6R to incorporate the revised expiry date.

> Q6: Is the extension to the residential mortgage LGD floor clear?

8.3 One respondent said that the proposals were clear, but suggested we be 'open to the acceptance of models that prove that a lower LGD is more accurate than an arbitrary floor of 10%, once these models have proved to be robust, accurate and sustainable'.

8.4 Another respondent asked if the average exposure weighted LGD can be calculated over a firm's whole residential mortgage portfolio at consolidated level and, if not, then how should the portfolio be defined?

**Our response:** The 10% limit is a hard limit set by the CRD, and we cannot be sub-equivalent to it by setting or accepting a lower limit.

On the question about calculating the average exposure weighted LGD – there is no change proposed to the calculation method of the LGD mortgage floor, just an extension of the transition. Therefore, firms should continue calculating as performed previously. However, the LGD should be applied at each level at which capital requirements are required to be calculated – that is at solo and consolidated levels.

# List of non-confidential respondents to the questions in CP10/17, and Chapter 3 of CP10/22

## Non-confidential respondents to CP10/17

Association for Financial Markets in Europe

British Bankers' Association

Building Societies Association

C. Hoare & Co.

HSBC

Linklaters

Lloyds Banking Group

Menelaus Analytics

The Co-operative Financial Services Limited

In addition we received one response where the respondent requested confidentiality for part or all of their response.

## Non-confidential respondents to chapter 3 of CP10/22

Lloyds Banking Group

British Bankers' Association

# Final Handbook text

# CAPITAL REQUIREMENTS DIRECTIVE (HANDBOOK AMENDMENTS NO 2) INSTRUMENT 2010

## Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 150(2) (Actions for damages);
(3) section 156 (General supplementary powers); and
(4) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

## Commencement

C. This instrument comes into force as follows:

(1) the amendments in Annex A, Annex B and Part 1 of Annex C come into force on 31 December 2010; and
(2) the remainder of the instrument comes into force on 1 January 2011.

## Amendments to the Handbook

D. The General Prudential sourcebook (GENPRU) is amended in accordance with Annexes A and B to this instrument.

E. The Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU) is amended in accordance with Annex C to this instrument.

## Citation

F. This instrument may be cited as the Capital Requirements Directive (Handbook Amendments No 2) Instrument 2010.

By order of the Board
16 December 2010

## Annex A

## Amendments to the General Prudential sourcebook (GENPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text.

### 2.2 Capital resources

…

Core tier one capital: permanent share capital

2.2.83 R *Permanent share capital* means an item of capital which (in addition to satisfying *GENPRU* 2.2.64R) meets the following conditions:

(1) …

(2) any *coupon* on it is not cumulative, the *firm* is under no obligation to pay a *coupon* in any circumstances and the *firm* has the right to choose the amount of any *coupon* that it pays; ~~and~~

(3) the terms upon which it is issued do not permit redemption and it is otherwise incapable of being redeemed to at least the same degree as an ordinary *share* issued by a company incorporated under the Companies Act 2006 (whether or not it is such a *share*); and

(4) (in the case of a *BIPRU firm*) it meets the conditions set out in *GENPRU* 2.2.83AR (General conditions for eligibility of capital instruments as core tier one capital (*BIPRU firm* only)).

General conditions for eligibility of capital instruments as core tier one capital (BIPRU firm only)

2.2.83A R The conditions that a *BIPRU firm's permanent share capital* must comply with under *GENPRU* 2.2.83R(4) or that a *BIPRU firm's eligible partnership capital* or *eligible LLP members' capital* must comply with under *GENPRU* 2.2.95R are as follows:

(1) it is undated;

(2) the terms upon which it is issued do not give the holder a preferential right to the payment of a *coupon*;

(3) the terms upon which it is issued do not indicate the amount of any *coupon* that may be payable nor impose an upper limit on the amount of any *coupon* that may be payable;

(4) the *firm's* obligations under the instrument do not constitute a liability (actual, contingent or prospective) under section 123(2) of the Insolvency Act 1986 and the holder has no right to petition for the

winding up or administration of the *firm* or for any similar procedure in relation to the *firm* arising from the non-payment of a *coupon* or any other sums payable under the instrument;

(5) there is no contractual or other obligation arising out of the terms upon which it is issued that requires the *firm* to repay capital to the holders other than on a liquidation of the *firm*;

(6) the terms upon which it is issued do not include a dividend pusher or a dividend stopper;

(7) the *firm* is under no obligation to issue *core tier one capital* or to make a payment in kind in lieu of making a *coupon* payment and non-payment of a *coupon* is not an event of default on the part of the *firm*;

(8) it is simple and the terms upon which it is issued are clearly defined;

(9) it is able to fully and unconditionally absorb losses on a non-discretionary basis as soon as they arise to allow the *firm* to continue trading, and it absorbs losses before all *capital instruments* that are not eligible for inclusion in stage A of the *capital resources table* and equally and proportionately with all *capital instruments* that are eligible for inclusion in stage A of the *capital resources table*;

(10) it ranks for repayment on winding up, administration or any other similar process lower than all other items of capital, and on a liquidation of the *firm* the holders have a claim on the residual assets remaining after satisfaction of all prior claims that is proportional to their holding and do not have a priority claim or a fixed claim for the nominal amount of their holding;

(11) the *firm* has not provided the holder with a direct or indirect financial contribution specifically to pay for the whole or a part of its subscription or purchase;

(12) a reasonable person would not think that the *firm* is likely to redeem or purchase it because of the description of its characteristics used in its marketing and in its contractual terms of issue; and

(13) its issue is not connected with one or more other transactions which, when taken together with its issue, could result in it no longer displaying all of the characteristics set out in *GENPRU* 2.2.83R(2), *GENPRU* 2.2.83AR(1) to (12) and (in the case of *permanent share capital*) *GENPRU* 2.2.83R(3).

2.2.83B R A *BIPRU firm* must not include in stage A of the *capital resources table* different classes of the same *share* type (for example "A ordinary shares" and "B ordinary shares") that meet the conditions in *GENPRU* 2.2.83R and *GENPRU* 2.2.83AR but have differences in voting rights, unless it has notified the *FSA* of its intention at least one month before the *shares* are

issued or (in the case of existing issued *shares*) the differences in voting rights take effect.

2.2.83C R A *BIPRU firm* must not pay a *coupon* on a *tier one instrument* included in stage A of the *capital resources table* if it has no distributable reserves.

2.2.83D G A *BIPRU firm* may disclose its dividend policy, provided that the policy only reflects the current intention of the *firm* and does not undermine the *firm's* right to choose the amount of any *coupon* that it pays.

Core tier one capital: exception to eligibility criteria (building societies only)

2.2.83E R A *building society* may include in stage A of the *capital resources table* a *capital instrument* that includes in its terms of issue an upper limit on the amount of any *coupon* that may be payable and the prohibition on a *coupon* limit under *GENPRU* 2.2.83AR(3) does not apply to that *capital instrument*, provided that:

(1) the *capital instrument* satisfies all other conditions for eligibility as *core tier one capital* set out in *GENPRU* 2.2.83R to *GENPRU* 2.2.83AR;

(2) the *coupon* limit has been imposed by law or the constitutional documents of the *firm*;

(3) the objective of the limit is to protect the capital reserves of the *firm*;

(4) the *firm* continues to have the effective right to choose the amount of any *coupon* that it pays;

(5) all other *capital instruments* issued by the *firm* and included in stage A of the *capital resources table*:

(a) meet the conditions set out in *GENPRU* 2.2.83R(2), *GENPRU* 2.2.83R(3) and *GENPRU* 2.2.83AR (General conditions for eligibility of capital instruments as core tier one capital (BIPRU firm only)); and

(b) if subject to a *coupon* limit, are subject to the same *coupon* limit; and

(6) any preferential *coupon* on a *capital instrument* included in stage A of the *capital resources table*, arising as a result of the inclusion of a *coupon* limit on another *capital instrument*, must be restricted to a fixed multiple of the *coupon* payment on the *capital instrument* that is subject to the *coupon* limit. *GENPRU* 2.2.83AR(2) to (3) do not prevent a *capital instrument* from being included in stage A of the *capital resources table* if the only reason for those prohibitions not being met is that a preferential *coupon* arises, and is restricted, in the manner referred to in this paragraph (6).

2.2.83F R A *building society* must not issue a *capital instrument* that includes a *coupon* limit in its terms of issue in accordance with *GENPRU* 2.2.83ER unless it has notified the *FSA* of its intention to do so at least one month before the intended date of issue.

2.2.83G G Under *GENPRU* 2.2.83ER(4), an effective right means that in practice the *firm* has, and exercises, full discretion to choose the amount of *coupon* that it pays (for example, it has not fettered that discretion by indicating to instrument holders that the *coupon* limit is the standard level of *coupon* they will receive).

2.2.83H G The purpose of *GENPRU* 2.2.83ER(6) is to limit the potential preferential rights that may arise on *capital instruments* that are not subject to a *coupon* limit. The *FSA* considers that "preferential" refers to both priority of *coupon* payment and level of *coupon* payment. Therefore the *FSA* considers that:

(1) a *coupon* arising on a *capital instrument* which is not subject to an explicit *coupon* limit within its terms of issue is likely to be preferential to a coupon on a *capital instrument* included in the *same stage of capital* which is subject to a *coupon* limit; and

(2) the preference so arising should be restricted so that it is not an unlimited preference.

Core tier one capital: additional information

2.2.84 G In the case of an *insurer*, *GENPRU* ~~2.2.83R~~ 2.2.83R(2) and *GENPRU* 2.2.83R(3) have ~~has~~ the effect that the *firm* should be under no obligation to make any payment in respect of a *tier one instrument* if it is to form part of its *permanent share capital* unless and until the *firm* is wound up. A *tier one instrument* that forms part of *permanent share capital* should not therefore count as a liability before the *firm* is wound up. The fact that relevant company law permits the *firm* to make earlier repayment does not mean that the *tier one instruments* are not eligible. However, the *firm* should not be required by any contractual or other obligation arising out of the terms of that capital to repay *permanent share capital*. Similarly, a *tier one instrument* may still qualify if company law allows dividends to be paid on this capital, provided the *firm* is not contractually or otherwise obliged to pay them. There should therefore be no fixed costs. *GENPRU* 2.2.83AR to *GENPRU* 2.2.83FR impose more specific conditions on *coupon* payment and winding up which are applicable to *BIPRU firms*.

2.2.84A G Under *GENPRU* 2.2.83AR(13) a *tier one instrument* does not meet the conditions for inclusion as *core tier one capital* if in isolation it does meet those requirements but fails to meet those requirements when other transactions are taken into account. Examples of those transactions include guarantees, pledges of assets or other side agreements provided by the *firm* to the holder of a *tier one instrument* designed to enhance the legal or economic seniority of the *tier one instrument*.

…

2.2.95 R A *BIPRU firm* that is a partnership or a *limited liability partnership* may not include *eligible partnership capital* or *eligible LLP members' capital* in its *tier one capital resources* unless (in addition to *GENPRU* 2.2.62R (General conditions relating to *tier one capital*) it complies with *GENPRU* 2.2.83R(2) (~~*Coupons*~~ Coupons should not be cumulative or mandatory) and *GENPRU* 2.2.83AR to *GENPRU* 2.2.83CR (General conditions for eligibility of capital instruments as core tier one capital (BIPRU firm only). However, *GENPRU* 2.2.64R(3) (Redemption), *GENPRU* 2.2.83AR(5) (Capital repayment) and *GENPRU* 2.2.83AR(12) (Characteristics in contract) are ~~is~~ replaced by *GENPRU* 2.2.93R or *GENPRU* 2.2.94R.

…

**Schedule 2 Notification and reporting requirements**

…

3 Table

| Handbook reference | Matter to be notified | Contents of notification | Trigger events | Time allowed |
|---|---|---|---|---|
| … | … | … | … | … |
| *GENPRU* 2.2.79GR | … | … | … | … |
| *GENPRU* 2.2.83BR | Intention to include in stage A of the *capital resources table* different classes of the same *share* type that meet the conditions in *GENPRU* 2.2.83R and *GENPRU* 2.2.83AR but have differences in voting rights. | Fact of intention. | Intention to include in stage A of the *capital resources table* classes of the same *share* type that have different voting rights. | At least one month before the *shares* are issued or (in the case of existing issued *shares*) the differences in voting rights take effect. |
| *GENPRU* 2.2.83FR | Intention by a *building society* to issue a *capital instrument* that includes a *coupon* limit in | Fact of intention. | Intention to issue a *capital instrument* that includes a *coupon* limit. | At least one month before the intended date of issue. |

| | | | | |
|---|---|---|---|---|
| | its terms of issuance in accordance with *GENPRU* 2.2.83ER. | | | |
| … | … | … | … | … |

## Annex B

## Further amendments to the General Prudential sourcebook (GENPRU)

The amendments shown in this Annex are to the version of the General Prudential sourcebook (GENPRU) as amended by Annex B to the Capital Requirements Directive (Handbook Amendments) Instrument 2010 (FSA 2010/29) which comes into force, together with this Annex, on 31 December 2010.

Although the amendments in Annex B to the Capital Requirements Directive (Handbook Amendments) Instrument 2010 (FSA 2010/29) have not come into force as at the date of this instrument, they are not shown as underlined for the purpose of this Annex.

In this Annex, underlining indicates new text inserted into the version of the General Prudential Sourcebook amended in Annex B to the Capital Requirements Directive (Handbook Amendments) Instrument 2010 (FSA 2010/29) and striking through indicates text deleted from that version, unless otherwise stated.

### 2.2 Capital resources

…

Table: Arrangement for GENPRU 2.2

2.2.6 G This table belongs to *GENPRU* 2.2.5G

| Topic | Location of text |
|---|---|
| … | … |
| *Core tier one capital: permanent share capital* | *GENPRU* 2.2.83R to *GENPRU* ~~2.2.84G~~ 2.2.84AG |
| General conditions for eligibility of *capital instruments* as *core tier one capital* (*BIPRU firm* only) | *GENPRU* 2.2.83AR to *GENPRU* 2.2.83DG; *GENPRU* 2.2.84AG |
| *Core tier one capital:* exception to eligibility criteria (*building societies* only) | *GENPRU* 2.2.83ER to *GENPRU* 2.2.83HG |
| … | … |
| Purchases of *tier one instruments*: *BIPRU firm* only | *GENPRU* 2.2.79AR to *GENPRU* 2.2.79HG; *GENPRU* 2.2.79LG |
| … | … |

…

General conditions for eligibility as tier one capital

2.2.64 R The conditions that an item of capital of a *firm* must comply with under *GENPRU* 2.2.62R(2) are as follows:

…

(6) it is able to absorb losses to allow the *firm* to continue trading and:

…

(b) in the case of a *BIPRU firm*, it does not, through appropriate mechanisms, hinder the recapitalisation of the *firm*, and in particular it complies with:

(i) *GENPRU* 2.2.80R to *GENPRU* 2.2.81R (Loss absorption); ~~and~~

(ii) ~~in the case of *hybrid capital*, *GENPRU* 2.2.116R to *GENPRU* 2.2.118R (Other tier one capital: loss absorption);~~ in the case of *core tier one capital*, *GENPRU* 2.2.83AR(9) to (10) (General conditions for eligibility of capital instruments as core tier one capital (BIPRU firm only)); and

(iii) in the case of *hybrid capital*, *GENPRU* 2.2.116R to *GENPRU* 2.2.118R (Other tier one capital: loss absorption);

…

…

Purchases of tier one instruments: BIPRU firm only

2.2.79A R A *BIPRU firm* must not purchase a *tier one instrument* that it has included in its *tier one capital resources* unless:

(1) the *firm* initiates the purchase;

(2) ~~it is on or after the fifth anniversary of the date of issue of the instrument; and~~ [deleted]

(3) the *firm* has given notice to the *FSA* in accordance with *GENPRU* 2.2.79GR; and

(4) (in the case of *hybrid capital*) it is on or after the fifth anniversary of the date of issue of the instrument.

2.2.79B G In exceptional circumstances a *BIPRU firm* may apply for a *waiver* of

~~*GENPRU* 2.2.79AR(2)~~ *GENPRU* 2.2.79AR(4) under section 148 (Modification or waiver of rules) of the *Act*.

2.2.79C R ~~*GENPRU* 2.2.79AR(2)~~ *GENPRU* 2.2.79AR(4) does not apply if:

(1) the *firm* replaces the *capital instrument* it intends to purchase with a *capital instrument* that is included in a *higher stage of capital* or the *same stage of capital*; and

(2) the replacement *capital instrument* has already been issued.

2.2.79D R ~~*GENPRU* 2.2.79AR(2)~~ *GENPRU* 2.2.79AR(4) does not apply if:

(1) the *firm* intends to hold the purchased instrument for a temporary period as *market maker*; and

(2) the purchased instruments held by the *firm* do not exceed the lower of:

(a) 10% of the relevant issuance; and

(b) 3% of the *firm's* total issued *hybrid capital*.

...

2.2.79I R A *BIPRU firm* must not announce to the holders of a *tier one instrument* its intention to purchase that instrument unless it has notified that intention to the *FSA* in accordance with *GENPRU* 2.2.79GR and it has not, during the period of one month from the date of giving notice, received an objection from the *FSA*.

2.2.79J R If a *BIPRU firm* announces the purchase of any *tier one instrument*, the *firm* must no longer include that instrument in its *tier one capital resources*.

2.2.79K R If a *BIPRU firm* does not comply with its *capital resources requirement*, or if the purchase of any *tier one instrument* would cause it to breach its *capital resources requirement*, it must suspend the purchase of *tier one instruments*.

2.2.79L G A *firm* should continue to exclude from its *tier one capital resources* all *tier one instruments* that are the subject of a purchase notification under *GENPRU* 2.2.79GR and for which the offer to purchase has been declined by the instrument holders unless the purchase offer period has expired.

…

2.2.82 G There are additional loss absorption requirements for (in the case of an *insurer*) *innovative tier one capital*, and (in the case of a *BIPRU firm*) *hybrid capital* in *GENPRU* 2.2.116R to *GENPRU* 2.2.118R (Other tier one capital: loss absorption) and (in the case of a *BIPRU firm*) for *core tier one capital* in *GENPRU* 2.2.83AR(9) to (10) (General conditions for eligibility of capital instruments as core tier one capital (*BIPRU firm* only)).

…

After GENPRU TP 8A, insert the following new transitional provisions. The text is not underlined.

**TP 8B Miscellaneous capital resources definitions for BIPRU firms: Core tier one capital**

Application

8B.1 R This section applies to a *BIPRU firm*.

Core tier one capital

8B.2 R A provision in this section applies on a consolidated basis for the purposes of *BIPRU* 8 (Group risk – consolidation) to a *UK consolidation group* to the extent that, and in the same manner that, the provision in *GENPRU* to which it relates applies on a consolidated basis.

8B.3 R The Royal Bank of Scotland plc may treat a *share* falling within *GENPRU* TP 8B.4R as eligible for inclusion within stage A of the *capital resources table* (Core tier one capital) if it would not otherwise be eligible provided that:

(1) the *share*:

(a) had been issued on or before 30 December 2010; or

(b) if issued after that date, is issued pursuant to a contractual obligation requiring its issue entered into on or before 30 December 2010;

(2) as at 30 December 2010 The Royal Bank of Scotland plc was entitled (or would have been entitled, had the *share* then been issued) to include it in the calculation of its *capital resources* under *GENPRU* as *permanent share capital* and, in the case of a *share* which had been issued as at that date, did so include it; and

(3) the *share* is held by or on behalf of the Government of the *United Kingdom*.

8B.4 R The *shares* referred to in *GENPRU* TP 8B.3R are as follows:

(1) The Royal Bank of Scotland Group plc Series 1 Class B Shares of 1p each; and

(2) The Royal Bank of Scotland Group plc Series 1 Dividend Access Share of 1p;

either as separate instruments or considered together as connected

instruments

Voting rights

8B.5 R A *BIPRU firm* may treat an ordinary *share* that has different voting rights to other ordinary *shares* issued by the *firm* as eligible for inclusion within stage A of the *capital resources table* (Core tier one capital) without making a notification of issue or change in voting rights to the *FSA* under *GENPRU* 2.2.83BR if:

(1) on 30 December 2010 the *firm* was subject to *GENPRU*;

(2) the *firm* issued the ordinary *share* on or before 30 December 2010 and the shareholders were bound by the differences in voting rights on or before 30 December 2010; and

(3) as at 30 December 2010 the *firm* included the ordinary *share*, and was entitled to include it, in the calculation of *capital resources* under *GENPRU* as *permanent share capital*;

provided that by 30 June 2011 the *firm* provides the *FSA* with full details of the ordinary *shares*, their terms of issue and the differences in voting rights applicable to those ordinary *shares*.

# Annex C

## Amendments to the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text.

**Part 1: Comes into force on 31 December 2010**

### 6.5 Operational risk: Advanced measurement approaches

…

6.5.30A G A *firm* that recognises the impact of insurance and operational risk mitigation techniques for the purposes of its *operational risk* measurement system should be able to show that it has considered the Commission of European Banking Supervisors' guidelines on operational risk mitigation techniques published in December 2009. This can be found at http://www.c-ebs.org/documents/Publications/Standards---Guidelines/2009/Operational-risk-mitigation-techniques/Guidelines.aspx.

…

### 10.2 Identification of exposures and recognition of credit risk mitigation

…

10.2.2A G The Committee of European Banking Supervisors (CEBS) has issued guidelines on the conditions applicable to the short-term *exposures* referred to in *BIPRU* 10.2.2R(4) and (5) in order to be exempted from the *large exposures* limits in *BIPRU* 10.5 (Limits on exposures). These guidelines can be found at: http://www.c-ebs.org/Publications/Standards-Guidelines/CEBS-Guidelines-on-Article-106(2)-(c)-and-(d)-of-D.aspx.

…

### 10.3 Identification of counterparties

…

Connected counterparties

10.3.8 R …

10.3.8A G The Committee of European Banking Supervisors (CEBS) has issued guidelines in relation to the definition of a *group of connected clients*, in particular with reference to the concepts of "control" and "economic interconnection". These guidelines can be found at: http://www.c-ebs.org/Publications/Standards-Guidelines/CEBS-Guidelines-on-the-revised-large-exposures-reg.aspx - Part I.

…

Exposures to underlying assets

10.3.15 R …

10.3.16 G The Committee of European Banking Supervisors (CEBS) has issued guidelines in relation to the treatment for *large exposures* purposes of schemes with *exposures* to underlying assets. These guidelines can be found at: http://www.c-ebs.org/Publications/Standards-Guidelines/CEBS-Guidelines-on-the-revised-large-exposures-reg.aspx - Part II.

…

**Part 2: Comes into force on 1 January 2011**

**3.4 Risk weights under the standardised approach to credit risk**

…

Exposures in the form of covered bonds

…

3.4.107 R (1) *Covered bonds* means covered bonds as defined in paragraph (1) of the definition in the *glossary* (Definition based on Article 22(4) of the *UCITS Directive*) and collateralised by any of the following eligible assets:

…

(d) loans secured:

(i) by residential real estate or shares in Finnish residential housing companies as referred to in *BIPRU* 3.4.57R up to the lesser of the principal amount of the liens that are combined with any prior liens and 80% of the value of the pledged properties; or

(ii) by senior units issued by French Fonds Communs de Créances or by equivalent *securitisation* entities governed by the laws of an *EEA State securitising* residential real estate *exposures* provided that ~~at least 90% of the assets of such Fonds Communs de Créances or of equivalent *securitisation* entities governed by the laws of an *EEA State* are composed of mortgages that are combined with any prior liens up to the lesser of the principal amounts due under the units,~~

~~the principal amounts of the liens, and 80% of the value of the pledged properties and the units qualify for *credit quality step* 1 where such units do not exceed 20% of the nominal amount of the outstanding issue~~ the special public supervision to protect bond holders as provided for in Article 52(4) of Directive 2009/65/EC of the European Parliament and of the Council ensures that the assets underlying such units must, at any time while they are included in the cover pool, be at least 90% composed of residential mortgages that are combined with any prior liens up to the lesser of the principal amounts due under the units, the principal amounts of the liens, and 80% of the value of the pledged properties, that the units qualify for *credit quality step* 1 and that such units do not exceed 10% of the nominal amount of the outstanding issue; or

(e) (i) loans secured by commercial real estate or shares in Finnish housing companies as referred to in *BIPRU* 3.4.57R up to the lesser of the principal amount of the liens that are combined with any prior liens and 60% of the value of the pledged properties; or

(ii) loans secured by senior units issued by French Fonds Communs de Créances or by equivalent *securitisation* entities governed by the laws of an *EEA State* *securitising* commercial real estate *exposures* provided that~~, at least, 90% of the assets of such Fonds Communs de Créances or of equivalent *securitisation* entities governed by the laws of an *EEA State* are composed of mortgages that are combined with any prior liens up to the lesser of the principal amounts due under the units, the principal amounts of the liens, and 60% of the value of the pledged properties and the units qualify for *credit quality step* 1 where such units do not exceed 20% of the nominal amount of the outstanding issue~~ the special public supervision to protect bond holders as provided for in Article 52(4) of Directive 2009/65/EC of the European Parliament and of the Council ensures that the assets underlying such units must, at any time while they are included in the cover pool, be at least 90% composed of commercial mortgages that are combined with any prior liens up to the lesser of the principal amounts due under the units, the principal amounts of the liens, and 60% of the value of the pledged properties, that the units qualify for *credit quality step* 1 and that such units do not exceed 10% of the nominal amount of the outstanding issue; or

(iii) …

…

…

(4) ~~Until 31 December 2010 the 20% limit for senior units issued by French Fonds Communs de Créances or by equivalent *securitisation* entities specified in subpoints (d) and (e) does not apply, provided that those senior units have a credit assessment by a *nominated ECAI* which is the most favourable category of credit assessment made by the *ECAI* in respect of *covered bonds*.~~ [deleted]

(4A) Until 31 December 2013, the 10% limit for senior units issued by French Fonds Communs de Créances or by equivalent *securitisation* entities as specified in (1)(d)(ii) and (1)(e)(ii) does not apply, provided that:

(a) the *securitised* residential or commercial real estate *exposures* were originated by a member of the same consolidated group of which the *issuer* of the *covered bonds* is also a member or by an entity affiliated to the same central body to which the *issuer* of the *covered bonds* is also affiliated (that common group membership or affiliation to be determined at the time the senior units are made collateral for *covered bonds*); and

(b) a member of the same consolidated group of which the *issuer* of the *covered bonds* is also a member or an entity affiliated to the same central body to which the *issuer* of the *covered bonds* is also affiliated retains the whole first loss tranche supporting those senior units.

…

…

## 4.4 The IRB approach: Exposures to corporates, institutions and sovereigns

…

IRB foundation approach: LGDs

4.4.34 R A *firm* must use the following *LGD* values:

…

(4) *covered bonds* may be assigned an *LGD* value of ~~12.5%~~ 11.25%; and

…

4.4.35 R ~~Until 31 December 2010, *covered bonds* as set out in *BIPRU* 3.4.107R to~~

~~*BIPRU* 3.4.110R may be assigned an *LGD* value of 11.25% if:~~

~~(1)~~ ~~assets set out in *BIPRU* 3.4.107R(1)(a) to (c) collateralising the *covered bonds* all qualify for *credit quality assessment step* one as set out in *BIPRU* 3;~~

~~(2)~~ ~~where assets set out in *BIPRU* 3.4.107R(1)(d) and *BIPRU* 3.4.107R(1)(e) are used as collateral, the respective upper limits laid down in each of those points is 10% of the nominal amount of the outstanding issue;~~

~~(3)~~ ~~assets as set out in *BIPRU* 3.4.107R(1)(f) are not used as collateral; or~~

~~(4)~~ ~~the *covered bonds* are the subject of a credit assessment by a *nominated ECAI*, and the *ECAI* places them in the most favourable category of credit assessment that the *ECAI* could make in respect of *covered bonds*.~~ <u>[deleted]</u>

~~[**Note:** *BCD* Annex VII Part 2 point 8 (part)]~~

…

**Transitional Provisions**

…

**TP 2 Capital floors for a firm using the IRB or AMA approaches**

…

<u>Waiver from IPRU capital resources requirement</u>

<u>2.11A</u> <u>G</u> <u>Article 152(5d) and (5e) of the *Banking Consolidation Directive* allows the *FSA* to waive the capital floor calculation based on the *IPRU* capital resources requirement in *BIPRU* TP 2.8R(3), or *BIPRU* TP 2.8R(3) as applied in *BIPRU* TP 2.9R, on a case-by-case basis only if a *firm* started to use the *IRB approach* or the *advanced measurement approach* on or after 1 January 2010. The *FSA* will consider an application for such a *waiver* in the light of the criteria in section 148 of the *Act* (Modification or waiver of rules).</u>

<u>2.11B</u> <u>R</u> <u>If a *firm* has a *waiver* referred to in *BIPRU* TP 2.11AG, it must provide *capital resources* that equal or exceed 80% of the *capital resources requirement* that the *firm* would be required to provide under the relevant sections of *BIPRU* applicable to it immediately before it started to use the *IRB approach* or the *advanced measurement approach* as those sections were in force on 31 December 2010.</u>

…

## TP 11 IRB transitionals

…

Residential properties

| | | |
|---|---|---|
| 11.6 | R | In accordance with Article 154(5) of the *Banking Consolidation Directive*, until ~~31 December 2010~~ 31 December 2012, the *exposure*-weighted average *LGD* for all *retail exposures* secured by residential properties and not benefiting from guarantees from central governments must not be lower than 10%. |

…

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