Instruments eligible for inclusion in Tier 1 capital ("Sydney Press Release")

27 October 1998

The Basle Committee on Banking Supervision has taken note that over the past years some banks have issued a range of innovative capital instruments, such as instruments with step-ups, with the aim of generating Tier 1 regulatory capital that is both cost-efficient and can be denominated, if necessary, in non-local currency. The Committee has carefully observed these developments and at its meeting on 21st October 1998 decided to limit acceptance of these instruments for inclusion in Tier 1 capital. Such instruments will be subject to stringent conditions and limited to a maximum of 15% of Tier 1 capital.

As its starting point, the Committee reaffirms that common shareholders' funds, i.e. common stock and disclosed reserves or retained earnings, are the key element of capital. Common shareholders' funds allow a bank to absorb losses on an ongoing basis and are permanently available for this purpose. Further, this element of capital best allows banks to conserve resources when they are under stress because it provides a bank with full discretion as to the amount and timing of distributions. Consequently, common shareholders' funds are the basis on which most market judgements of capital adequacy are made. The voting rights attached to common stock also provide an important source of market discipline over a bank's management. For these reasons, voting common shareholders' equity and the disclosed reserves or retained earnings that accrue to the shareholders' benefit should be the predominant form of a bank's Tier 1 capital.

To provide supervisors and market participants with sufficient information to ensure that the integrity of capital is maintained, the Committee agrees that, as set forth in its recent report "Enhancing Bank Transparency", banks should periodically publicly disclose each component of Tier 1 capital and its main features.

In order to protect the integrity of Tier 1 capital, the Committee has determined that minority interests in equity accounts of consolidated subsidiaries that take the form of SPVs should only be included in Tier 1 capital if the underlying instrument meets the following requirements which must, at a minimum, be fulfilled by all instruments included in Tier 1:

- issued and fully paid;
- non-cumulative;

- able to absorb losses within the bank on a going-concern basis;
- junior to depositors, general creditors, and subordinated debt of the bank;
- permanent;
- neither be secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors; and
- callable at the initiative of the issuer only after a minimum of five years with supervisory approval and under the condition that it will be replaced with capital of same or better quality unless the supervisor determines that the bank has capital that is more than adequate to its risks.

In addition, the following conditions have also to be fulfilled:

- the main features of such instruments must be easily understood and publicly disclosed;
- proceeds must be immediately available without limitation to the issuing bank, or if proceeds are immediately and fully available only to the issuing SPV, they must be made available to the bank (e.g. through conversion into a direct issuance of the bank that is of higher quality or of the same quality at the same terms) at a predetermined trigger point, well before serious deterioration in the bank's financial position;
- the bank must have discretion over the amount and timing of distributions, subject only to prior waiver of distributions on the bank's common stock and banks must have full access to waived payments; and
- distributions can only be paid out of distributable items; where distributions are pre-set they may not be reset based on the credit standing of the issuer.

Moderate step-ups in instruments issued through SPVs, as well as in directly issued Tier 1 instruments meeting the requirements set forth in paragraphs 4 and 5, are permitted, in conjunction with a call option, only if the moderate step-up occurs at a minimum of ten years after the issue date and if it results in an increase over the initial rate that is no greater than, at national supervisory discretion, either;

- 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or
- 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis.

The terms of the instrument should provide for no more than one rate step-up over the life of the instrument. The swap spread should be fixed as of the pricing date and reflect the differential in pricing on that date between the initial reference security or rate and the stepped-up reference security or rate.

National supervisors expect banks to meet the Basle minimum capital ratios without undue reliance on innovative instruments, including instruments that have a step-up. Accordingly, the aggregate of issuances of non-common equity Tier 1 instruments with any explicit feature - other than a pure call option - which might lead to the instrument being redeemed is limited - at issuance - to 15% of the consolidated bank's Tier 1 capital.

Any instruments authorised or issued under existing national rules of Tier 1 which no longer qualify under the above interpretation will be grandfathered; the same will apply to any issues of such instruments in excess of the 15% limitation.

This interpretation will be subject to further review as part of a broader effort already underway to reassess the present framework for evaluating banks' capital adequacy. In this respect, the Committee retains its flexibility to make any changes to this interpretation.