Annex 1a

Definition of Capital Included in the Capital Base

A. Capital elements

Tier 1 (a) Paid-up share capital/common stock

(b) Disclosed reserves

Tier 2 (a) Undisclosed reserves

(b) Asset revaluation reserves

(c) General provisions/general loan-loss reserves (subject to provisions of paragraphs 42 and 43)

(d) Hybrid (debt/equity) capital instruments

(e) Subordinated debt

Tier 3 At the discretion of their national authority, banks may also use a third tier of capital (Tier 3), consisting of short-term subordinated debt as defined in paragraphs 49(xxi) and 49(xxii) of this Framework, for the sole purpose of meeting a proportion of the capital requirements for market risks.

The sum of Tier 1, Tier 2, and Tier 3 elements will be eligible for inclusion in the capital base, subject to the following limits.

B. Limits and restrictions

(i) The total of Tier 2 (supplementary) elements will be limited to a maximum of 100% of the total of Tier 1 elements;

(ii) Subordinated term debt will be limited to a maximum of 50% of Tier 1 elements;

(iii) Tier 3 capital will be limited to 250% of a bank's Tier 1 capital that is required to support market risks.

(iv) Where general provisions/general loan-loss reserves include amounts reflecting lower valuations of asset or latent but unidentified losses present in the balance sheet, the amount of such provisions or reserves will be limited to a maximum of 1.25 percentage points;

(v) Asset revaluation reserves which take the form of latent gains on unrealised securities (see below) will be subject to a discount of 55%.

C. Deductions from the capital base

From Tier 1: Goodwill and increase in equity capital resulting from a securitisation exposure, pursuant to paragraph 562 of this Framework

50% from Tier 1 and 50% from Tier 2 capital:

(i) Investments in unconsolidated banking and financial subsidiary companies.

N.B. The presumption is that this Framework would be applied on a consolidated basis to banking groups.

(ii) Investments in the capital of other banks and financial institutions (at the discretion of national authorities).

(iii) Significant minority investments in other financial entities.

D. Definition of capital elements

(i) **Tier 1**: includes only **permanent shareholders' equity** (issued and fully paid ordinary shares/common stock and perpetual non-cumulative preference shares) and **disclosed reserves** (created or increased by appropriations of retained earnings or other surplus, e.g. share premiums, retained profit, general reserves and legal reserves). Disclosed reserves also include general funds (such as fund for general banking risk in certain EC countries) of the same quality that meet the following criteria:

- Allocations to the funds must be made out of post-tax retained earnings or out of pre-tax earnings adjusted for all potential tax liabilities;
- The funds and movements into or out of them must be disclosed separately in the bank's published accounts;
- The funds must be available to a bank to meet losses for unrestricted and immediate use as soon as they occur;
- Losses cannot be charged directly to the funds but must be taken through the profit and loss account.

In the case of consolidated accounts, this also includes minority interests in the equity of subsidiaries which are less than wholly owned. This basic definition of capital excludes revaluation reserves and cumulative preference shares.

(ii) **Tier 2**

(a) Undisclosed reserves are eligible for inclusion within supplementary elements provided these reserves are accepted by the supervisor. Such reserves consist of that part of the accumulated after-tax surplus of retained profits which banks in some countries may be permitted to maintain as an undisclosed reserve. Apart from the fact that the reserve is not identified in the published balance sheet, it should have the same high quality and character as a disclosed capital reserve; as such, it should not be encumbered by any provision or other known liability but should be freely and immediately available to meet unforeseen future losses. This definition of undisclosed reserves excludes hidden values arising from holdings of securities in the balance sheet at below current market prices (see below).

(b) **Revaluation** reserves arise in two ways. Firstly, in some countries, banks (and other commercial companies) are permitted to revalue fixed assets, normally their own premises, from time to time in line with the change in market values. In some of these countries the amount of such revaluations is determined by law. Revaluations of this kind are reflected on the face of the balance sheet as a revaluation reserve.

Secondly, hidden values of "latent" revaluation reserves may be present as a result of long-term holdings of equity securities valued in the balance sheet at the historic cost of acquisition.

Both types of revaluation reserve may be included in Tier 2 provided that the assets are prudently valued, fully reflecting the possibility of price fluctuation and forced sale. In the case of "latent" revaluation reserves a discount of 55% will be applied to the difference between historic cost book value and market value to reflect the potential volatility of this form of unrealised capital and the notional tax charge on it.

(c) **General provisions/general loan-loss reserves** (for banks using the Standardised Approach for credit risk): provisions or loan-loss reserves held against future, presently unidentified losses are freely available to meet losses which subsequently materialise and therefore qualify for inclusion within supplementary elements. Provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, should be excluded. Furthermore, general provisions/general loan-loss reserves eligible for inclusion in Tier 2 will be limited to a maximum of 1.25 percentage points of weighted risk assets

(d) **Hybrid (debt/equity) capital instruments**. This heading includes a range of instruments which combine characteristics of equity capital and of debt. Their precise specifications differ from country to country, but they should meet the following requirements:

- they are *unsecured, subordinated* and *fully paid-up*;
- they are *not redeemable* at the initiative of the holder or without the prior consent of the supervisory authority;
- they are *available to participate in losses* without the bank being obliged to cease trading (unlike conventional subordinated debt);
- although the capital instrument may carry an obligation to pay interest that cannot permanently be reduced or waived (unlike dividends on ordinary shareholders' equity), *it should allow service obligations to be deferred* (as with cumulative preference shares) where the profitability of the bank would not support payment.

Cumulative preference shares, having these characteristics, would be eligible for inclusion in this category. In addition, the following are examples of instruments that may be eligible for inclusion: long-term preferred shares in Canada, titres participatifs and titres subordonnés à durée indéterminée in France, Genusscheine in Germany, perpetual subordinated debt and preference shares in the United Kingdom and mandatory convertible debt instruments in the United States. Debt capital instruments which do not meet these criteria may be eligible for inclusion in item (e).

(e) **Subordinated term debt**: includes conventional unsecured subordinated debt capital instruments with a minimum original fixed term to maturity of over five years and limited life redeemable preference shares. During the last five years to maturity, a cumulative discount (or amortisation) factor of 20% per year will be applied to reflect the diminishing value of these instruments as a continuing source of strength. Unlike instruments included in item (d), these instruments are not normally available to participate in the losses of a bank which continues trading. For this reason these instruments will be limited to a maximum of 50% of Tier 1.