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Lloyds Banking Group Enhanced Capital Notes (ECNs)

We have received a number of enquiries relating to Lloyds Banking Group (LBG) ECNs. I am sharing our responses below, to ensure that all interested parties have access to the same information.

Can you confirm that the £1.2bn value of the embedded derivative constituted by the conversion clause in the ECN's was included in LBG's £27bn Common Equity Tier 1 (CET1) modelled through the PRA's 2014 Stress Test and, if not, what value was included?

In their stress test submission, LBG included the embedded derivative as a positively-valued asset on the balance sheet. For the purpose of the 2014 stress tests, in their forward projections of the balance sheet, LBG estimated that there would be no change in the value of the embedded derivative in the stress.

When calculating own funds, LBG are subject to a requirement under FSMA section 55M to ignore any cumulative unrealised gains which may arise due to changes in the value of the derivative embedded in the ECNs. You can view this requirement [online](#).¹ If the value of the embedded derivative rose above its value at inception in 2009, the resulting net gains that would otherwise feed into reserves and therefore the CET1/Core Tier 1 (CT1) capital calculation, would instead be ignored.

The [PRA letter](#) dated March 17 stated that "we note that as a result of the differences between the definitions of CT1 and CET1 capital, it is likely that the ECN's would only reach the contractual conversion trigger at a point materially below 4.5% CET1." Could you please provide the basis of your assessment?

The deductions and filters regime changed as a result of the Capital Requirements Regulation / Capital Requirements Directive IV (CRR/CRD IV), which entered into force on 1 January 2014, and introduced the CET1 regime. Many of the resulting changes would drive differences between CT1 and CET1 for a given bank balance sheet. Deferred tax assets and significant investments in insurers would have been key areas of difference between CT1 and CET1 for a firm such as Lloyds Banking Group.

The effect of deductions on stress testing results depends on the approach required by the Bank of England, expressed in guidance documents for participating firms, and, where not specified in the guidance, on firms' own judgements.

¹ See 'Fair value of conversion derivative'

In the 2014 stress tests, firms were expected to submit projections over a three year horizon under the CRR/CRDIV definition of capital set out in Supervisory Statement SS7/13 (available [here](#)) and the definition used by UK firms taking part in the EU wide exercise. The guidance (available [here](#)) made clear that firms were expected to assess the impact of the stress scenario on insurance activities and model the impact on any dividend stream, material holdings or minority interest capital deductions and risk weightings.

Whether CT1 and CET1 standards for assessing capital resources would converge or diverge in a stress test would depend on a number of factors, including the parameters of the stress test that would be set in guidance documents produced by the Bank of England at the time.

In 2009 and 2010, what were the criteria against which the Financial Services Authority (FSA) reviewed the terms and conditions of bank capital instruments prior to issuance to gain comfort that they would be classed as eligible Lower Tier 2 Capital under the prevailing capital regime?

The rules that set out the conditions under which instruments were eligible to qualify as Tier 2 regulatory capital in 2009 and 2010 were contained in in the EU Banking Consolidation Directive² and the FSA's General Prudential Sourcebook (GENPRU) rules 2.2.157 – 2.2.197, to be read in conjunction with the entirety of Section 2.2. GENPRU is a publicly available resource, and can be viewed online [here](#). You can select a date to review the rules that were applicable at a given point in time, for any date from 1 January 2001 onwards.

We would draw your attention to both the general terms for qualification as Tier 2 (outlined in rule 2.2.159) as well as the provisions specific to Lower Tier 2 (outlined in rule 2.2.194), though relevant material is contained throughout this section. It is the responsibility of a firm to satisfy itself that a capital instrument complies with the relevant rules. Rule 2.2.159R(12) required firms to obtain an independent legal opinion stating that the relevant eligibility criteria have been met.

What was the minimum Core Tier 1 or Common Equity Tier 1 threshold in the stress scenario for the FSA / Bank of England's stress test in the years 2009 to 2013?

The Bank of England ran a concurrent stress test, which compared the performance of each major UK bank in an identical stressed scenario with an identical CET1 'hurdle rate' in 2014, and is doing the same in 2015.

Concurrent stress tests were not performed in the years 2009-2013. Instead, banks were required to hold a capital planning buffer set through a combination of analysis and calculation based on information the firm provided during its Internal Capital Adequacy Assessment Process (ICAAP) review, which was supplemented, in some cases, by the FSA's, and in 2013 the PRA's own assessment. The analysis involved projecting the firm's capital resources and capital requirements over a three to five year horizon, incorporating the impacts of stressed conditions to assess movements in capital resources and capital requirements in adverse circumstances. The minimum threshold for stress testing evolved over the period from 2009 to 2013.

The FSA's 2007 'Our Pillar 2 assessment framework' document (available [here](#)) explains how the FSA required firms to be able to demonstrate how they will meet their regulatory capital requirement through a three to five year period which included the possibility of a severe economic downturn or business event occurring.


² Directive of the European Parliament and of the Council relating to the taking up and pursuit of business of credit institutions (recast) (2006/48/EC).

Subsequent publications built on the framework outlined above. In 2008 the FSA issued a [statement](#) on the capital thresholds employed in the context of the UK Bank Recapitalisation Package, which explained that the FSA used common benchmarks ratios of capital to risk weighted assets of Tier 1 Capital of at least 8% and Core Tier 1 Capital, as defined by the FSA, of at least 4% after the application of a stressed scenario. A subsequent [FSA Statement](#), issued in January 2009, set out further related developments in the capital framework. Additional clarification was provided in a May 2009 [FSA Statement](#) on the use of stress tests.

The FSA (and subsequently PRA) Handbook contained rules and guidance on stress testing in GENPRU 1.2 which applied from December 2009 to December 2013. This included guidance in GENPRU 1.2.83AG which stated that *“If, after taking account of realistic management actions, a firm's stress testing management plan shows that the firm's projected capital resources are less than those required to continue to meet its CRR or less than those needed to continue to meet the overall financial adequacy rule over the projection period, the FSA may require the firm to set out additional countervailing measures and off-setting actions to reduce such difference or to restore the firm's capital adequacy after the stress event.”*

The purpose of the capital planning buffer was further outlined in Policy Statement 10/14 (available [here](#)). PS10/14 introduced some changes to GENPRU 1.2 and to the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU) 2.2, to make it clear that the capital planning buffer was “the amount and quality of capital resources that a firm should hold at a given time in accordance with the general stress and scenario testing rule, so that the firm is able to continue to meet the overall financial adequacy rule throughout the relevant capital planning period in the face of adverse circumstances, after allowing for realistic management actions.”

Yours Sincerely,

A handwritten signature in black ink that reads "Andrew Bailey". The signature is written in a cursive, slightly slanted style.

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