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Dear Simon

Definition of Core Tier 1 Capital

Further to our recent discussions and correspondence we are writing to confirm the definition of Core Tier 1 capital ("CT1") that banks should use for specific reporting and disclosure purposes.

Positive items

For all purposes the positive items that will be included in CT1 are those set out in Stage A of GENPRU Annex 2R. Preference shares eligible for inclusion in Stage B cannot be included in CT1.

Consolidated capital – for disclosure purposes and for FSA measurement of consolidated capital

Firms have the option under GENPRU 2.2.237R of deducting certain securitisation positions or including them in their capital requirements calculation. The proposal from the major listed firms is that they will all choose the deduction option so that CT1 is calculated consistently across firms.

We concluded that it is appropriate that the tier 1 share of the material holdings deduction should be excluded from the calculation of CT1 at the consolidated level (ie they do not have to be deducted from CT1).

As a result, the following deductions should be made from CT1:

- Items set out in Stage E of GENPRU 2 Annex 2R (such as investments in own shares and intangible assets)
- The tier 1 share of the securitisation positions deduction
- The tier 1 share of the expected loss amount in excess of provisions

We also concluded that the expected loss less provisions amount deducted from CT1 can be reduced as a result of the tax effect of that deduction. That is to say 50% of the adjustment to reserves in respect of the tax effect of the whole of the expected loss amount in excess of provisions deduction can be included in CT1. The remaining 50% of this adjustment will continue to be included in total Tier 1 capital.

Solo and solo consolidated capital

Firms continue to report solo and solo-consolidated capital positions to the FSA as part of our on-going supervisory approach. The only change to current arrangements at this stage is that the adjustment to reserves, in respect of the tax effect of the deduction relating to expected loss less provisions, should be allocated as set out above.

As you know, the FSA carries out a number of calculations when considering a firm's capital adequacy. Where the FSA uses different calculations for the supervision of specific firms on an individual basis, these calculations may deliver a different – and possibly lower – outcome to a calculation carried out using the methodology set out above for consolidated purposes.

This point should be highlighted in any external disclosure of consolidated positions so that external stakeholders are clear that different calculations may be carried out for specific purposes.

We have agreed that the definition of CT1 set out above should be used in firms' first quarter disclosures. Thereafter we expect CT1 will be used as part of firms' normal disclosures.

Future developments

As part of our supervisory focus on the capital position of regulated firms and our ongoing domestic and international work on the definition of capital we will keep this issue under review. We will continue to discuss developments in respect of the definition of CT1 with you and your member firms.

We look forward to working with you and your member firms to deliver this consistent approach to capital measurement and disclosure in practice.

Yours sincerely,

Paul Sharma
Director, Wholesale & Prudential Policy