Appendix 1

Determination of equity exposure

1. Equity exposures are defined on the basis of the economic substance of the instrument. They include both direct and indirect ownership interests[50], whether voting or non-voting, in the assets and income of a commercial enterprise or of a financial institution that is not consolidated or deducted. An instrument is considered to be an equity exposure if it meets all of the following requirements:
   - i) It is irredeemable in the sense that the return of invested funds can be achieved only by the sale of the investment or sale of the rights to the investment or by the liquidation of the issuer;
   - ii) It does not embody an obligation on the part of the issuer; and
   - iii) It conveys a residual claim on the assets or income of the issuer.

2. Additionally any of the following instruments must be categorised as an equity exposure:
   - i) An instrument with the same structure as those permitted as Tier 1 capital for banking organisations.
   - ii) An instrument that embodies an obligation on the part of the issuer and meets any of the following conditions:
     - a) The issuer may defer indefinitely the settlement of the obligation;
     - b) The obligation requires (or permits at the issuer's discretion) settlement by issuance of a fixed number of the issuer's equity shares;
     - c) The obligation requires (or permits at the issuer's discretion) settlement by issuance of a variable number of the issuer's equity shares and (ceteris paribus) any change in the value of the obligation is attributable to, comparable to, and in the same direction as, the change in the value of a fixed number of the issuer's equity shares[51]; or,
     - d) The holder has the option to require that the obligation be settled in equity shares, unless either (i) in the case of a traded instrument, the supervisor is content that the bank has demonstrated that the instrument trades more like the debt of the issuer than like its equity, or (ii) in the case of non-traded instruments, the supervisor is content that the bank has demonstrated that the instrument should be treated as a debt position.

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[50] Indirect equity interests include holdings of derivative instruments tied to equity interests, and holdings in corporations, partnerships, limited liability companies or other types of enterprises that issue ownership interests and are engaged principally in the business of investing in equity instruments.

[51] For certain obligations that require or permit settlement by issuance of a variable number of the issuer's equity shares, the change in the monetary value of the obligation is equal to the change in the fair value of a fixed number of equity shares multiplied by a specified factor. Those obligations meet the conditions of item 3 if both the factor and the referenced number of shares are fixed. For example, an issuer may be required to settle an obligation by issuing shares with a value equal to three times the appreciation in the fair value of 1,000 equity shares. That obligation is considered to be the same as an obligation that requires settlement by issuance of shares equal to the appreciation in the fair value of 3,000 equity shares.

In cases (i) and (ii), the bank may decompose the risks for regulatory purposes, with the consent of the supervisor.

3. Debt obligations and other securities, partnerships, derivatives or other vehicles structured with the intent of conveying the economic substance of equity ownership are considered an equity holding.[52] This includes liabilities from which the return is linked to that of equities.[53] Conversely, equity investments that are structured with the intent of conveying the economic substance of debt holdings or securitisation exposures shall not be considered an equity holding.[54]

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[52] Equities that are recorded as a loan but arise from a debt/equity swap made as part of the orderly realisation or restructuring of the debt are included in the definition of equity holdings. However, these instruments may not attract a lower capital charge than would apply if the holdings remained in the debt portfolio.
[53] Supervisors may decide not to require that such liabilities be included where they are directly hedged by an equity holding, such that the net position does not involve material risk.
[54] The national supervisor has the discretion to re-characterise debt holdings as equites for regulatory purposes and to otherwise ensure the proper treatment of holdings under Pillar 2.