ADOPTION OF THE BASEL COMMITTEE'S POLICY ON INNOVATIVE CAPITAL INSTRUMENTS

Over the last few years a number of banks across the world have issued a range of innovative capital instruments, such as instruments with step-ups, with the aim of generating Tier 1[1] regulatory capital that is both cost-efficient and capable of being denominated in non-local currency. This article provides background information on the HKMA's adoption of the policy of the Basel Committee on Banking Supervision on innovative capital instruments for capital adequacy purposes.

Introduction

In light of market developments in respect of innovative capital instruments, the Basel Committee on Banking Supervision ("Basel Committee") announced in October 1998 the limited acceptance of innovative capital instruments for inclusion in Tier 1 capital.

As it is considered that innovative capital instruments would enable authorised institutions (AIs) to expand their sources of Core Capital and thus enhance their competitiveness, the Monetary Authority (MA) has decided to adopt the Basel Committee's policy on Tier 1 capital and has recently issued a supervisory guideline under section 16(10) of the Banking Ordinance which sets out the general requirements and qualifying conditions for innovative capital instruments to be eligible for inclusion in an AI's Core Capital.

Potential Benefits of Issuing the Innovative Capital Instruments to the Banking Sector

As compared to common equity, the issuance of innovative capital instruments has the following potential benefits to the banking sector:

- It enables AIs to raise cost-efficient Core Capital, through structures which confer tax deductibility and/or demand a lower required rate of return.
- It expands the possible sources of Core Capital, in either local or foreign currency, through the capital market.
- It diversifies the potential investor base, by tapping new groups of investors such as global investors or local high net-worth individuals through the capital markets.

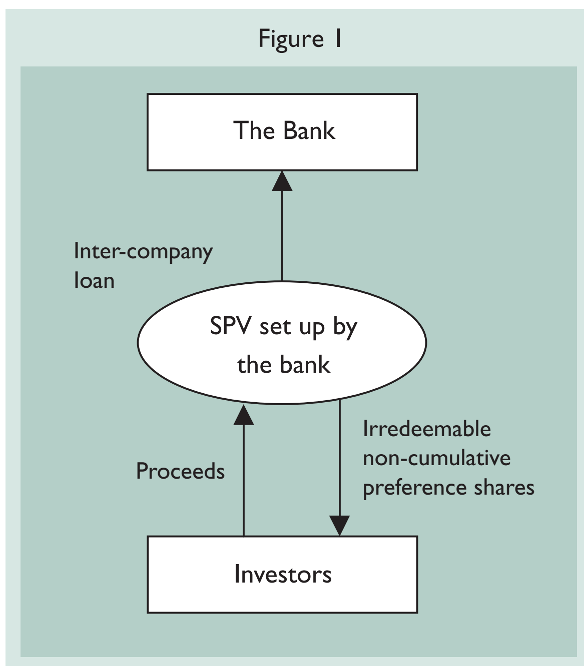
However, in order to protect the integrity of Tier 1 capital, the Basel Committee requires that innovative capital instruments should be subject to a number of stringent conditions before they can be regarded as Tier 1 capital for capital adequacy purpose. To discourage undue reliance on innovative capital instruments in meeting capital adequacy requirement, the Basel Committee has decided that the aggregate amount of innovative capital instruments allowed for inclusion as Tier 1 capital should be limited to a maximum of 15% of a bank's Tier 1 capital.

Incorporation into Hong Kong's Regulatory Framework

Legal Framework

An amendment to the Third Schedule to the Banking Ordinance was gazetted on 5 October 2000. The amendment deals specifically with innovative capital instruments in the form of irredeemable non-cumulative preference shares issued to third-party investors by a special purpose vehicle (SPV) set up by an AI. The proceeds so received by the SPV in issuing the preference shares would be upstreamed to the AI in the form of an inter-company loan. Figure 1 below is a typical example on how an innovative capital instrument in the form of irredeemable non-cumulative preference shares is structured.

1 "Tier 1 capital", as referred to by the Basel Committee, is equivalent to "Core Capital" under the Third Schedule to the Banking Ordinance.



The effect of the amendment is to limit the minority interest arising on consolidation in the paid-up irredeemable non-cumulative preference shares of all subsidiaries of an AI that are SPVs to 15% of the Core Capital of that institution. The excess amount over the 15% is to be included as minority interests in the Supplementary Capital of that institution.

Guideline Under Section 16(10)

The legislative amendment is supplemented by a Guideline on "Instruments Eligible for Inclusion in Core Capital" issued by the MA under section 16(10) of the Banking Ordinance which sets out the general requirements and qualifying conditions for innovative capital instruments to be eligible for inclusion in an AI's Core Capital.

Qualifying Conditions

Basic features

To follow the Basel Committee's recommendations, the Guideline stipulates that the instruments must fulfil the following minimum requirements:

- issued and fully paid;
- non-cumulative;
- able to absorb losses within the AI on a going-concern basis;
- junior to depositors, general creditors and subordinated debt of the AI;
- permanent;
- neither be secured nor covered by a guarantee of the AI or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-a-vis the AI's creditors;
- callable at the initiative of the AI only after a minimum of five years with prior approval by the MA and under the condition that it will be replaced with capital of same or better quality unless the MA determines that the AI has capital that is more than adequate in relation to its risks;
- the main features of such instruments must be easily understood and publicly disclosed;
- proceeds must be immediately available without limitation to the AI;
- the AI must have discretion over the amount and timing of distributions, subject only to prior waiver of distributions on the AI's common stock and the AI must have full access to waived payments;
- distributions can only be paid out of distributable items; where distributions are preset they may not be reset based on the credit standing of the AI; and
- the inter-company loan from the SPV to the AI must match substantially the terms and conditions of the preference shares issued by the SPV. The terms of the inter-company loan must not compromise the Tier 1 qualities of the underlying instrument. This means, inter alia, that failure to make payments on the loan or meet covenants must not

cause acceleration of repayment and the loan must be subordinated to depositors, other creditors and subordinated debt.

Loss absorption

As one of the components of the AI's Core Capital, an innovative capital instrument should be available to absorb the AI's losses on an on-going basis without triggering the start of insolvency proceedings, and well before serious deterioration in the AI's financial position.

When any of the following trigger event occurs, mandatory conversion should be exercised to convert an innovative capital instrument into ordinary shares or irredeemable non-cumulative preference shares issued directly by the AI:

(a) the MA determines in writing that the AI has a capital adequacy ratio (CAR), calculated in accordance with the provisions set out in the Third Schedule to the Ordinance, of less than 8%. The MA may, at its discretion, allow a grace period of no more than 6 months for the AI to bring its CAR to a level above 8%. During such period, the mandatory conversion mechanism need not be triggered;

(b) a winding up petition against the AI is presented to the court; or

(c) the MA exercises his powers under section 52 of the Ordinance to appoint a Manager of the AI.

The rate of conversion must be fixed at the time of subscription to the instrument.

Step-up restrictions

Moderate step-ups in the instruments are permitted in conjunction with a call option only if the step-up occurs at a minimum of 10 years after the issue date and if it results in an increase over the initial rate that is no greater than either:

- 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or

- 50 percent 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.

Consolidation for Capital Adequacy

The preference shares issued by the SPV will be treated as minority interests for the purposes of calculating an AI's consolidated CAR.[2] For the purposes of section 98 of the Ordinance, with the consent of the MA, an AI may also calculate a "solo-consolidated" capital ratio. This would replace the need for the AI to calculate an unconsolidated ratio.

For the purposes of the Guideline, an SPV may only be solo-consolidated with an AI if the following conditions are satisfied:

(a) the ordinary share capital of the SPV is wholly owned by the AI and it is in full control of the voting rights;

(b) the SPV is wholly managed by the AI;

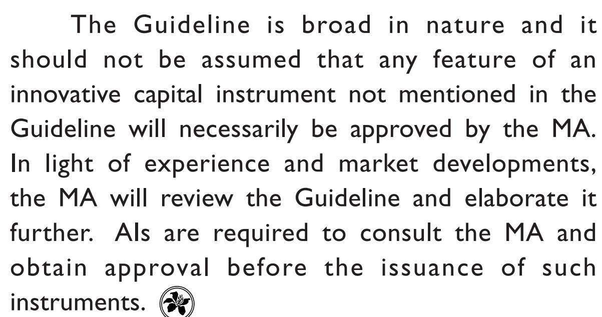
(c) the sole purpose of the SPV is to issue the preference shares, the entire proceeds of which are on-lent to the AI;

(d) the SPV has no external creditors; and

(e) the preference shares issued by the SPV comply with all other requirements under the Guideline.

2 This is subject to confirmation from the AI's auditors that the same treatment will be applied for the purposes of the AI's consolidated financial statements.

Way Forward

The Guideline is broad in nature and it should not be assumed that any feature of an innovative capital instrument not mentioned in the Guideline will necessarily be approved by the MA. In light of experience and market developments, the MA will review the Guideline and elaborate it further. AIs are required to consult the MA and obtain approval before the issuance of such instruments. 

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