Supervisory Policy Manual		
CA-S-7	**Term Subordinated Debt and Paid-up Term Preference Shares for Inclusion in Supplementary Capital**	V.1 – 14.03.03

This module should be read in conjunction with the Introduction and with the Glossary, which contains an explanation of abbreviations and other terms used in this Manual. If reading on line, click on blue underlined headings to activate hyperlinks to the relevant module.

Purpose

To provide guidance on the criteria for term subordinated debt and paid-up term preference shares to be included in Category II – Supplementary Capital of an AI for the purpose of capital adequacy under Part XVII of the Banking Ordinance

Classification

A statutory guideline issued by the MA under the Banking Ordinance, §16(10)

Previous guidelines superseded

This is a new guideline.

Application

To all locally incorporated AIs

Structure

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1. Introduction

1.1 Terminology

1.1.1 In this module the following abbreviations and expressions have the meanings set out:

- "call option" means an issuer's right or option to repay or redeem an instrument before maturity;
- "capital instrument(s)" and "instrument(s)" mean, unless otherwise specified, term debt and term preference shares;
- “CAR” means capital adequacy ratio;
- "SPV" means special purpose vehicle, which is a non-operating entity established for the sole purpose of raising capital for an AI;
- "step-up provision" means a provision in a capital instrument whereby the interest rate or dividends

payable on it are liable to be increased under the terms of the instrument;

- "term debt" means term subordinated debt; and
- "term preference shares" means paid-up term preference shares.

1.2 Background

1.2.1 The method for the calculation of the CAR of AIs incorporated in Hong Kong is set out in the Third Schedule to the Banking Ordinance. Paragraphs 3(m) and 3(n) of the Schedule prescribe the statutory requirements for recognising term debt and term preference shares respectively as supplementary capital.

1.2.2 This module provides guidance on the statutory requirements and specifies the approach that the MA will adopt in interpreting these requirements in relation to capital instruments with call option and step-up features. In addition, this module sets out the MA's views on the use of SPVs for the purposes of calculating the CAR of an AI under the Banking Ordinance.

1.2.3 Any AI wishing to issue such instruments, whether directly itself or indirectly through an SPV, for recognition as supplementary capital should discuss the proposed arrangements with the MA in advance to establish whether they are acceptable for this purpose.

1.2.4 The MA's prior consent should be obtained before making any subsequent modification of the terms or conditions of a capital instrument which may affect its eligibility to continue qualifying as supplementary capital.

1.2.5 This module applies to the issue of capital instruments after its effective date. Any issue that had been accepted by the MA for inclusion in supplementary capital prior to the effective date but does not comply fully with the requirements of this module will be grandfathered.

2. General requirements

2.1 Term debt

2.1.1 The MA requires to be satisfied that under the terms of the debt instrument, the following conditions are met:

- the claims of the lender against the AI are fully subordinated to those of all unsubordinated creditors;
- the term debt is not secured against any assets of the AI;
- the term debt has a minimum initial period to maturity of more than five years[1]. As an example, if the debt is issued on 1 January 2003, the earliest maturity date would be 2 January 2008;
- any term debt repayable prior to maturity will not be so repaid without the prior consent of the MA (see subsections 2.3 and 3.1 below for details); and
- if the rate of interest payable on the term debt is liable to be increased under the terms of the debt instrument (i.e. where there is a step-up provision), the rate of interest will not be increased:
  - until the expiry of five years from the day when the debt is issued;
  - more than once; and
  - beyond a limit considered appropriate by the MA.

(See subsections 3.2 and 3.3 below for details.)

2.2 Term preference shares

[1] Even though that period may be subsequently reduced with the prior consent of the MA.

2.2.1 The MA requires to be satisfied that under the terms on which the shares are to be issued, the following conditions are met:

- the term preference shares have a minimum initial period to maturity of more than five years[1]. As an example, if the shares are issued on 1 January 2003, the earliest maturity date would be 2 January 2008;
- any term preference shares redeemable prior to maturity will not be so redeemed without the prior consent of the MA (see subsections 2.3 and 3.1 below for details); and
- if the dividends payable on the term preference shares are liable to be increased under the terms (i.e. where there is a step-up provision), such dividends will not be increased:
  - until the expiry of five years from the day when the shares are issued;
  - more than once; and
  - beyond a limit considered appropriate by the MA.

  (See subsections 3.2 and 3.3 below for details.)

2.3 Repayment or redemption prior to maturity

2.3.1 Consent for an instrument to be repaid or redeemed prior to maturity, whether in part or in full, will only be given where the MA is satisfied that an AI's capital is likely to remain adequate after repayment or redemption, as the case may be. In making this assessment the MA will have regard to the AI's capital plan covering its capital position for two years after repayment or redemption. The plan should:

- demonstrate that the AI's consolidated and solo CARs will remain above their trigger levels without resorting to new capital issues for at least two years after repayment or redemption;

- be consistent with the AI's strategic and operating plans; and
- take account of any possible acquisitions, locked-in capital in subsidiaries and the possibility of exceptional losses.

2.3.2 The MA's consent for early repayment or redemption of a capital instrument will not normally be given in the first five years of the issue unless there are strong justifications therefor, e.g. the early repayment or redemption is made necessary by a capital restructuring of the AI or the instrument will be replaced by a simultaneous issue of new capital which is neither smaller in size nor of a lower quality than the original issue.

2.4 Limitation on amount to be included

2.4.1 The total amount of term debt and term preference shares recognised as supplementary capital by an AI under paragraphs 3(m) and 3(n) of the Third Schedule should not exceed 50% of the total amount of its core capital.

2.4.2 In addition, the total amount of an AI's supplementary capital (i.e. including all other eligible items in the Third Schedule) should not exceed the total amount of its core capital.

2.5 Discounting requirement

2.5.1 Term debt and term preference shares that qualify as supplementary capital are both subject to a discounting requirement under proviso (A) to paragraphs 3(m) and 3(n) of the Third Schedule.

2.5.2 The amount to be included in supplementary capital, as described below, should be discounted on a straight-line basis at a rate of 20% of the original amount of the instrument per year during the four years immediately preceding maturity, viz:

Years to maturity	% of original amount eligible for inclusion in supplementary capital
Up to 1	20%
> 1 ≤ 2	40%
> 2 ≤ 3	60%
> 3 ≤ 4	80%
> 4	100%

2.5.3 See Annex A for an illustration of precisely how a term debt is to be discounted for reporting under supplementary capital. This method is also applicable to term preference shares.

2.5.4 Unless otherwise approved by the MA, the original maturity will be used for discounting purposes. The criteria for approving the maturity date for discounting purposes in respect of instruments with a call option (with or without step-up) are set out in subsections 3.1 and 3.3 below.

2.5.5 For the avoidance of doubt, where an instrument provides holders with the right or option to demand repayment or redemption prior to maturity, the earliest possible repayment or redemption date will be regarded as the maturity date for discounting purposes. Such right or option should be exercisable only after the first five years of the issue of the instrument (see para. 2.3.2 above).

3. Qualifying conditions for special features

3.1 Call option

3.1.1 Under the Third Schedule, no early repayment of term debt or redemption of term preference shares that qualify as supplementary capital should be made without the MA's prior consent. Any AI intending to issue a capital instrument with a call option should therefore ensure that the terms of the option are acceptable to the MA.

3.1.2 The MA expects a call option to be exercisable only after the expiry of five years from the day when the instrument is issued. As an example, if an instrument is issued on 1 January 2003, the earliest possible date for exercising the call option would be 2 January 2008. In addition, the issue documentation should give clear and prominent notice to prospective investors that the issuer's right to exercise any such option to repay, purchase or otherwise redeem the instrument is subject to the MA's prior consent.

3.1.3 For the avoidance of doubt, the fact that the MA recognises a capital instrument with a call option as supplementary capital does not necessarily imply that an AI would be free to repay or redeem the instrument on the day when the call option is available. The AI should still seek the MA's consent prior to exercising the option. It should also observe the relevant requirements under subsection 2.3 above.

3.1.4 Where an AI has an option to repay or redeem before maturity, the MA does not normally assume early repayment or redemption for the purpose of the discounting requirement under para. 2.5.1 above.

3.1.5 See also subsection 3.3 below for the treatment in respect of a call option that coincides with a step-up.

3.2 Step-up

3.2.1 As mentioned, step-up refers to a situation where the rate of interest or dividends payable on an instrument are liable to be increased under the terms of the instrument. It may involve an increase in the margin on a floating rate instrument or an increase in the rate on a fixed rate instrument. Other forms, such as a change in the reference rate of a floating rate instrument (e.g. from a Treasury bill rate to a LIBOR rate), a conversion from fixed to floating rate or vice versa, may also imply a step-up.

3.2.2 The Third Schedule requires that a step-up should not occur more than once and should not be operative until the expiry of five years from the day when the instrument is issued. As an example, if an instrument is issued on 1 January 2003, the earliest possible step-up date would be 2 January 2008.

3.2.3 In addition, the size of a step-up should not be beyond a limit considered appropriate by the MA. In determining whether a step-up is appropriate, the MA will have regard to the following limits :

- for an issue with a maturity of up to ten years, 50 basis points less the swap spread between the initial index basis and the stepped-up index basis;
- for an issue with a maturity of more than ten years, 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 swap spread, if applicable, should be fixed at the pricing date of the instrument and reflect the differential in pricing on that date between the initial reference security or rate and the stepped-up reference security or rate.

3.2.4 The MA may require an AI to provide a plan demonstrating its ability to service the stepped-up interest or dividends without compromising its financial strength. Where necessary, the MA may also require the AI to earmark the revenue generated from the investment projects that are funded by the issue of the instrument.

3.3 Call option coinciding with step-up

3.3.1 Where the date of a step-up coincides with that of a call option, an AI's decision not to exercise the call option will lead to a step-up.

3.3.2 Where an instrument has a call option that is linked to a step-up which exceeds the limits of para. 3.2.3 above, the instrument will be deemed to mature on the date on which the step-up provision takes effect for discounting purposes under para. 2.5.1 above. Where that date is not more than five years from the date of the issue, the instrument is not eligible for inclusion in supplementary capital.

4. Use of SPVs

4.1 General requirements

4.1.1 Capital instruments issued through SPVs should satisfy the following requirements:

- the SPV should be a non-operating entity established for the sole purpose of raising capital for the AI;
- the SPV should be used for booking no more than one issue of capital instrument;
- the ordinary share capital of the SPV should be wholly owned by the AI, which should be in full control of the voting rights;
- the SPV should be wholly managed by the AI;
- the SPV should have no external creditors[2];
- all the proceeds should be passed to the AI in the form of an intercompany loan or investment in capital instruments issued by the AI;
- the terms and conditions of the intercompany loan to the AI or the instrument(s) issued by the AI

[2] The MA is prepared to consider exceptions to this requirement on de minimis grounds, i.e. when the SPV's liabilities to external creditors (e.g. accounts payable for audit fees, company secretarial services or sundry expenses) are very small in relation to its assets. Requests for such exceptions will be considered on a case by case basis.

should match in all significant aspects those of the instrument issued by the SPV (for example, they should be unsecured and subordinated to other creditors);

- the instrument issued by the SPV should not be covered by a guarantee of the issuer or related entity or any other arrangement if that guarantee or arrangement legally or economically enhances the seniority of the holders vis-à-vis other creditors; and
- the instrument issued by the SPV should comply with all other relevant requirements under this module.

4.2 Consolidation

4.2.1 Where under §98 of the Banking Ordinance the MA requires an AI to calculate its CAR on a consolidated basis in respect of its subsidiaries which include the SPV, any term preference shares issued by the SPV will be treated as minority interests arising on such consolidation in such shares and any term debt issued by the SPV will be treated as term debt in the consolidated accounts of the AI for the purpose of calculating its consolidated CAR[3].

4.3 Solo consolidation

4.3.1 Subject to the consent of the MA, an AI may also calculate a "solo-consolidated" CAR for the purpose of §98 of the Banking Ordinance. This would replace the need for the AI to calculate an unconsolidated or solo ratio.

4.3.2 For the purpose of this module, an SPV may only be solo-consolidated with an AI if all the requirements under subsection 4.1 above are satisfied.

[3] 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.

Annex A: Illustration of discounting requirement under paragraphs 3(m)(A) and 3(n)(A) of the Third Schedule

A1. Assumptions

A1.1 An AI issued a term debt as follows:

- the term is five years plus one day, was issued on 01.01.00;
- the maturity date is therefore 02.01.05.

A1.2 The instrument will be fully repaid upon maturity[4].

A2. Discounting requirements

A2.1 As required under proviso (A) to paragraph 3(m) of the Third Schedule, the discounting should cover the four years immediately preceding maturity of the debt.

A2.2 In this example, the discounting should start on 02.01.01, which was exactly four years preceding the maturity date of 02.01.05.

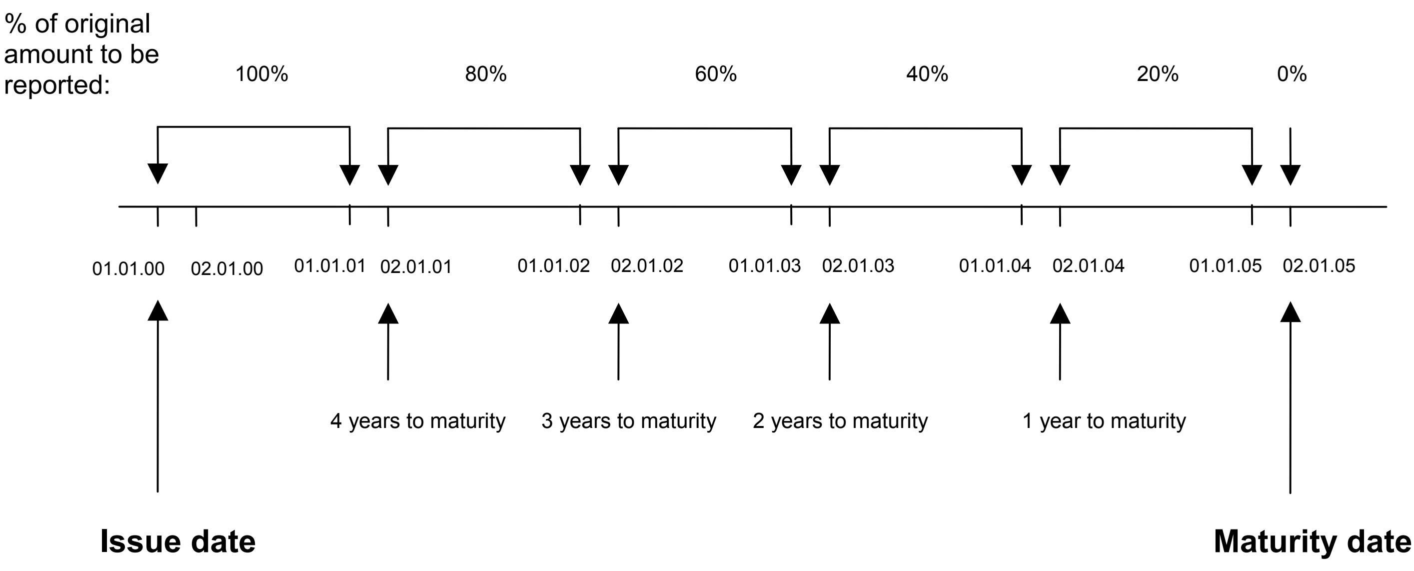
A2.3 Under the straight-line discounting method, the AI should report the debt as supplementary capital in accordance with the following schedule:

[4] Where one or more partial repayments are made during the life of an instrument with the MA's consent, the amount to be included as supplementary capital should, after applying the cumulative amount of discount as shown above (i.e. 20% of original amount each year in the four years preceding maturity), be further reduced by the amount of repayments made to date. The discounting will stop when the net amount to be included is reduced to zero. In case of doubt, AIs should consult the HKMA on the appropriate discounting method to be used.

Period	% of original amount
01.01.00 to 01.01.01	100%
02.01.01 to 01.01.02	80%
02.01.02 to 01.01.03	60%
02.01.03 to 01.01.04	40%
02.01.04 to 01.01.05	20%
02.01.05 (maturity)	0%

A3. Illustration

A3.1 The following diagramme demonstrates how the discounting is carried out in the four years preceding maturity:



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