Supervisory Policy Manual		
CA-S-6	**Instruments Eligible for Inclusion in Core Capital**	V.1 – 21.09.01

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 set out the general requirements and qualifying conditions for innovative capital instruments to be included in Category I – Core 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Previous guidelines superseded

Guideline "Instruments Eligible for Inclusion in Core Capital" dated 05.10.00

Application

To all locally incorporated AIs

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1. Introduction

1.1 Terminology

1.1.1 In this module:

- CAR means capital adequacy ratio, calculated in accordance with the provisions set out in the Third Schedule to the Banking Ordinance; and
- SPV means special purpose vehicle.

1.2 Background

1.2.1 In October 1998 the Basel Committee announced limited acceptance of innovative capital instruments for inclusion in Tier 1 capital. These instruments will, however, be subject to stringent conditions and limited to a maximum of 15% of an institution's Tier 1 capital.

1.2.2 The MA considers that common shareholders' funds, i.e. ordinary shares, retained earnings and disclosed reserves should be the key elements of capital because they are permanently available to an AI and allow it to absorb losses on a continuing basis. Thus the MA expects AIs to meet their minimum CARs without undue reliance on innovative capital instruments. Since, nevertheless, the latter enable AIs to expand their sources of core capital cost-effectively and thus enhance their competitiveness, the MA has

decided to adopt the Basel Committee's policy on Tier 1 capital.

1.2.3 This module deals specifically with innovative capital instruments in the form of non-cumulative preference shares issued indirectly by an AI to third party investors. Typically, this will be done through an SPV, with the proceeds being passed to the AI in the form of an intercompany loan. Further types of innovative capital instrument may be included within the scope of this module as they are developed.

1.2.4 The main intention of this module is to set out the basic features an innovative capital instrument would require to qualify for approval by the MA for inclusion in core capital. It should not be assumed, however, that an instrument having all these features but containing others not mentioned in the module will necessarily be approved by the MA.

1.2.5 This module will be subject to review and further refinement in the light of experience. An existing instrument already approved by the MA will not be retrospectively excluded from core capital if the module is subsequently amended.

2. Qualifying conditions

2.1 Basic features

2.1.1 Innovative capital instruments will be limited to a maximum of 15% of an AI's total core capital. Any excess over the 15% limit will be included as minority interests in Category II – Supplementary Capital.

2.1.2 AIs should seek the MA's prior approval before the issue of such instruments. In giving approval, the MA will apply the criteria set out in para. 2.1.3 below.

2.1.3 In accordance with the recommendations of the Basel Committee, the instruments should fulfil the following minimum requirements:

- they should be:

- 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;
- neither 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-à-vis the AI's creditors; and
- permanently available to the AI and callable at the initiative of the AI only after a minimum of five years with the prior approval of the MA and on the condition that they will be replaced with capital of the 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 the instruments should be easily understood and publicly disclosed;

• the proceeds should be immediately available to the AI without limitation;

• the AI should have discretion over the amount and timing of distributions, subject only to prior waiver of distributions of the AI's common stock, and the AI should have full access to waived payments[1];

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[1] Without affecting the generality of this requirement, an AI would not be regarded as having discretion over the distribution of dividends to the holders of the instruments in the following situations:

• the AI has committed to make a distribution of dividends to its common stockholders; or

• even if the distribution of dividends to the common stockholders is waived, the AI does not have full access to the 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 intercompany loan from the SPV to the AI should match substantially the terms and conditions of the preference shares issued by the SPV. Its terms should 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 should not cause acceleration of repayment and the loan should be subordinated to depositors, other creditors and subordinated debt.

2.2 Loss absorption

2.2.1 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 a continuing basis without triggering the start of insolvency proceedings and well before serious deterioration in the AI's financial position.

2.2.2 If 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:

- the MA determines in writing that the AI has a CAR of less than 8%. The MA may exercise discretion to allow a grace period of no more than six months for the AI to bring its CAR to a level above 8%. During such period, the mandatory conversion mechanism need not be triggered;
- a winding-up petition against the AI is presented to the court; or
- the MA exercises the power to appoint a Manager of the AI under §52 of the Banking Ordinance.

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

2.3 Step-up restrictions

2.3.1 Moderate step-ups in the instruments are permitted in conjunction with a call option only if the step-up occurs at a minimum of ten 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.

2.3.2 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 at 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.

3. Consolidation for capital adequacy

3.1 Consolidation

3.1.1 The preference shares issued by the SPV will be treated as minority interests for the purposes of calculating an AI's consolidated CAR[2].

3.2 Solo consolidation

3.2.1 For the purposes of §98 of the Banking Ordinance, subject to the consent of the MA, an AI may also calculate a solo-consolidated CAR. This would replace the need for the AI to calculate an unconsolidated or solo ratio.

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[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.

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

- the ordinary share capital of the SPV is wholly owned by the AI and it is in full control of the voting rights;
- the SPV is wholly managed by the AI;
- the sole purpose of the SPV is to issue the preference shares, the entire proceeds of which are on-lent to the AI;
- the SPV has no external creditors; and
- the preference shares issued by the SPV comply with all other requirements under this module.