HONG KONG MONETARY AUTHORITY 香港金融管理局		
Supervisory Policy Manual		
CA-S-8	**Perpetual Subordinated Debt and Paid-up Irredeemable Cumulative 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 perpetual subordinated debt and paid-up irredeemable cumulative 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Previous guidelines superseded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

1. Introduction
   - 1.1 Terminology
   - 1.2 Background
2. General requirements
   - 2.1 Perpetual debt
   - 2.2 Cumulative preference shares
   - 2.3 Repayment or redemption

2.4 Loss absorption

2.5 Deferral of servicing obligations

2.6 Limitation on amount to be included

3. Qualifying conditions for special features

3.1 Call option

3.2 Step-up

3.3 Call option coinciding with step-up

4. Use of SPVs

4.1 General requirements

4.2 Consolidation

4.3 Solo consolidation

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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;
- "capital instrument(s)" and "instrument(s)" mean, unless otherwise specified, perpetual debt and cumulative preference shares;
- “CAR” means capital adequacy ratio;
- "cumulative preference shares" means paid-up irredeemable cumulative preference shares;
- "perpetual debt" means perpetual subordinated debt;

- "SPV" means special purpose vehicle, which is a non-operating entity established for the sole purpose of raising capital for an AI; and
- "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.

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(k) and 3(l) of the Schedule prescribe the statutory requirements for recognising perpetual debt and cumulative 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 Perpetual 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 perpetual debt is not secured against any assets of the AI;
- the money advanced to the AI is permanently available to it;
- the perpetual debt is not repayable without the prior consent of the MA (see subsections 2.3 and 3.1 below);
- the money advanced to the AI is available to meet losses without the AI being obliged to cease trading (see subsection 2.4 below);
- the AI is entitled to defer the payment of interest where its profitability will not support such payment (see subsection 2.5 below); and
- if the rate of interest payable on the perpetual 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 ten 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 Cumulative preference shares

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 cumulative preference shares are not redeemable without the prior consent of the MA (see subsections 2.3 and 3.1 below);
- the money raised by the issue of the cumulative preference shares is available to meet losses without the AI being obliged to cease trading (see subsection 2.4 below); and
- if the dividends payable on the cumulative 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 ten 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.)

2.2.2 See also subsection 2.5 below regarding the deferral of servicing obligations which is a basic feature of cumulative preference shares.

2.3 Repayment or redemption

2.3.1 The instrument should have no maturity. It should not be repayable or redeemable at the initiative of the holder nor should it carry any other provision which requires future repayment or redemption by the AI. The instrument may, however, be repayable or redeemable at the option of the AI in accordance with the criteria set out below and in subsection 3.1 below.

2.3.2 Consent for an instrument to be repaid or redeemed, 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.

2.3.3 The MA's consent for 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 Loss absorption

2.4.1 The instrument should be available to absorb an AI's losses on a continuing basis without the AI being obliged to cease trading. In the case of perpetual debt, this can be achieved in two ways :

- the instrument may provide for automatic conversion of the debt (including any unpaid interest) into share capital of the AI when reserves[1] become negative. The rate of conversion should be fixed in terms of the share price at the time of subscription to the instrument; or

[1] Refers to an AI's profit and loss account and other reserves included in core capital under the Third Schedule.

- the instrument may provide for the principal and unpaid interest on the debt to absorb losses where the AI would not otherwise be solvent, and for the holders of the debt to be treated as if they were holders of a specific class of share capital in any liquidation of the AI.

2.4.2 The issue documentation should disclose to prospective investors the manner in which the instrument is to be treated in a loss situation.

2.4.3 Given the loss absorption feature required of perpetual debt, the MA will normally expect the claims of the holders of perpetual debt to be subordinated to other debt instruments issued by the AI that do not have such feature.

2.4.4 If the perpetual debt has an automatic conversion clause (see para. 2.4.1 above), the AI should maintain a sufficient margin of authorized but unissued share capital in order to allow the debt to be converted into equity at any time.

2.5 Deferral of servicing obligations

2.5.1 An AI which issues the instrument should have an option to defer servicing obligations. In the case of perpetual debt, the AI should be entitled to defer the payment of interest if its profitability will not support such payment. Typically, an AI may link this option to the non-distribution of dividends on its share capital. For example, the terms of the instrument may allow the AI to defer the payment of interest if it has not declared or paid dividends to any of its equity holders during a specified period (say 12 months) preceding a date on which interest is due to be paid.

2.5.2 If dividends payable on cumulative preference shares are deferred, such dividends should not themselves bear interest. If deferred interest on perpetual debt is to bear interest, the rate should not be materially different from the market rate.

2.5.3 The instrument should not provide for payment of any form of compensation to investors other than by way of a distribution of profits.

2.6 Limitation on amount to be included

2.6.1 Under the Third Schedule, the total amount of an AI's supplementary capital (i.e. including perpetual debt, cumulative preference shares and all other eligible items) should not exceed the total amount of its core capital.

3. Qualifying conditions for special features

3.1 Call option

3.1.1 Under the Third Schedule, no repayment of perpetual debt or redemption of cumulative preference shares that qualify as supplementary capital should be made without the MA's prior consent. Any AI intending to issue such instruments 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 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 ten 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 2013.

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 :

- 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 be a dated instrument and ineligible for recognition as perpetual debt or cumulative preference shares under supplementary capital, as the case may be.

3.3.3 For the avoidance of doubt, whether such instrument deemed by the MA to be a dated instrument can qualify as other supplementary capital would depend on fulfilment of the relevant requirements under the Third Schedule.

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 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 cumulative preference shares issued by the SPV will be treated as minority interests arising on such consolidation in such shares and any perpetual debt issued by the SPV will be treated as perpetual debt in the consolidated accounts of the AI for the purpose of calculating its consolidated CAR[3].

[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.

[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.

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.
