

LEGISLATIVE COUNCIL BRIEF

Banking Ordinance (Chapter 155)

BANKING ORDINANCE (AMENDMENT OF THIRD SCHEDULE) NOTICE 2000

INTRODUCTION

The Banking Ordinance (Amendment of Third Schedule) Notice 2000 (the Notice) made by the Financial Secretary will be gazetted on 5 October 2000.

BACKGROUND AND ARGUMENT

2. The Third Schedule to the Banking Ordinance provides for the calculation of an authorized institution's (AI's) capital adequacy ratio (CAR). An AI's capital adequacy ratio is the ratio of its capital base to its risk weighted exposures.

Innovative capital instruments

3. This amendment to the Third Schedule 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 set up by an AI. The special purpose vehicle upstreams the proceeds to the AI in the form of an inter-company loan.

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

- (a) It enables AIs to raise cost-efficient Core Capital, through structures which confer tax deductibility and/or demand a lower required rate of return.

- (b) It expands the possible sources of Core Capital, in either local or foreign currency, through the capital market.
- (c) 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 market.

Basel Committee's position

5. In light of the market developments on innovative capital instruments, the Basel Committee on Banking Supervision (Basel Committee) announced in October 1998 the limited acceptance of such instruments for inclusion in Tier 1 capital¹.

6. The Basel Committee considers that common shareholders' funds, i.e. common stock and disclosed reserves or retained earnings, remain as the key elements of capital. Common shareholders' funds allow a bank to absorb losses on an ongoing basis and are permanently available for such purpose. Further, it allows a bank to conserve resources when under stress as the bank has full discretion as to the amount and timing of distributions. The voting rights attached to common stock also provide an important source of market discipline over a bank's management.

7. In order to protect the integrity of Tier 1 capital, innovative capital instruments should be subject to a number of stringent conditions before they could be regarded as Tier 1 capital for capital adequacy purpose. Besides, 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.

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

Hong Kong's position

8. Our policy is to keep our regulatory framework in line with international standards and to improve the framework in the light of market developments. This is fundamental to maintaining Hong Kong's status as an international financial centre. Considering also that innovative capital instruments enable AIs to expand their sources of Core Capital and thus enhance their competitiveness, the HKMA has decided to adopt the Basel Committee's policy on Tier 1 capital. In fact, countries including UK and Japan have granted approval for the issuance of a number of innovative capital instruments for Tier 1 capital adequacy purpose.

Guideline on eligible innovative capital instruments

9. For the purpose of incorporating the Basel Committee's policy on Tier 1 capital into Hong Kong's regulatory framework, the HKMA has, in consultation with the banking industry, prepared the guideline at **Annex**. The guideline, which will be issued upon the amendment of the Third Schedule, deals specifically with innovative capital instruments in the form of irredeemable non-cumulative preference shares issued indirectly by an institution to third-party investors. It also sets out the general requirements and qualifying conditions for such instruments to be eligible for inclusion in Core Capital.

Amendments to the Third Schedule

10. To enable the Monetary Authority to have the power to set the 15% limit, the Third Schedule is amended to limit the inclusion of eligible innovative capital instruments as minority interests into Core Capital so that the amount included shall not exceed 15% of the AI's Core Capital. The excess amount over the 15% limit shall be included as minority interests in Category II – Supplementary Capital (Tier 2 capital). The Third Schedule is amended to refer to "paid-up irredeemable non-cumulative preference shares of all subsidiaries which are special purpose vehicles", as this embodies the major features of the innovative capital instruments hitherto permitted by the Basel Committee as eligible Tier 1 capital.

11. There is no need to amend the Banking Ordinance for bringing

into effect the requirements on the special purpose vehicle as set out in paragraph 3.2 of the guideline at Annex. The requirements will be enforced by making them the conditions for the Monetary Authority's consent under section 98 of the Banking Ordinance to allow the AI to include the special purpose vehicle in calculating its "solo-consolidated"² capital adequacy ratio.

THE NOTICE

12. Under section 135(3) of the Banking Ordinance, the Financial Secretary may, by notice in the Gazette, amend the Third Schedule.

13. This Notice to be made by the Financial Secretary will amend the Third Schedule to limit the minority interests arising on consolidation in the paid-up irredeemable non-cumulative preference shares of all subsidiaries of an authorized institution that are special purpose vehicles to 15% of the Core Capital of that institution. The excess amount over the 15% limit is to be included as minority interests in the Supplementary Capital of the institution.

LEGISLATIVE TIMETABLE

14. The Notice, being subsidiary legislation, will come into operation when it is published in the Gazette on 5 October 2000. The Notice will be tabled at the Legislative Council on 11 October 2000 for negative vetting.

² Under section 98(2A) of the Banking Ordinance, the Monetary Authority may require the capital adequacy ratio of the institution to be calculated on a consolidated basis only in respect of certain subsidiaries of the institution. Solo-consolidated capital adequacy ratio is considered as one of the basis for calculating the consolidated ratio.

BASIC LAW IMPLICATIONS

15. The Department of Justice advises that the Notice does not conflict with those provisions of the Basic Law carrying no human rights implications.

HUMAN RIGHTS IMPLICATIONS

16. The Department of Justice advises that the Notice has no human rights implications.

BINDING EFFECT OF THE LEGISLATION

17. The amendments will not affect the current binding effect of the Banking Ordinance.

FINANCIAL AND STAFFING IMPLICATIONS

18. There are no financial or staffing implications for the Government.

PUBLIC CONSULTATION

19. We have consulted the Hong Kong Association of Banks, the Deposit-taking Companies Association and industry participants. In general, they have no objection to the Guideline and their comments, where appropriate, have been reflected in the Guideline.

PUBLICITY

20. The HKMA will issue to all locally incorporated AIs a letter on the amendments and the Guideline upon gazetting of the Notice.

ENQUIRIES

21. Inquiries on this brief may be directed to Ms Rita Yeung, Head (Banking Policy) of HKMA (telephone number: 2878 1388) or Mr Edward Mak, Assistant Secretary for Financial Services (telephone number: 2527 3974).

Financial Services Bureau
October 2000

INSTRUMENTS ELIGIBLE FOR INCLUSION IN CORE CAPITAL

Purpose

To set out the general requirements and qualifying conditions for innovative capital instruments for inclusion in the Category I - Core Capital of an authorized institution ("AI") for the purpose of capital adequacy under Part XVII of the Banking Ordinance

Classification

A statutory guideline issued by the Monetary Authority ("MA") under the Banking Ordinance, section 16(10)

Previous guidelines superseded

This is a new guideline.

Application

To all locally incorporated AIs

Structure

1. Introduction
 2. Qualifying conditions
 - 2.1 Basic features
 - 2.2 Loss absorption
 - 2.3 Step-up restrictions
 3. Consolidation for capital adequacy
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1. Introduction

- 1.1 The Basel Committee on Banking Supervision (the "Basel Committee") in October 1998 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 a bank's Tier 1 capital.
- 1.2 It is the position of the MA 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 the AI and allow it to absorb losses on an on-going basis. As such, the MA expects AIs to meet their minimum capital adequacy ratios ("CARs") without undue reliance on innovative capital instruments. However, considering that innovative capital instruments enable AIs to expand their sources of core capital and thus enhance their competitiveness, the MA has decided to adopt the Basel Committee's policy on Tier 1 capital.
- 1.3 This guideline 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 a special purpose vehicle ("SPV") with the proceeds being upstreamed to the AI in the form of an inter-company loan. Further types of innovative capital instrument may be included within the scope of this guideline as they are developed. This 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 be approved by the MA. The guideline will be subject to review and further elaboration in the light of experience. However, any instrument approved by the MA will not be subject to exclusion from Core Capital should the relevant guidelines subsequently change.

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. AIs should consult the MA and obtain his approval before the issuance of such instruments. In accordance with the

recommendations of the Basel Committee, 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-à-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.

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 an on-going basis without triggering the start of insolvency proceedings, and well before serious deterioration in the AI's financial position.

2.2.2 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 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.

2.2.3 The rate of conversion must 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 moderate 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.

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 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.

3. Consolidation for Capital Adequacy

3.1 The preference shares issued by the SPV will be treated as minority interests for the purposes of calculating an AI's consolidated CAR.¹ 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.

3.2 For the purposes of this 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;

¹ 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.

- (d) the SPV has no external creditors; and
- (e) the preference shares issued by the SPV comply with all other requirements under this guideline.

[] October 2000

D T R Carse for Monetary Authority