

LEGISLATIVE COUNCIL BRIEF

Banking Ordinance (Chapter 155)

BANKING ORDINANCE (AMENDMENT OF THIRD SCHEDULE) NOTICE 2002

INTRODUCTION

The Financial Secretary will issue the Banking Ordinance (Amendment of Third Schedule) Notice 2002 (“the Notice”), at **Annex A**, to revise the requirements under the Third Schedule to the Banking Ordinance (“Third Schedule”) for certain capital instruments issued by locally incorporated authorized institutions (“AIs”) for inclusion in Supplementary Capital for the calculation of capital adequacy ratio. These capital instruments, namely perpetual subordinated debt, term subordinated debt, paid-up irredeemable cumulative preference shares and paid-up term preference shares, are collectively known by financial market participants as tier 2 capital instruments.

BACKGROUND AND ARGUMENT

2. In recent years, an increasing number of AIs and other financial institutions have approached the HKMA and expressed their interest in issuing or arranging the issue of tier 2 capital instruments with certain special features, which may be considered for inclusion in Supplementary Capital of an AI for capital adequacy purpose under the Banking Ordinance. These special features normally include call option¹, step-up provision² and the use of special purpose vehicle³ (SPV). For more details about these special features, please refer to the two supervisory guidelines

¹ Call option means an issuer’s right or option to repay or redeem a capital instrument before maturity.

² 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.

³ Special purpose vehicle is a non-operating entity established for the sole purpose of raising capital for an AI.

to be issued by the HKMA after the Notice comes into operation. Copies of the two draft guidelines are attached at **Annex B** for the ease of reference.

3. The HKMA has compared the capital adequacy framework of a number of bank regulators in advanced economies, including in particular, the Australian Prudential Regulation Authority (“APRA”) and the Financial Services Authority (“FSA”) of the United Kingdom in respect of their treatment of tier 2 capital instruments. Both APRA and the FSA have issued comprehensive policy guidelines on the general requirements for tier 2 capital instruments as well as detailed qualifying conditions for the special features of these instruments. These requirements are not provided in law as these regulators are vested with the power to make rules and prudential standards. In Hong Kong, the capital adequacy framework for tier 2 capital instruments is only embodied in the Third Schedule, in a relatively general manner.

4. The HKMA considers that while the Third Schedule would enable the Monetary Authority to approve tier 2 capital instruments which have call option features or are issued through an SPV, it does not have adequate provisions for setting out the detailed requirements on step-up features included in such instruments. In order to help maintain Hong Kong as an attractive international financial centre, the HKMA has endeavoured to keep its regulatory framework in line with international standards and to make any necessary improvement in the light of market developments. The HKMA also recognises that while these special features may, if not structured prudently, undermine the quality of a capital instrument for capital adequacy purpose, limited acceptance of instruments with such special features based on prudent criteria could be considered. It would expand the sources of Supplementary Capital of AIs and accordingly enhance their competitiveness.

5. Section 135(3) of the Banking Ordinance specifies that the Financial Secretary may, by notice in the Gazette, amend the Third Schedule.

THE NOTICE

6. This Notice amends some of the provisions for the calculation of the capital adequacy ratio of an AI under the Third Schedule. The main purpose is to enable the Monetary Authority to approve tier 2 capital instruments which have step-up features to be included in the Supplementary Capital of the institution. The Notice also takes the opportunity to make certain housekeeping amendments which are aimed at aligning the legal drafting of requirements for different kinds of tier 2 capital instruments.

LEGISLATIVE TIMETABLE

7. The Notice, being subsidiary legislation, will come into operation when it is published in the Gazette on 27 December 2002. The Notice will be tabled at the Legislative Council on 8 January 2003 for negative vetting.

IMPLICATIONS OF THE PROPOSAL

8. The proposal is in conformity with the Basic Law, including the provisions concerning human rights. It has no financial or civil service, productivity, environmental or sustainability implications.

BINDING EFFECT OF THE LEGISLATION

9. The amendments will not affect the current binding effect of the existing provisions of the Banking Ordinance.

PUBLIC CONSULTATION

10. The HKMA has consulted the Hong Kong Association of Banks, the Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies and the Hong Kong Capital Markets Association on the proposed supervisory framework for tier 2 capital instruments and has taken into account their comments in preparing this Notice.

PUBLICITY

11. After the expiry of the negative vetting period of the Legislative Council on this Notice, the HKMA will inform all locally incorporated AIs on the amendments and will issue the two supervisory guidelines on tier 2 capital instruments to set out in detail their qualifying criteria for inclusion in Supplementary Capital under the Third Schedule.

ENQUIRIES

12. Inquiries on this brief may be directed to Ms Rita Yeung, Head (Banking Policy) of HKMA (telephone number: 2878 1388) or Miss Millie Kiang, Assistant Secretary for Financial Services and the Treasury (Financial Services) (telephone number: 2528 9076).

Financial Services Branch
Financial Services and the Treasury Bureau
27 December 2002

**BANKING ORDINANCE (AMENDMENT OF THIRD
SCHEDULE) NOTICE 2002**

(Made under section 135(3) of the Banking
Ordinance (Cap. 155))

1. Capital Adequacy Ratio

The Third Schedule to the Banking Ordinance (Cap. 155) is amended, in paragraph 3 -

(a) in subparagraph (k), by adding -

"(vii) if the rate of interest payable on the debt is liable to be increased under the terms of the debt instrument, the rate of interest will not be increased -

(A) until the expiry of 10 years from the day when the debt is issued;

(B) more than once; and

(C) beyond a limit considered appropriate by the Monetary Authority;"

(b) in subparagraph (l), by repealing everything after "preference shares" and substituting -

", if the Monetary Authority is satisfied that under the terms on which the shares are to be issued, the following conditions are met -

(i) the shares are not redeemable without the prior consent of the Monetary Authority;

(ii) the money raised by the issue of the shares is available to meet losses without the authorized institution

being obliged to cease trading;

(iii) if the dividends payable on the shares are liable to be increased under the terms, such dividends will not be increased -

(A) until the expiry of 10 years from the day when the shares are issued;

(B) more than once; and

(C) beyond a limit considered appropriate by the Monetary Authority;"

(c) in subparagraph (m) -

(i) in sub-subparagraph (iii), by repealing everything after "years" and substituting "(even though that period may be subsequently reduced with the prior consent of the Monetary Authority);";

(ii) by repealing sub-subparagraph (iv) and substituting -

"(iv) any debt repayable prior to maturity will not be so repaid without the prior consent of the Monetary Authority;"

(iii) by adding before the proviso -

"(v) if the rate of interest payable on the debt is liable to be increased under the terms of the debt instrument, the rate of interest will not

be increased -

- (A) until the expiry of 5 years from the day when the debt is issued;
- (B) more than once; and
- (C) beyond a limit considered appropriate by the Monetary Authority:";

(iv) in paragraph (A) of the proviso, by adding "of the original amount of such debt" after "20%";

(d) in subparagraph (n) -

- (i) by repealing "the shares have been issued and remain subject to the following conditions" and substituting "under the terms on which the shares are to be issued, the following conditions are met";
- (ii) in sub-subparagraph (i), by adding "(even though that period may be subsequently reduced with the prior consent of the Monetary Authority)" after "years";
- (iii) by repealing sub-subparagraph (ii) and substituting -

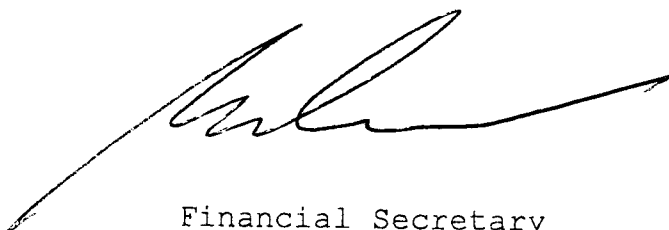
"(ii) any shares redeemable prior to maturity will not be so redeemed without the prior consent of the Monetary Authority;

(iii) if the dividends payable on

the shares are liable to be increased under the terms, such dividends will not be increased -

- (A) until the expiry of 5 years from the day when the shares are issued;
- (B) more than once; and
- (C) beyond a limit considered appropriate by the Monetary Authority:";

(iv) in paragraph (A) of the proviso, by adding "of such shares" after "amount".



Financial Secretary

20 December 2002

Explanatory Note

This Notice amends some of the provisions for the calculation of the capital adequacy ratio of an authorized institution under the Third Schedule to the Banking Ordinance (Cap. 155). The main purpose is to enable the Monetary Authority to approve certain capital instruments (namely perpetual subordinated debt, term subordinated debt, paid-up term preference shares and paid-up

irredeemable cumulative preference shares), which permit increase in the interest rate or dividends, to be included in the Supplementary Capital of the institution.

《2002年銀行業條例(修訂附表3)公告》

(根據《銀行業條例》(第155章)第135(3)條訂立)

1. 資本充足比率

《銀行業條例》(第155章)附表3現予修訂，在第3段中 —

(a) 在(k)分節中，加入 —

“(vii) 如根據該債項文書的條款，須就該債項支付的利息的利率可予提高，則 —

(A) 在由該債項發行之日起計的10年期屆滿前，該利率不會提高；

(B) 該利率的提高不會多於一次；及

(C) 該利率提高的幅度不會超過金融管理專員認為適當的上限；”；

(b) 在(l)分節中，廢除在“優先股，”之後的所有字句而代以 —

“而金融管理專員信納根據該等股份的發行條款，以下條件得以符合 —

(i) 未得金融管理專員事先同意，不可贖回該等股份；

- (ii) 發行該等股份所籌集的款項，可用以彌補虧損而無需該認可機構停止經營；
- (iii) 如根據該等條款，須就該等股份支付的股息可予增加，則 —
 - (A) 在由該等股份發行之日起計的10年期屆滿前，該等股息不會增加；
 - (B) 該等股息的增加不會多於一次；及
 - (C) 該等股息的加幅不會超過金融管理專員認為適當的上限；”；

(c) 在(m)分節中 —

- (i) 在第(iii)小分節中，廢除在“的期間”之後的所有字句而代以“(即使其後該期間可在得到金融管理專員事先同意下予以縮減亦然)；”；
- (ii) 廢除第(iv)小分節而代以 —
 - “(iv) 在未得金融管理專員事先同意下，任何可在到期前付還的債項均不會如此付還；”；
- (iii) 在但書之前加入 —
 - “(v) 如根據該債項文書的條款，須就該債項支付的利息的利率可予提高，則 —

- (A) 在由該債項發行之日起計的 5 年期屆滿前，該利率不會提高；
- (B) 該利率的提高不會多於一次；及
- (C) 該利率提高的幅度不會超過金融管理專員認為適當的上限；”；

(iv) 在但書的(A)段中，在“折減”之前加入“按該債項的原款額”；

(d) 在(n)分節中 —

- (i) 廢除在“信納”之後而在破折號之前的所有字句而代以“根據該等股份的發行條款，以下條件得以符合”；
- (ii) 在第(i)小分節中，在分號之前加入“(即使其後該期間可在得到金融管理專員事先同意下予以縮減亦然)”；
- (iii) 廢除第(ii)小分節而代以 —

“(ii) 在未得金融管理專員事先同意下，任何可在到期前贖回的股份均不會如此贖回；

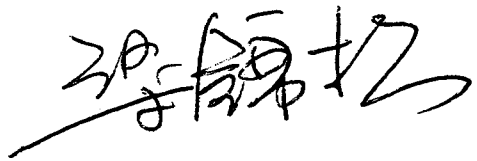
(iii) 如根據該等條款，須就該等股份支付的股息可予增加，則 —

- (A) 在由該等股份發行之日起計的 5 年期屆滿前，該等股息不會增加；

(B) 該等股息的增加不會多於一次；及

(C) 該等股息的加幅不會超過金融管理專員認為適當的上限；”；

(iv) 在但書的(A)段中，在“按”之後加入“該等股份的”。




財政司司長

2002年 12月 20日

註釋

本公告對《銀行業條例》(第155章)附表3中關於計算認可機構的資本充足比率的若干條文作出修訂。該等修訂的主要目的是授權金融管理專員認可若干准許提高利率或增加股息的資本票據(即永久後償債項、有期後償債項、繳足股款的有期優先股以及繳足股款、不可贖回而可累積的優先股)，並將該等資本票據納入為有關認可機構的附加資本。

 HONG KONG MONETARY AUTHORITY 香港金融管理局		
Supervisory Policy Manual		
CA-S-7	Term Subordinated Debt and Paid-up Term Preference Shares for Inclusion in Supplementary Capital	Consultation

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

1. Introduction
 - 1.1 Terminology
 - 1.2 Background
2. General requirements
 - 2.1 Term debt
 - 2.2 Term preference shares
 - 2.3 Repayment or redemption prior to maturity
 - 2.4 Limitation on amount to be included



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- 2.5 Discounting requirement
 - 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
- Annex A: Illustration of discounting requirement under subparas. 3(m)(A) and 3(n)(A) of the Third Schedule

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



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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. Subparas. 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.



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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 years¹. 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 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 for details.)

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



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2.2 Term 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 term preference shares have a minimum initial period to maturity of more than five years¹. 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 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 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;



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- 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/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 subparas. 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 subparas. 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:



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Years to maturity	% of original amount eligible for inclusion in supplementary capital
Up to 1	20%
≥ 2	40%
≥ 3	60%
≥ 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



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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.
- 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.
- 3.1.5 See also subsection 3.3 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.



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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, the



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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. 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;
- 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 creditors²;
- 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

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.



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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 on consolidation 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 CAR³.

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 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.



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Annex A: Illustration of discounting requirement under subparas. 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 maturity⁴.

A2. Discounting requirements

A2.1 As required under proviso (A) to subpara. 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.



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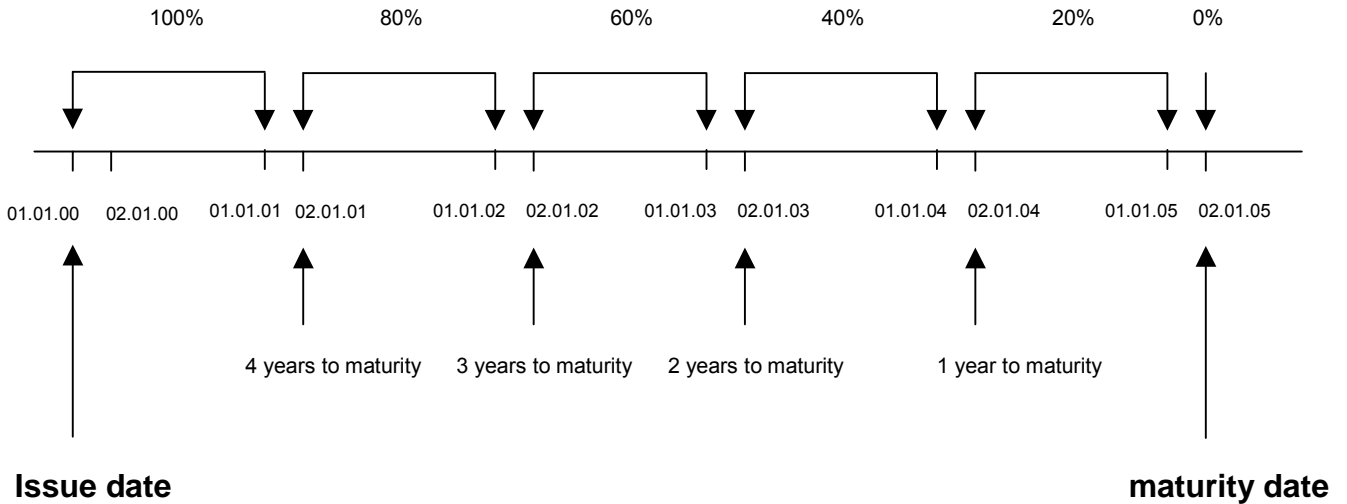
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Period	% of original amount
01.01.00 to 01.01.01	100%
02.01.01 to 01.01.02	80%
02.01.02 to 01.01.03	60%
02.01.03 to 01.01.04	40%
02.01.04 to 01.01.05	20%
02.01.05 (maturity)	0%

A3. Illustration

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

% of original amount to be reported:





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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



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- 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

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;



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- "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. Subparas. 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.



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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.)



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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



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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 reserves¹ become negative. The rate of conversion should be fixed in terms of the share

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



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price at the time of subscription to the instrument;
or

- 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 is to bear interest, the rate should not be materially different from the market rate.



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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.



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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



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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;



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- the SPV should have no external creditors²;
- 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 on consolidation 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 CAR³.

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.



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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.

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