



Bangko Sentral ng Pilipinas

OFFICE OF THE GOVERNOR

CIRCULAR NO. 503
Series of 2005

**Subject: Amendment of Risk-Based Capital Adequacy Framework
to Allow Qualification of Hybrid Tier 1 Instruments**

The Monetary Board in its Resolution No. 1569 dated 8 December 2005, approved the following amendments to the guidelines on the risk-based capital adequacy framework to include Hybrid Tier 1 as part of qualifying capital; and to rationalize the minimum requirements for eligibility of unsecured subordinated debt instruments that qualify as Upper or Lower Tier 2 capital.

Section 1. Subsection X116.1 of the Manual of Regulations for Banks is hereby amended to read as follows:

"§ X116.1 Qualifying Capital. The qualifying capital shall be the sum of -

a. Tier 1 capital -

a.1 Core Tier 1 capital

1. Paid-up common stock;
2. Paid-up perpetual and non-cumulative preferred stock;
3. Common stock dividends distributable;
4. Perpetual and non-cumulative preferred stock dividends distributable;
5. Surplus;
6. Surplus reserves;
7. Undivided profits (for domestic banks only); and
8. Minority interest in the equity of subsidiary financial allied undertakings which are less than wholly-owned: *Provided*, That a bank shall not use minority interests in the equity accounts of consolidated subsidiaries as avenue for introducing into its capital structure elements that might not otherwise qualify as Tier 1 capital or that would, in effect, result in an excessive reliance on preferred stock within Tier 1:

Provided, further, that the following items shall be deducted from the total of Tier 1 capital:

1. Common stock treasury shares;
2. Perpetual and non-cumulative preferred stock treasury shares;
3. Net unrealized losses on underwritten listed equity securities purchased (for domestic banks and Philippine branches of foreign banks);
4. Unbooked valuation reserves and other capital adjustments based on the latest report of examination as approved by the Monetary Board;
5. Total outstanding unsecured credit accommodations, both direct and indirect, to directors, officers, stockholders and their related interests (DOSRI);
6. Deferred income tax; and
7. Goodwill; and

a.2 Hybrid Tier 1 (HT1)

1. With prior BSP approval, perpetual preferred stock and perpetual unsecured subordinated debt, subject to the following conditions:
 - i. The HT1 must be issued and fully paid-up. Only the net proceeds received from the issuance of HT1 shall be included as capital;
 - ii. The dividends/coupons on the HT1 must be non-cumulative. It is acceptable to pay dividends/coupons in scrip or shares of stock if a cash dividend/coupon is withheld: *Provided*, That this does not result on issuing lower quality capital: *Provided, further*, That where such dividend/coupon stock settlement feature is included, the bank should ensure that it has an appropriate buffer of authorized capital stock and appropriate stockholders and board authorization, if necessary, to fulfill their potential obligations under such issues;
 - iii. The HT1 must be available to absorb losses of the bank without it being obliged to cease carrying on business. The agreement governing the issuance of the HT1 should specifically provide for the dividend/coupon and principal to absorb losses where the bank would otherwise be insolvent, or for the holders of the HT1 to be treated as if they were holders of a specified class of share capital in any proceedings commenced for the winding up of the bank. Issue documentation must disclose to prospective investors the manner by which the instrument is to be treated in loss situation.

Alternatively, the agreement governing the issuance of the HT1 can provide for automatic conversion into common shares or perpetual and non-cumulative preferred shares upon occurrence of certain trigger events, as follows:

- Breach of minimum capital ratio;
- Commencement of proceedings for winding up of the bank or
- Upon appointment of receiver for the bank.

The rate of conversion must be fixed at the time of subscription to the instrument. The bank must also ensure that it has appropriate buffer of authorized capital stock and appropriate stockholders and board authorization for conversion/issue to take place anytime;

- iv. The holders of the HT1 must not have a priority claim, in respect of principal and dividend/coupon payments of the HT1 in the event of winding up of the bank, which is higher than or equal with that of depositors, other creditors of the bank and holders of LT2 and UT2 capital instruments. The holder of the HT1 must waive his right to set-off any amount he owes the bank against any subordinated amount owed to him due to the HT1;
- v. The HT1 must be perpetual;
- vi. The HT1 must neither be secured nor covered by a guarantee of the issuer or related party or other arrangement that legally or economically enhances the priority of the claim of any holder of the HT1 as against depositors, other creditors of the bank and holders of LT2 and UT2 capital instruments;
- vii. The HT1 must not be redeemable at the initiative of the holder. It must not be repayable prior to maturity without the prior approval of the BSP: *Provided*, That repayment may be allowed only in connection with call option after a minimum of five (5) years from issue date: *Provided, however*, That a call option may be exercised within the first five (5) years from issue date when –
 - The HT1 was issued for the purpose of a merger with or acquisition by the bank and the merger or acquisition is aborted;
 - There is a change in tax status of the HT1 due to changes in the tax laws and/or regulations; or

- The HT1 does not qualify as Hybrid Tier 1 capital as determined by the BSP:

Provided, further, That such repayment prior to maturity shall be approved by the BSP only if the preferred share/debt is simultaneously replaced with issues of new capital which is neither smaller in size nor of lower quality than the original issue, unless the bank's capital ratio remains more than adequate after redemption.

It must not contain any clause which requires acceleration of payment of principal, except in the event of insolvency. The agreement governing the issuance of the HT1 must not contain any provision that mandates or creates an incentive for the bank to repay the outstanding principal of the instrument, e.g., a cross-default or negative pledge or a restrictive covenant, other than a call option which may be exercised by the bank;

- viii. The main features of the HT1 must be publicly disclosed by annotating the same on the instrument and in a manner that is easily understood by the investor;
- ix. The proceeds of the HT1 must be immediately available without limitation to the bank;
- x. The bank must have full discretion over the amount and timing of dividends/coupons under the HT1 where the bank –
 - Has not paid or declared a dividend on its common shares in the preceding financial year; or
 - Determines that no dividend is to be paid on such shares in the current financial year.

The bank must have full control and access to waived payments;

- xi. Any dividend/coupon to be paid under the HT1 must be paid only to the extent that the bank has profits distributable determined in accordance with existing BSP regulations. The dividend/coupon rate, or the formulation for calculating dividend/coupon payments must be fixed at the time of issuance of the HT1 and must not be linked to the credit standing of the bank;
- xii. The HT1 may allow only one (1) moderate step-up in the dividend/coupon rate in conjunction with a call option, only if the step-up occurs at a minimum of ten (10) years after the issue date and if it results in an increase over the initial rate that is

not more than –

- 100 basis points less the swap spread between the initial index basis and the stepped-up index basis; or
- 50% of the initial credit spread less the swap spread between the initial index basis and the stepped-up index basis.

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 (Refer to Annex A for computation of dividend/coupon rate step-up);

- xiii. The HT1 must be underwritten or purchased by a third party not related to the issuer bank nor acting in reciprocity for and in behalf of the issuer bank;
- xiv. The HT1 must be issued in minimum denominations of at least five hundred thousand pesos (P500,000.00) or its equivalent;
- xv. The HT1 must clearly state on its face that it is not a deposit and is not insured by the Philippine Deposit Insurance Corporation (PDIC); and
- xvi. The bank must submit a written external legal opinion that the abovementioned requirements, including the subordination and loss absorption features, have been met:

Provided, That for purposes of reserve requirement regulation, the HT1 shall not be treated as time deposit liability, deposit substitute liability or other forms of borrowings: *Provided, further*, That the total amount HT1 that may be included in the Tier 1 capital shall be limited to a maximum of 15% of total Tier 1 capital (net of deductions therefrom). To determine the allowable amount of HT1, the amount of total Tier 1 capital (net of deductions therefrom) excluding the HT1 should be multiplied by 17.65%, the number derived from the proportion of 15% to 85% (i.e., $15\%/85\% = 17.65\%$);

b. Tier 2 (supplementary) capital which shall be the sum of –

b.1 Upper Tier 2 capital -

1. Paid-up perpetual and cumulative preferred stock;
2. Paid-up limited life redeemable preferred stock issued with the condition that redemption thereof shall be allowed only if the shares redeemed are replaced with at least an equivalent amount of newly paid-in shares so that the total paid-in capital stock is

- maintained at the same level prior to redemption;
3. Perpetual and cumulative preferred stock dividends distributable;
 4. Limited life redeemable preferred stock with the replacement requirement upon redemption dividends distributable;
 5. Appraisal increment reserve – bank premises, as authorized by the Monetary Board;
 6. Net unrealized gains on underwritten listed equity securities purchased: *Provided*, That the amount thereof that may be included in upper Tier 2 capital shall be subject to a 55% discount (for domestic banks and Philippine branches of foreign banks);
 7. General loan loss provision: *Provided*, That the amount thereof that may be included in upper Tier 2 capital shall be limited to a maximum of 1.25% of gross risk-weighted assets, and any amount in excess thereof shall be deducted from the total risk-weighted assets in computing the denominator of the risk-based capital ratio;
 8. With prior BSP approval, unsecured subordinated debt with a minimum original maturity of at least ten (10) years, hereinafter referred to as "UT2", subject to the following conditions:
 - i. The UT2 must be issued and fully paid-up. Only the net proceeds received from the issuance of UT2 shall be included as capital;
 - ii. The UT2 must be available to absorb losses of the bank without it being obliged to cease carrying on business. The agreement governing the issuance of the UT2 should specifically provide for the coupon and principal to absorb losses where the bank would otherwise be insolvent, or for the holders of the UT2 to be treated as if they were holder of a specified class of share capital in any proceedings commenced for the winding up of the bank. Issue documentation must disclose to prospective investors the manner by which the instrument is to be treated in loss situation.

Alternatively, the agreement governing the issuance of the UT2 can provide for automatic conversion into common shares or perpetual and non-cumulative shares or perpetual and cumulative preferred shares upon occurrence of certain trigger events, as follows:

- Breach of minimum capital ratio;
- Commencement of proceedings for winding up of the bank or
- Upon appointment of receiver for the bank.

The rate of conversion must be fixed at the time of subscription to the instrument. The bank must also ensure that it has

appropriate buffer of authorized capital stock and appropriate stockholders and board authorization for conversion/issue to take place anytime;

- iii. The holders of the UT2 must not have a priority claim, in respect of principal and coupon payments of the UT2 in the event of winding up of the bank, which is higher than or equal with that of depositors, other creditors of the bank, and holders of LT2 capital instruments. The holder of the UT2 must waive his right to set-off any amount he owes the bank against any subordinated amount owed to him due to the UT2;
- iv. The UT2 must neither be secured nor covered by a guarantee of the issuer or related party or other arrangement that legally or economically enhances the priority of the claim of any holder of the UT2 as against depositors, other creditors of the bank and holders of LT2 capital instruments;
- v. The UT2 must not be redeemable at the initiative of the holder. It must not be repayable prior to maturity without the prior approval of the BSP: *Provided, That* repayment may be allowed only in connection with call option after a minimum of five (5) years from issue date: *Provided, however, That* a call option may be exercised within the first five (5) years from issue date when –
 - The UT2 was issued for the purpose of a merger with or acquisition by the bank and the merger or acquisition is aborted;
 - There is a change in tax status of the UT2 due to changes in the tax laws and/or regulations; or
 - The UT2 does not qualify as Upper Tier 2 capital as determined by the BSP:

Provided, further, That such repayment prior to maturity shall be approved by the BSP only if the debt is simultaneously replaced with issues of new capital which is neither smaller in size nor of lower quality than the original issue, unless the bank's capital ratio remains more than adequate after redemption,

It must not contain any clause which requires acceleration of payment of principal, except in the event of insolvency. The agreement governing the issuance of the UT2 must not contain any provision that mandates or creates an incentive for the bank to repay the outstanding principal of the instrument, e.g., a cross-default or negative pledge or a restrictive covenant, other than a call option which may be exercised by the bank;

- vi. The main features of the UT2 must be publicly disclosed by annotating the same on the instrument and in a manner that is easily understood by the investor;
- vii. The proceeds of the UT2 must be immediately available without limitation to the bank;
- viii. The bank must have the option to defer any coupon payment on the UT2 where the bank –
 - Has not paid or declared a dividend on its common shares in the preceding financial year; or
 - Determines that no dividend is to be paid on such shares in the current financial year;

It is acceptable for the deferred coupon to bear interest but the interest rate payable must not exceed market rates;

- ix. The coupon rate, or the formulation for calculating coupon payments must be fixed at the time of issuance of the UT2 and must not be linked to the credit standing of the bank;
- x. The UT2 may allow only one (1) moderate step-up in the coupon rate in conjunction with a call option, only if the step-up occurs at a minimum of ten (10) years after the issue date and if it results in an increase over the initial rate that is not more than –;
 - 100 basis points less the swap spread between the initial index basis and the stepped-up index basis; or
 - 50% of the initial credit spread less the swap spread between the initial index basis and the stepped-up index basis.

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 or rate (Refer to Annex A for computation of coupon rate step-up);

- xi. The UT2 must be underwritten or purchased by a third party not related to the issuer bank nor acting in reciprocity for and in behalf of the issuer bank;
- xii. The UT2 must be issued in minimum denominations of at least five hundred thousand pesos (P500,000.00) or its equivalent;
- xiii. The UT2 must clearly state on its face that it is not a deposit

and is not insured by the Philippine Deposit Insurance Corporation (PDIC); and

- xiv. The bank must submit a written external legal opinion that the abovementioned requirements, including the subordination and loss absorption features, have been met:

Provided, That the UT2 shall be subject to a cumulative discount factor of 20% per year during the last five (5) years to maturity (i.e., 20% if the remaining life is 4 years to less than 5 years, 40% if the remaining life is 3 years to less than 4 years, etc.): *Provided*, further, That where it is denominated in a foreign currency, it shall be revalued in accordance with PAS 21: *Provided*, furthermore, That for purposes of reserve requirement regulation, it shall not be treated as time deposit liability, deposit substitute liability or other forms of borrowings;

9. Deposit for common stock subscription; and
10. Deposit for perpetual and non-cumulative preferred stock subscription;

Provided, That the following items shall be deducted from the total of Upper Tier 2 capital:

1. Perpetual and cumulative preferred stock treasury shares;
2. Limited life redeemable preferred stock treasury shares with the replacement requirement upon redemption; and
3. Sinking fund for redemption of limited life redeemable preferred stock with the replacement requirement upon redemption; and

b.2 Lower Tier 2 capital –

1. Paid-up limited life redeemable preferred stock without the replacement requirement upon redemption: *Provided*, That it shall be subject to a cumulative discount factor of 20% per year during the last five (5) years to maturity (i.e., 20% if the remaining life is 4 years to less than 5 years, 40% if the remaining life is 3 years to less than 4 years, etc.);
2. Limited life redeemable preferred stock without the replacement requirement upon redemption dividends distributable;
3. Unsecured subordinated debt with a minimum original maturity of at least five (5) years, hereinafter referred to as "LT2", subject to the following conditions:
 - i. The LT2 must be issued and fully paid-up. Only the net proceeds received from the issuance of LT2 shall be included as capital;

- ii. The holders of the LT2 must not have a priority claim, in respect of principal and coupon payments of the LT2 in the event of winding up of the bank, which is higher than or equal with that of depositors and other creditors of the bank. The holder of the LT2 must waive his right to set-off any amount he owes the bank against any subordinated amount owed to him due to the LT2;
- iii. The LT2 must neither be secured nor covered by a guarantee of the issuer or related party or other arrangement that legally or economically enhances the priority of the claim of any holder of the LT2 as against depositors and other creditors of the bank;
- iv. The LT2 must not be redeemable at the initiative of the holder. It must not be repayable prior to maturity without the prior approval of the BSP: *Provided*, That repayment may be allowed only in connection with call option after a minimum of five (5) years from issue date: *Provided, however*, That a call option may be exercised within the first five (5) years from issue date when –
 - The LT2 was issued for the purpose of a merger with or acquisition by the bank and the merger or acquisition is aborted;
 - There is a change in tax status of the LT2 due to changes in the tax laws and/or regulations; or
 - The LT2 does not qualify as Lower Tier 2 capital as determined by the BSP:

Provided, further, That such repayment prior to maturity shall be approved by the BSP only if the debt is simultaneously replaced with issues of new capital which is neither smaller in size nor of lower quality than the original issue, unless the bank's capital ratio remains more than adequate after redemption.

It must not contain any clause which requires acceleration of payment of principal, except in the event of insolvency. The agreement governing the issuance of the LT2 must not contain any provision that mandates or creates an incentive for the bank to repay the outstanding principal of the instrument, e.g., a cross-default or negative pledge or a restrictive covenant other than a call option which may be exercised by the bank;

- v. The main features of the LT2 must be publicly disclosed by annotating the same on the instrument and in a manner that is easily understood by the investor;

- vi. The proceeds of the LT2 must be immediately available without limitation to the bank;
 - vii. The coupon rate, or the formulation for calculating coupon payments must be fixed at the time of issuance of the LT2 and must not be linked to the credit standing of the bank;
 - viii. The LT2 may allow only one (1) moderate step-up in the coupon rate in conjunction with a call option, only if the step-up occurs at a minimum of five (5) years after the issue date and if it results in an increase over the initial rate that is not more than-
 - 100 basis points less the swap spread between the initial index basis and the stepped-up index basis; or
 - 50% of the initial credit spread less the swap spread between the initial index basis and the stepped-up index basis.
- 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 (Refer to Annex A for computation of coupon rate step-up);
- ix. The LT2 must be underwritten or purchased by a third party not related to the issuer bank nor acting in reciprocity for and in behalf of the issuer bank;
 - x. The LT2 must be issued in minimum denominations of at least five hundred thousand pesos (P500,000.00) or its equivalent;
 - xi. The LT2 must clearly state on its face that it is not a deposit and is not insured by the Philippine Deposit Insurance Corporation (PDIC); and
 - xii. The bank must submit a written external legal opinion that the abovementioned requirements, including the subordination feature, have been met:

Provided, That the LT2 shall be subject to a cumulative discount factor of 20% per year during the last five (5) years to maturity (i.e., 20% if the remaining life is 4 years to less than 5 years, 40% if the remaining life is 3 years to less than 4 years, etc.): *Provided, further*, That where it is denominated in a foreign currency, it shall be revalued in accordance with PAS 21: *Provided, furthermore*, That for purposes of reserve requirement regulation, it shall not be

treated as time deposit liability, deposit substitute liability or other forms of borrowings;

4. Deposit for perpetual and cumulative preferred stock subscription; and
5. Deposit for limited life redeemable preferred stock subscription with the replacement requirement upon redemption:

Provided, That the following items shall be deducted from the total of Lower Tier 2 capital:

1. Limited life redeemable preferred stock treasury shares without the replacement requirement upon redemption;
2. Sinking fund for redemption of limited life redeemable preferred stock without the replacement requirement upon redemption:
Provided, That the amount to be deducted shall be limited to the balance of redeemable preferred stock after applying the cumulative discount factor:

Provided, That the total amount of Lower Tier 2 capital that may be included in the Tier 2 capital shall be limited to a maximum of 50% of total Tier 1 capital (net of deductions therefrom): *Provided, further*, That the total amount of Upper and Lower Tier 2 capital that may be included in the qualifying capital shall be limited to a maximum of 100% of total Tier 1 capital (net of deductions therefrom);

- c. Less deductions from the total of Tier 1 and Tier 2 capital, as follows:

1. Investments in equity of unconsolidated subsidiary banks and other financial allied undertakings, but excluding insurance companies;
2. Investments in debt capital instruments of unconsolidated subsidiary banks;
3. Investments in equity of subsidiary insurance companies and non-financial allied undertakings; and
4. Reciprocal investments in equity of other banks/enterprises;
5. Reciprocal investments in unsecured subordinated term debt instruments of other banks/quasi-banks qualifying as Hybrid Tier 1, Upper Tier 2 and Lower Tier 2, in excess of the lower of (i) an aggregate ceiling of 5% of total Tier 1 capital of the bank excluding Hybrid Tier 1; or (ii) 10% of the total outstanding unsecured subordinated term debt issuance of the other bank/quasi-banks

Provided, That any asset deducted from the qualifying capital in computing the numerator of the risk-based capital ratio shall not be included in the risk-weighted assets in computing the denominator of

the ratio.

For foreign bank branches, Tier 1 capital elements shall consist of -

1. Assigned capital; and
2. Net due "to" head office, branches, subsidiaries and other offices outside the Philippines as defined under Subsec. X121.5.d (inclusive of earnings not remitted to head office per Subsec. X121.5.c): *Provided*, that the amount of "Net due to account" shall be limited to an amount prescribed under Subsec. X121.6: *Provided, further*, that should there be any "Net due from account", the same shall be deducted from the Tier 1 capital.

Section 2. Except for the accounting treatment, the issuance of the abovementioned Hybrid Tier 1 capital instruments shall generally follow the guidelines on the issuance of unsecured subordinated debts eligible as Upper or Lower Tier 2 capital as provided in the Memorandum to All Banks and Non-Bank Financial Institutions Concerned dated 17 February 2003, as amended.

Eligible Hybrid Tier 1 capital instrument shall be booked as equity instrument under the account "Other Equity Instrument – Others", which shall be accounted for in accordance with the provisions of PAS 32.

Section 3. All outstanding issues of unsecured subordinated term debt instruments qualifying as UT2 and LT2 capital shall *continue* to be governed by the provisions of regulations existing at the time of their issuance, except that premiums thereon may now be counted as part of capital.

This Circular shall take effect fifteen (15) days after its publication either in the Official Gazette or in a newspaper of general circulation.

FOR THE MONETARY BOARD:


AMANDO M. TETANGCO, JR.
Governor

22 December 2005

Step-up Calculation

Case I. Change in Index Basis

(e.g., from 10-year US Treasury Notes to 10-year US Swap Rate)

Step 1. Determining the swap spread

A. Breakdown of Coupon Rate Based on Initial Index

Index basis (10-year US Treasury Notes)	4.49%
Credit spread	5.00%
Coupon rate	<u>9.49%</u>

B. Breakdown of Coupon Rate Based on Stepped-up Index

Index basis (10-year US swap rate at issuance)	5.05%
Adjusted credit spread to achieve initial coupon rate of 9.49%	4.44%
Coupon rate	<u>9.49%</u>

Swap spread of
0.56%

Step 2. Calculating Stepped-Up Coupon Rate

A. Assuming a ceiling of not more than 100 b.p. less the swap spread between the initial index basis and the stepped-up index basis

Index basis (10-year US swap rate)	5.05%
Initial credit spread	5.00%
Total before step-up	10.05%
Step-up (100 b.p.)	1.00%
Total after step-up but before swap spread	11.05%
Less: Swap spread	-0.56%
Stepped-up coupon rate	<u>10.49%</u>

B. Assuming a ceiling of not more than 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis

Index basis (10-year US swap rate)	5.05%
Initial Credit spread	5.00%
Total before step-up	10.05%
Step-up (50% of the initial credit spread)	2.50%
Total after step-up but before swap spread	12.55%
Less: Swap spread	-0.56%
Stepped-up coupon rate	<u>11.99%</u>