



BANGKO SENTRAL NG PILIPINAS

OFFICE OF THE GOVERNOR

CIRCULAR NO. 709

Series of 2011

Subject: Amendment of the Risk-Based Capital Adequacy Framework for Banks/Quasi-Banks on the Definition of Qualifying Capital Instruments

The Monetary Board, in its Resolution No. 1882 dated 29 December 2010, decided to amend the Risk-Based Capital Adequacy Framework for Philippine banks/quasi-banks issued under: (a) Circular No. 538 dated 4 August 2006 for universal/commercial banks and their subsidiary banks/quasi-banks; (b) Circular No. 280 dated 29 March 2001, as amended, and Circular No. 688 dated 26 May 2010 that will take effect on 1 January 2012 for stand-alone thrift banks, rural bank and cooperative banks; and (c) Circular No. 400 dated 1 September 2003 for quasi-banks, particularly on the definition of qualifying capital instruments:

Rationale. The Basel Committee on Banking Supervision (BCBS) has issued new standards¹ that modify the structure of banks' regulatory capital, among others. The standards divide capital elements into (1) Tier 1 capital, which is also referred to as Going-Concern capital, and is composed of Common Equity and Additional Going Concern capital, and (2) Tier 2 capital, which is also referred to as Gone-Concern capital. Moreover, the standards set forth eligibility criteria for inclusion of capital instruments as Additional Going Concern capital and Tier 2 capital.

To align with the international standards, the BSP hereby adopts the BCBS' eligibility criteria on Additional Going Concern capital and Tier 2 capital to determine the eligibility of capital instruments to be issued by Philippine banks/quasi-banks as Hybrid Tier 1 capital and Lower Tier 2 capital, respectively, under the existing Risk-Based Capital Adequacy Framework for banks/quasi-banks effective 1 January 2011.

Following are the guidelines on banks'/quasi-banks' issuances of qualifying capital instruments:

Section 1. Effective 1 January 2011, capital instruments issued by banks/quasi-banks should comply with the following minimum conditions in order to be eligible as Hybrid Tier 1 or Lower Tier 2 capital, as applicable:

1. For Hybrid Tier 1 :

- a) It must be issued and paid-in;

¹ See "Basel III: A global regulatory framework for more resilient banks and banking systems", Basel Committee on Banking Supervision, December 2010. Available at www.bis.org

- b) It must be subordinated to depositors, general creditors and subordinated debt of the bank/quasi-bank;
- c) It is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank/quasi-bank creditors;
- d) It is perpetual, i.e., there is no maturity date and there are no step-ups or other incentives to redeem;
- e) It may be callable at the initiative of the issuer only after a minimum of five years, subject to the following conditions:
 - i. To exercise a call option a bank/quasi-bank must receive prior supervisory approval; and
 - ii. A bank/quasi-bank must not do anything which creates an expectation that the call will be exercised; and
 - iii. Banks/quasi-banks must not exercise a call unless:
 - a. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank/quasi-bank;¹ or
 - b. The bank/quasi-bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised;
- f) Any repayment of principal (e.g. through repurchase or redemption) must be with prior supervisory approval and banks/quasi-banks should not assume or create market expectations that supervisory approval will be given;
- g) With regard to dividend/coupon discretion:
 - i. The bank/quasi-bank must have full discretion at all times to cancel distributions/payments²;
 - ii. Cancellation of discretionary payments must not be an event of default;
 - iii. Banks/quasi-banks must have full access to cancelled payments to meet obligations as they fall due; and

¹ Replacement issues can be concurrent with but not after the instrument is called.

² A consequence of full discretion at all times to cancel distributions/payments is that "dividend pushers" are prohibited. An instrument with a dividend pusher obliges the issuing bank/quasi-bank to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term "cancel distributions/payments" means extinguish these payments. It does not permit features that require the bank/quasi-bank to make distributions/payments in kind.

- iv. Cancellation of distributions/payments must not impose restrictions on the bank/quasi-bank except in relation to distributions to common stockholders;
- h) Dividends/coupons must be paid out of distributable items;
- i) The instrument cannot have a credit sensitive dividend feature, that is, a dividend/coupon that is reset periodically based in whole or in part on the bank's/quasi-bank's credit standing;
- j) The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law;
- k) Instruments classified as liabilities for accounting purposes must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:
 - i. Reduce the claim of the instrument in liquidation;
 - ii. Reduce the amount re-paid when a call is exercised; and
 - iii. Partially or fully reduce coupon/dividend payments on the instrument;
- l) Neither the bank/quasi-bank nor a related party over which the bank/quasi-bank exercises control or significant influence can have purchased the instrument, nor can the bank/quasi-bank directly or indirectly have funded the purchase of the instrument;
- m) The instrument cannot have any features that hinder recapitalization, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame;
- n) It must be underwritten by a third party not related to the issuer bank/quasi-bank nor acting in reciprocity for and in behalf of the issuer bank/quasi-bank;
- o) It must clearly state on its face that it is not a deposit and is not insured by the Philippine Deposit Insurance Corporation (PDIC); and
- p) The bank/quasi-bank must submit a written external legal opinion that the abovementioned requirements, including the subordination and loss absorption features, have been met:

Provided, That instruments that meet the foregoing conditions shall be subject to the same treatment as eligible Hybrid Tier 1 capital issued prior to 1 January 2011 for purposes of (1) reserve requirement regulation, and (2) the limit on the amount of Hybrid Tier 1 capital that may be included in Tier 1 capital.

2. For Lower Tier 2 capital:

- a) It must be issued and paid-in;
- b) It must be subordinated to depositors and general creditors of the bank/quasi-bank;
- c) It is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general bank/quasi-bank creditors;
- d) With regard to maturity:
 - i. It must have a minimum original maturity of at least five (5) years;
 - ii. Its recognition in regulatory capital in the remaining five (5) years before maturity will be amortized on a straight line basis; and
 - iii. There are no step-ups or other incentives to redeem;
- e) It may be callable at the initiative of the issuer only after a minimum of five (5) years:
 - i. To exercise a call option a bank/quasi-bank must receive prior supervisory approval; and
 - ii. A bank/quasi-bank must not do anything which creates an expectation that the call will be exercised;³ and
 - iii. Banks/quasi-banks must not exercise a call unless:
 - a. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank/quasi-bank;⁴ or
 - b. The bank/quasi-bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised;
- f) The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation;
- g) The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the bank's/quasi-bank's credit standing;

³ An option to call the instrument after five (5) years but prior to the start of the amortization period will not be viewed as an incentive to redeem as long as the bank/quasi-bank does not do anything that creates an expectation that the call will be exercised at this point.

⁴ Replacement issues can be concurrent with but not after the instrument is called.

- h) Neither the bank/quasi-bank nor a related party over which the bank/quasi-bank exercises control or significant influence can have purchased the instrument, nor can the bank/quasi-bank directly or indirectly have funded the purchase of, the instrument;
- i) It must be underwritten by a third party not related to the issuer bank/quasi-bank nor acting in reciprocity for and in behalf of the issuer bank/quasi-bank;
- j) It must clearly state on its face that it is not a deposit and is not insured by the Philippine Deposit Insurance Corporation (PDIC); and
- k) The bank/quasi-bank must submit a written external legal opinion that the abovementioned requirements, including the subordination and loss absorption features, have been met:

*Provided, That, instruments that meet the foregoing conditions shall be subject to the same treatment as Unsecured Subordinated Debt issued prior to 1 January 2011 that are eligible as Lower Tier 2 capital, for purposes of (1) the limit on the amount that may be included in Lower Tier 2 capital during the instrument's last five (5) years to maturity; (2) foreign exchange revaluation in accordance with Philippine Accounting Standards (PAS) 21: *The Effects of Changes in Foreign Exchange Rates*, if the instrument is denominated in foreign currency; (3) reserve requirement regulation; and (4) the limit on the total amount of Lower Tier 2 capital that may be included in Total Tier 2 capital.*

Section 2. Effective 1 January 2011, no new issuances of capital instruments shall be included in Upper Tier 2 capital.

Section 3. Eligible capital instruments under Hybrid Tier 1, Upper Tier 2 and Lower Tier 2 capital that have been issued as of 31 December 2010 shall continue to be recognized as qualifying capital subject to limits provided under the existing Risk-Based Capital Adequacy Framework for banks/quasi-banks until such time that the BSP issues further guidelines, in accordance with developments in international standards.

Section 4. This Circular shall take effect fifteen (15) calendar days following its publication either in the Official Gazette or in a newspaper of general circulation.

FOR THE MONETARY BOARD:


AMANDO M. TETANGCO, JR.
Governor

10 January 2011