[BSP CIRCULAR NO. 709, January 10, 2011]

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 standards[1] that modify the structure of banks' regulatory capital, among others. The standards divide capital elements in (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.
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> 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:
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> 1. For Hybrid Tier 1 :

a) It must be issued and paid-in;
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:
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> > 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/payments[2] ;

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

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