مصرف الإمارات العربية المتحدة المركزي
CENTRAL BANK OF THE U.A.E.

Standard re Tier Capital Instruments

Standards re Tier Capital Instruments

Date: 29/03/2018

To: All Banks

Subject: Tier Capital Instruments

INTRODUCTION

This Standard re Tier Capital Instrument must be read in conjunction with the Capital Regulations Circular No 52/2017 and Guidance re Tier Capital Instrument. For the criteria of qualifying Tier capital, please refer to the Standard re Capital Supply Notice No. 28/2018. It defines further criteria required for capital to be classified as Additional Tier 1 and Tier 2. Non-exhaustive examples of features that are based on the Basel requirements are optional calls, coupon payments, and distributable items.

- The issuer, for example, can call the instruments in full at its own initiative but only after a minimum of 5 years.
- Coupon payments are paid from distributable items.
- Coupon payments are discretionary and are not cumulative.

Liability accounted instruments must set the loss absorption trigger at a level of 7.625% of CET1

The purpose of this Standard is to:

- Clarify on the requirements for the classification of Instruments in the UAE
- Provide a robust Tier capital Instrument framework to the industry,
- Support a standardisation of the instruments in the market
- Implement a clear application and approval process.

Banks wishing to issue any type of capital must inform the Central Bank of the UAE prior to issuance of the instrument. The bank may only issue the intended capital component after having submitted all papers required as described in the Application Process in the Appendix and after the Board of the Central Bank of the UAE has approved the application for capital issuances of Additional Tier 1 and Tier 2 capital.

This standard is for banks approaching CBUAE for issuing regulatory capital. The Central Bank wants to keep Tier capital instruments simple and robust. The capital Instrument standard intends:

- To ensure the soundness of individual institutions
- To reduce the variety of capital instruments in the market
- To monitor the quality of instruments issued in the UAE
- To monitor the amount of capital being issued in the market;
- To enhance the financial stability of the banking sector.

SCOPE OF APPLICATION

This standard explains the requirements for Tier capital Instruments, the application process, and approval procedures followed by the CBUAE. It applies to all local banks operating in the UAE (only local banks are permitted to issue Additional Tier 1 or Tier 2 instruments). Foreign branches, however, are permitted to issue Tier 2 subordinated term loans from their Head Offices with a restriction of 3% of their risk-weighted assets. All banks must ensure they adhere to the solo (once the guideline on solo reporting is published) and group capital adequacy ratio requirements at all times. Banks are responsible for ensuring that their capital instruments comply with all relevant requirements. This Standard will be updated from time to time to reflect any relevant regulatory development.

Article 1. Definitions and interpretations:

1. **Capital Regulations and Standards**, means regulatory capital requirements for the maintenance of capital applicable to the issuer, including transitional rules. It includes the Capital Regulation, the Capital Standards, and Capital Guidances.

2. **Capital Event**, is deemed to have occurred if the issuer is notified in writing by the CBUAE to the effect that the outstanding principal amount of the capital securities would cease to be eligible to qualify for inclusion in its current Tier capital component (Additional Tier 1 or Tier 2 capital) of the issuer such that the outstanding principal amount would be excluded in full or in part from the applicable Tier capital component of the issuer;

3. **Distributable Items,** means the amount of the issuer's consolidated retained earnings and reserves after the transfer of any amounts to non-distributable reserves, all as set out in the most recent audited or auditor reviewed consolidated financial statements of the issuer or any equivalent or successor term from time to time as prescribed by the Capital Regulations, including the applicable criteria for Tier 1 capital instruments that do not constitute Common Equity Tier 1 Capital;

4. **Grandfathering** is part of the transition process. In order to qualify for the grandfathering arrangements, an instrument must have a particular cut-off date. Any instrument entered into before 1st January 2018, which does not meet the new Basel III qualifying criteria for the particular tier of capital, will be grandfathered.

5. **Non-Viable:** The issuer shall be Non-Viable if it is at least (a) insolvent, bankrupt, unable to pay a material part of its obligations as they fall due or unable to carry on its business, or (b) any other event or circumstance occurs that CBUAE deems necessary.

6. **Point of Non-Viability (PONV):** A Point of Non-Viability means that the Regulator has determined that the issuer has or will become, Non-Viable without: (a) a Write-down, or (b) a public injection of capital (or equivalent support).

General Requirements for Additional Tier 1 instruments and Tier 2:
Tier capital Instruments must fulfill the criteria of the respective Tier capital components as described in the Capital Standard. The below requirements are additional requirements for the issued capital in the UAE.

Article 2. Point of Non Viability (PONV)

i. The terms and conditions of Additional Tier 1 and Tier 2 instruments must have a provision that requires such instruments to be written off upon the occurrence of a trigger event.
ii. Banks will be informed in writing upon the occurrence of a Point of Non-Viability (PONV).
iii. When a Non-Viability Event occurs on or after the date of issuance, the capital issuance will be cancelled and all rights of any holder of capital issuance for payment of any amounts under or in respect of the capital issuance (including, without limitation, any amounts arising as a result of, or due and payable upon the occurrence of, an Enforcement Event) shall be cancelled and not restored under any circumstances, irrespective of whether such amounts have become due and payable prior to the date of the Non-Viability Event or notice in relation thereto.
iv. The write-down at the PONV will occur in full and be permanent in nature. A partial write-down may be considered only in exceptional cases as decided by the CBUAE.
v. There must not be any impression to the investor that a write-down notice will be sent before the issuer can write-down the instrument.
vi. If a bank issues Tier capital out of a subsidiary and wishes that such capital to be eligible in the consolidated group’s capital, the terms and conditions must specify an additional trigger event: The trigger is the earlier of: (1) a decision that a write-off is required, without which the subsidiary would become non-viable, is necessary, as determined by the regulator of the subsidiary in the home jurisdiction, and (2) CBUAE has determined a Point of Non-Viability for the consolidated bank.

Article 3. Subordination

To ensure subordination of Tier capital instruments, Tier Capital instruments must be fully written down upon liquidation or bankruptcy.

Article 4. Solvency Conditions:

Capital issuances must define Solvency Conditions in the terms and conditions. Solvency Conditions must contain at least the following:

i. The issuer must be solvent at all times.
ii. The issuer being able to make payments on the obligations and any payments required to be made on the relevant date in respect to all senior obligations and pari passu obligations
iii. The total share of capital of the issuer must be greater than zero at all times from the first day of the relevant coupon period to the time of payment of obligations.

Article 5. Capital Event:

i. If an instrument ceases to count as Tier capital (for example due to a change in the regulation), CBUAE will inform a bank of such "Capital Event" accordingly with a written notification.

ii. A Capital Event may occur at any time, due to its unforeseen nature, on or after the issue date. Any attempt to redeem must be subject to the CBUAE's prior consent.

Article 6. Redemption:

i. To ensure that Instruments comply with the capital requirements as shown in the Capital Definition Standards or requirements in this standard, any redemption of the instruments requires prior consent of CBUAE, satisfaction of the solvency conditions, and satisfaction of the capital regulations and standards.

ii. The issuer may redeem all, but not some part, of the capital instrument. Only in certain exceptional cases would the CBUAE consider approving partial calls.

iii. The wording of the document must not include terms that seem to indicate that the purchase or redemption of the instrument may occur at any time.

Article 7. Redemption notices:

All notices are revocable before redemption as well as after a notice of redemption has been given.

Article 8. Special Purpose Vehicle (SPV):

Only Islamic banks may use a SPV for capital issuances. The SPV has to be 100% owned by the bank if it will be used for capital issuances. The requirements for these issuances are as follows:

i. The mudaraba contract between the issuer and the SPV:
   a. Must be subordinated.
   b. No such contract will be given on the cancelled coupons so that flexibility of payments is given at any time.

ii. The contract must be specific enough and its scope is restricted to a change affecting the issuer, such as a restructure or a merger. CBUAE will reassess the eligibility of the instrument.

iii. Every capital instrument requires a separate SPV.

Article 9. Currencies:

i. Only Instruments in UAE Dirhams (AED) and US Dollars (USD) will be accepted for banks incorporated in the UAE Emirates. This also applies to instruments issued through a SPV by Islamic banks.

ii. For issuances by subsidiaries, the respective local currency will be acceptable only in exceptional circumstances together with the approval of the CBUAE.

Specific Requirements for Additional Tier 1:

Article 10. Coupon Cancellation:

In the event of a coupon cancellation (as stated in the terms and conditions of the issuance), the coupon will not be paid by the issuer and the following events should be covered as a minimum (Non-Payment Event):

i. The coupon payable, when aggregated with any distributions or amounts payable by the issuer as bank or SPV, on any pari passu obligations having:
   a. the same dates in respect of payment of such distributions or amounts as, or;
   b. otherwise due and payable on the dates for payment of the coupon, exceeds the Distributable Items (on the relevant date for payment of such coupon);

ii. The issuer is, on that coupon date:
   a. in breach of the Capital Regulations and Standards including any payment restrictions due to breach of capital buffers imposed on the issuer by the CBUAE, as appropriate;
   b. or payment of the relevant coupon would cause it to be in breach thereof;

iii. The CBUAE requires that the coupon due on the coupon date will not be paid (for any reason the CBUAE may deem necessary);

iv. The Solvency Conditions are not satisfied or would no longer be satisfied if the relevant coupon was paid; or

v. The issuer, in its sole discretion, has elected that coupon shall not be paid to holders of the capital securities on any coupon date, for example but not limited to, due to a net loss for that period. Other than in respect of any amounts due on any date on which the capital securities are to be redeemed in full, unless the redemption notice is revoked.

Therefore, cancellation of the distributions can be discretionary (v) or mandatory (i)-(iv). Any distributions on the Notes so cancelled, must be cancelled definitively and must not accumulate or be payable at any time thereafter.

It should be noted that a Non-Payment Event is:

i. Not an Event of Default and;

ii. Not an Enforcement Event.

Article 11. Non-Payment Event Notices:

i. All notices are revocable before a Non-Payment Event is exercised. This also applies to a notice already issued for a Non-Payment Event.

ii. Any failure to provide a notice of a Non-Payment Event will not invalidate the right to cancel the payment of the coupon.

Article 12. Enforcement Events:

The right to institute winding-up proceedings is limited to circumstances where payment has become due. Solvency conditions have to be met in order for the principal, coupon, or any other amount to be due on the relevant payment date. Payments on capital securities can be cancelled after which it will not be due on the relevant payment date. Upon the occurrence of an Enforcement Event, any holder of the capital securities may give a written notice to the issuer of the capital securities. An enforcement event is related to a non-payment when due and to insolvency. A Non Payment Event is not an Enforcement Event

Article 13. Maximum Distributable Amount (MDA):

Distributions are restricted if the bank does not have sufficient capital to fulfill the Effective Capital Conservation Buffer. Banks are hence prohibited from making a distribution if their CET1 is below the combined buffer requirement (CBR). The distributions have to be lower than the maximum distributable amount which is calculated as follows:

MDA is calculated as the sum of:

i. Interim profits not included in CET1 capital and
ii. Year-end profits not included in CET1 capital minus
iii. Amounts that would be payable by tax if i) and ii) were to be retained, multiplied by a factor set at:
    a. Zero if the CET1 ratio not used to meet the own funds requirement is within the first quartile (i.e. the lowest) of the CBR;
    b. 0.2 if the CET1 is in the second quartile;
    c. 0.4 if the CET1 is in the third quartile; and
    d. 0.6 if the CET1 is in the fourth quartile

MDA should be reduced by:

i. A distribution in connection with CET1 capital;
ii. Variable remuneration pay or discretionary pension benefits, or variable remuneration pay if the obligation to pay was created at a time when the institution failed to meet the CBR; and
iii. Payments on additional tier 1 instruments.

Specific Requirements for Tier 2 instruments:

Banks have to follow the Tier 2 criteria in the Capital Standards as well as the following additional requirements of this standard:

Article 14. Amortisation of Tier 2 Instruments:

i. Recognition of the capital instrument as Tier 2 Capital in its final 5 years to maturity is amortised on a straight-line basis by 20% per annum.
ii. If the capital instrument is repayable in separate tranches, each tranche shall be amortised individually, as if it were a separate loan.

Transition Period

Article 15. Grandfathering Rules for Additional Tier 1 and Tier 2

Grandfathering rules apply only to instruments that were issued before the effective date of the Capital Regulation.

i. Instruments that are fully Basel III complaint will be grandfathered at 100% eligibility for 10 years starting from Jan 1, 2018 until 31 Dec 2017.

ii. Instruments that are not Basel III compliant do no longer qualify as non-common equity Tier 1 capital or Tier 2 capital and will be phased out beginning 1st January 2018.
    a. Fixing the base at the nominal amount of such instruments outstanding on 1 January 2018, their recognition will be capped at 90% from 1 January 2018, with the cap reducing by 10 percentage points in each subsequent year.
    b. This cap will be applied to Additional Tier 1 and Tier 2 Instruments on an individual instrument base and refers to the amount of that instrument outstanding that no longer meets the relevant entry criteria.
    c. If an instrument is repaid in separate tranches, the cap will be applied on the reduced amount in all circumstances.

Appendix A: Application Process:

The application process for banks issuing Additional Tier 1 or Tier 2 as a two-stage process:

1. Initial information to be provided to the CBUAE:

The bank shall inform the CBUAE from the beginning of the whole process. The bank must inform CBUAE about the main features of the planned capital increase.

1. Reason(s) for the Instrument of the capital instrument
2. Main features of the planned Capital Instrument: Section 1, 2 and 3 of the Capital Notification form (signature not required)
3. Capital planning for 5 years include
    i. business as usual conditions
    ii. without the planned capital Instrument
4. Stress Testing with a stress scenario of top 2 customers are defaulting
5. CBUAE – Financial Stability Stress Test results

The intention of such Instrument request will be checked by Central Bank and a Non-objection may be granted, so that the bank can proceed with the second stage of the approval process.

2. Actual application:

To start the approval process the bank must submit all of the following documents:

i. Specify the reason(s) for the Instrument of the capital instrument.
ii. Certification of an independent appropriately qualified and experienced lawyer that the submitted documents are relevant and compliant with the country's applicable laws and requirements for qualification under the Capital Regulations, Standards and Guidance.
iii. Confirmation of the bank's external auditor on the accounting treatment of the planned Instrument.
iv. Fully filled out Application form (CN1-form), signed by the CEO, CFO, Internal Audit, Compliance, and Risk.
v. Detailed terms and conditions of the Instrument that will be part of the prospectus/ contract
    a. Note that the CN-1 form must contain details of any new, unusual or different features of the capital instrument
    b. Comparison of the intended terms and conditions with a version that is already publicly available and approved. (Black-lined version)
vi. Capital forecast for 5-year period based on capital planning projections BAU and without the Instrument.
vii. Stress testing to be conducted by the bank and that a stress scenario of top 2 customers defaulting.
viii. CBUAE-Financial Stability Unit FSU performed stress test result.
ix. Provide key SPV related documents, if applicable: Terms and conditions, incorporated documents etc.
x. Market Conformity Analysis.
xi. Any other required documents by the regulator if deemed necessary.

Appendix B: Central Bank of UAE – processes and requirements form for Financial Institutions operating in UAE

Summary checklist notification to the CBUAE of planned Instrument of a regulatory capital instrument. Alongside the application, pack (i.e. the CN1-form and the draft prospectus terms & conditions).

Please note that your submission is incomplete unless you have included the following:

Stage 1: Initial Information to CBUAE	
Name of the bank	
Reason(s) for the Issuance of the capital instrument	
Bank to inform the CBUAE from the beginning of the Instrument and main features of the capital increase	
Main features of the planned capital Instrument (section 1,2, and 3 of the Capital Notification Form)	
Stage 2: Capital Planning for 5 years under: i. Business as usual conditions ii. Without the capital planning Instrument	
Stress scenario with a stress scenario of top 2 customers are defaulting	
CBUAE- Financial Stability Stress Test Results	
i. Actual Application	
The bank must submit the following documents to start the approval process:	
a. A legal opinion of an independent qualified and experienced lawyer that the submitted documents are in compliance with the applicable laws and regulations and with the Capital Regulations, Standards, and Guidance, and the documents are legally enforceable.	
b. Confirmation of the bank's auditor on the accounting treatment of the instrument	
c. Fully filled out CN1-form signed by the CEO, CFO, CRO, Head of Internal Audit, and Head of Compliance	

d. Detailed terms and conditions that will be part of the prospectus (Note that a comparison of the terms and conditions need to be black-lined if any changes occur)	
e. Capital forecast of 5 year period with business as usual scenario and no capital Instrument scenario	
f. Stress testing to be conducted by the bank that top 2 customers are defaulting	
g. CBUAE-FSU stress test result	
h. Relevant SPV documents: Terms and Conditions, incorporated documents, etc.	
i. Other required documents if needed such as Market Conformity Analysis	

Appendix C: Process of the Eligibility of Capital Instruments

Banks will adhere to the following process when an application for the eligibility of a current capital instrument is submitted to the CBUAE:

i) The applicant bank has to determine if the current capital instrument has the following features:
   a) A conditional Point Of Non-Viability (PONV) that;
   b) Needs to be activated by the CBUAE.
ii) Once (i) has been met as:
   a) Yes: A letter from the CBUAE, the bank should request a letter from the CBUAE, which activates the PONV.
   b) No: The bank may directly go to (iii) without approaching the CBUAE for an activation of a PONV letter.
iii) The bank will have to go over Stage 2 of the process in Appendix B then approach its appointed external lawyers who will certify if the capital instrument conforms to the requirements of the CBUAE for grandfathering purposes. This certification will have to accompany the eligibility application to the CBUAE.
iv) The CBUAE will determine if the application fulfills the necessary requirements as approved by the Board of the CBUAE.
v) The final application will be submitted to the CBUAE. The CBUAE will decide as to which grandfathering clause to apply to the subject capital instrument.

It should be noted that a separate eligibility application for each current capital instrument is required by the CBUAE.