Appendix

Revised Annex 16: Minimum Requirements to Ensure Loss Absorbency of Additional Tier 1 Instruments at Pre-specified Trigger and of All Non-equity Regulatory Capital Instruments at the Point of Non-viability

(Ref. Circular DBOD.No.BP.BC.102/21.06.201/2013-14 dated March 27, 2014 – Implementation of Basel III Capital Regulations in India – Capital Planning)

1. INTRODUCTION

1.1 As indicated in paragraph 4.2.4 of Basel III Capital Regulations, under Basel III non-common equity elements to be included in Tier 1 capital should absorb losses while the bank remains a going concern. Towards this end, one of the important criteria for Additional Tier 1 instruments is that these instruments should have principal loss absorption through either (i) conversion into 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.

1.2 Further, during the financial crisis, a number of distressed banks were rescued by the public sector injecting funds in the form of common equity and other forms of Tier 1 capital. While this had the effect of supporting depositors it also meant that Tier 2 capital instruments (mainly subordinated debt), and in some cases Tier 1 instruments, did not absorb losses incurred by certain large internationally-active banks that would have failed had the public sector not provided support. Therefore, the Basel III requires that the terms and conditions of all non-common Tier 1 and Tier 2 capital instruments issued by a bank must have a provision that requires such instruments, at the option of the relevant authority, to either be written off or converted into common equity upon the occurrence of the trigger event.

1.3 Therefore, in order for an instrument issued by a bank to be included in Additional (i.e. non-common) Tier 1 or in Tier 2 capital, in addition to criteria for individual types of non-equity regulatory capital instruments mentioned in **Annex 3, 4, 5 and 6,** it must also meet or exceed minimum requirements set out in the following paragraphs.

2. LOSS ABSORPTION OF ADDITIONAL TIER 1 INSTRUMENTS (AT1) AT THE PRE-SPECIFIED TRIGGER

I. Level of Pre-specified Trigger and Amount of Equity to be Created by Conversion / Write-down

2.1 As a bank's capital conservation buffer falls to 0.625% of RWA, it will be subject to 100% profit retention requirements. One of the important objectives of capital conservation buffer is to ensure that a bank always operates above minimum Common Equity Tier 1 (CET1) level. Therefore, a pre-specified trigger for loss absorption through conversion / write-down of the level of Additional Tier 1 (AT1) instruments (PNCPS and PDI) at CET1 of 6.125% of RWAs (minimum CET1 of 5.5% + 25% of capital conservation buffer of 2.5% i.e. 0.625%) has been fixed[1].

2.2 The write-down / conversion must generate CET1 under applicable Indian Accounting Standard equal to the written-down / converted amount net of tax, if any.

2.3 The aggregate amount to be written-down / converted for all such instruments on breaching the trigger level must be at least the amount needed to immediately return the bank's CET1 ratio to the trigger level or, if this is not sufficient, the full principal value of the instruments. Further, the issuer should have full discretion to determine the amount of AT1 instruments to be converted/written-down subject to the amount of conversion/write-down not exceeding the amount which would be required to bring the total Common Equity ratio to 8% of RWAs (minimum CET1 of 5.5% + capital conservation buffer of 2.5%).

2.4 The conversion / write-down of AT1 instruments are primarily intended to replenish the equity in the event it is depleted by losses. Therefore, banks should not use conversion / write-down of AT1 instruments to support expansion of balance sheet by incurring further obligations / booking assets. Accordingly, a bank whose total Common Equity ratio slips below 8% due to losses and is still above 6.125% i.e. trigger point, should seek to expand its balance sheet further only by raising fresh equity from its existing shareholders or market and the internal accruals. However, fresh exposures can be taken to the extent of amortization of the existing ones. If any expansion in exposures, such as due to draw down of sanctioned borrowing limits, is inevitable, this should be compensated within the shortest possible time by reducing other exposures[2]. The bank should maintain proper records to facilitate verification of these transactions by its internal auditors, statutory auditors and Inspecting Officers of RBI.

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[1] All AT1 instruments issued before March 31, 2019 i.e. before the full implementation of Basel III will have two pre-specified triggers. A lower pre-specified trigger at CET1 of 5.5% of RWAs will apply and remain effective before March 31, 2019, after which this trigger would be raised at CET1 of 6.125% of RWAs for all such instruments. AT1 instruments issued on or after March 31, 2019 will, however, have pre-specified trigger at CET1 of 6.125% of RWAs only.

[2] For the purpose of determination of breach of trigger, the fresh equity, if any, raised after slippage of CET1 below 8% will not be subtracted. In other words, if CET1 of the bank now is above the trigger level though it would have been below the trigger had it not raised the fresh equity which it did, the trigger will not be treated as breached.

II Types of Loss Absorption Features

2.5 Banks may issue AT1 instruments with conversion[3] / write-down[4] features. Further, banks may issue single AT1 instrument having both conversion and write-down features with the option for conversion or write-down to be exercised by the bank. However, whichever option is exercised, it should be exercised across all investors of a particular issue.

2.6 When a bank breaches the pre-specified trigger of loss absorbency of AT1 and the equity is replenished either through conversion or write-down, such replenished amount of equity will be excluded from the total equity of the bank for the purpose of determining the proportion of earnings to be paid out as dividend in terms of rules laid down for maintaining capital conservation buffer. However, once the bank has attained total Common Equity ratio of 8% without counting the replenished equity capital, that point onwards, the bank may include the replenished equity capital for all purposes[5].

2.7 The conversion / write-down may be allowed more than once in case a bank hits the pre-specified trigger level subsequent to the first conversion / write-down which was partial.

III. Treatment of AT1 Instruments in the event of Winding-Up, Amalgamation, Acquisition, Re-Constitution etc. of the Bank

2.8 If a bank goes into liquidation before the AT1 instruments have been written-down/ converted, these instruments will absorb losses in accordance with the order of seniority indicated in the offer document and as per usual legal provisions governing priority of charges.

2.9 If a bank goes into liquidation after the AT1 instruments have been written-down, the holders of these instruments will have no claim on the proceeds of liquidation.

(a) Amalgamation of a banking company: (Section 44 A of BR Act, 1949)

2.10 If a bank is amalgamated with any other bank before the AT1 instruments have been written-down/converted, these instruments will become part of the corresponding categories of regulatory capital of the new bank emerging after the merger.

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[3] Conversion means conversion to common shares
[4] Write-down means permanent write-down
[5] If the total CET1 ratio of the bank falls again below the 8%, it would include the replenished capital for the purpose of applying the capital conservation buffer framework.

2.11 If a bank is amalgamated with any other bank after the non-equity regulatory capital instruments have been written-down, these cannot be written-up by the amalgamated entity.

(b) Scheme of reconstitution or amalgamation of a banking company: (Section 45 of BR Act, 1949)

2.12 If the relevant authorities decide to reconstitute a bank or amalgamate a bank with any other bank under the Section 45 of BR Act, 1949, such a bank will be deemed as non-viable or approaching non-viability and both the pre-specified trigger and the trigger at the point of non-viability for conversion / write-down of AT1 instruments will be activated. Accordingly, the AT1 instruments will be converted / written-down before amalgamation / reconstitution in accordance with these rules.

IV. Fixation of Conversion Price, Capping of Number of Shares / Voting Rights

2.13 Banks may issue AT1 instruments with conversion features either based on price fixed at the time of issuance or based on the market price prevailing at the time of conversion[6].

2.14 There will be possibility of the debt holders receiving a large number of shares in the event the share price is very low at the time of conversion. Thus, debt holders will end up holding the number of shares and attached voting rights exceeding the legally permissible limits. Banks should therefore, always keep sufficient headroom to accommodate the additional equity due to conversion without breaching any of the statutory / regulatory ceilings especially that for maximum private shareholdings and maximum voting rights per investors / group of related investors. In order to achieve this, banks should cap the number of shares and / or voting rights in accordance with relevant laws and regulations on Ownership and Governance of banks. Banks should adequately incorporate these features in the terms and conditions of the instruments in the offer document. In exceptional circumstances, if the breach is inevitable, the bank should immediately inform the Reserve Bank of India (DBOD) about it. The investors will be required to bring the shareholdings below the statutory / regulatory ceilings within the specific time frame as determined by the Reserve Bank of India.

2.15 In the case of unlisted banks, the conversion price should be determined based on the fair value of the bank's common shares to be estimated according to a mutually

[6] Market price here does not mean the price prevailing on the date of conversion; banks can use any pricing formula such as weighted average price of shares during a particular period before conversion.

acceptable methodology which should be in conformity with the standard market practice for valuation of shares of unlisted companies.

2.16 In order to ensure the criteria that the issuing bank must maintain at all times all prior authorisation necessary to immediately issue the relevant number of shares specified in the instrument's terms and conditions should the trigger event occur, the capital clause of each bank will have to be suitably modified to take care of conversion aspects.

V. Order of Conversion / Write-down of Various Types of AT1 Instruments

2.17 The instruments should be converted / written-down in order in which they would absorb losses in a gone concern situation. Banks should indicate in the offer document clearly the order of conversion / write-down of the instrument in question vis-à-vis other capital instruments which the bank has already issued or may issue in future, based on the advice of its legal counsels.

3. Minimum Requirements to Ensure Loss Absorbency of Non-equity Regulatory Capital Instruments at the Point of Non-Viability

I. Mode of Loss Absorption and Trigger Event

3.1 The terms and conditions of all non-common equity Tier 1 and Tier 2 capital instruments issued by banks in India must have a provision that requires such instruments, at the option of the Reserve Bank of India, to either be written off or converted into common equity upon the occurrence of the trigger event, called the 'Point of Non-Viability (PONV) Trigger' stipulated below:

The PONV Trigger event is the earlier of:

a. a decision that a conversion[7] or write-off[8], without which the firm would become non-viable, is necessary, as determined by the Reserve Bank of India; and

b. the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority. Such a decision would invariably imply that the write-off or issuance of any new shares as a result of conversion or consequent upon the trigger event must occur prior to any public sector

[7] Conversion means conversion to common shares
[8] Write-off means permanent write-off

injection of capital so that the capital provided by the public sector is not diluted.

II. A Non-viable Bank

3.2 For the purpose of these guidelines, a non-viable bank will be:

A bank which, owing to its financial and other difficulties, may no longer remain a going concern on its own in the opinion of the Reserve Bank unless appropriate measures are taken to revive its operations and thus, enable it to continue as a going concern. The difficulties faced by a bank should be such that these are likely to result in financial losses and raising the Common Equity Tier 1 capital of the bank should be considered as the most appropriate way to prevent the bank from turning non-viable. Such measures would include write-off / conversion of non-equity regulatory capital into common shares in combination with or without other measures as considered appropriate by the Reserve Bank[9].

III. Restoring Viability

3.3 A bank facing financial difficulties and approaching a PONV will be deemed to achieve viability if within a reasonable time in the opinion of Reserve Bank, it will be able to come out of the present difficulties if appropriate measures are taken to revive it. The measures including augmentation of equity capital through write-off/conversion/public sector injection of funds are likely to:

a. Restore depositors'/investors' confidence;
b. Improve rating /creditworthiness of the bank and thereby improve its borrowing capacity and liquidity and reduce cost of funds; and
c. Augment the resource base to fund balance sheet growth in the case of fresh injection of funds.

IV. Other Requirements to be met by the Non-common Equity Capital Instruments so as to Absorb Losses at the PONV

3.4 A single instrument may have one or more of the following features:

a. conversion;
b. write-off

[9] In rare situations, a bank may also become non-viable due to non-financial problems, such as conduct of affairs of the bank in a manner which is detrimental to the interest of depositors, serious corporate governance issues, etc. In such situations raising capital is not considered a part of the solution and therefore, may not attract provisions of this framework.

3.5 The amount of non-equity capital to be converted / written-off will be determined by RBI.

3.6 When a bank breaches the PONV trigger and the equity is replenished either through conversion or write-off, such replenished amount of equity will be excluded from the total equity of the bank for the purpose of determining the proportion of earnings to be paid out as dividend in terms of rules laid down for maintaining capital conservation buffer. However, once the bank has attained total Common Equity ratio of 8% without counting the replenished equity capital, that point onwards, the bank may include the replenished equity capital for all purposes[10].

3.7 The provisions regarding treatment of AT1 instruments in the event of winding-up, amalgamation, acquisition, re-constitution etc. of the bank as given in paragraphs 2.8 to 2.12 will also be applicable to all non-common equity capital instruments when these events take place after conversion/write-off at the PONV.

3.8 The provisions regarding fixation of conversion price, capping of number of shares/voting rights applicable to AT1 instruments in terms of paragraphs 2.13 to 2.16 above will also be applicable for conversion at the PONV.

3.9 The provisions regarding order of conversion/write-down of AT1 instruments as given in paragraph 2.17 above will also be applicable for conversion/ write-off of non-common equity capital instruments at the PONV.

V. Criteria to Determine the PONV

3.10 The above framework will be invoked when a bank is adjudged by Reserve Bank of India to be approaching the point of non-viability, or has already reached the point of non-viability, but in the views of RBI:

a) there is a possibility that a timely intervention in form of capital support, with or without other supporting interventions, is likely to rescue the bank; and

b) if left unattended, the weaknesses would inflict financial losses on the bank and, thus, cause decline in its common equity level.

3.11 The purpose of write-off and / or conversion of non-equity regulatory capital elements will be to shore up the capital level of the bank. RBI would follow a two-stage

[10] If the total CET1 ratio of the bank falls again below the total Common Equity ratio of 8%, it would include the replenished capital for the purpose of applying the capital conservation buffer framework.

approach to determine the non-viability of a bank. The **Stage 1** assessment would consist of purely objective and quantifiable criteria to indicate that there is a *prima facie* case of a bank approaching non-viability and, therefore, a closer examination of the bank's financial situation is warranted. The **Stage 2** assessment would consist of supplementary subjective criteria which, in conjunction with the Stage 1 information, would help in determining whether the bank is about to become non-viable. These criteria would be evaluated together and not in isolation.

3.12 Once the PONV is confirmed, the next step would be to decide whether rescue of the bank would be through write-off/conversion alone or write-off/conversion in conjunction with a public sector injection of funds.

3.13 The trigger at PONV will be evaluated both at consolidated and solo level and breach at either level will trigger conversion / write-off.

3.14 As the capital adequacy is applicable both at solo and consolidated levels, the **minority interests** in respect of capital instruments issued by subsidiaries of banks including overseas subsidiaries can be included in the consolidated capital of the banking group only if these instruments have pre-specified triggers/loss absorbency at the PONV[11]. In addition, where a bank wishes the instrument issued by its subsidiary to be included in the consolidated group's capital, the terms and conditions of that instrument must specify an additional trigger event.

The additional trigger event is the earlier of:

(1) a decision that a conversion or write-off, without which the bank or the subsidiary would become non-viable, is necessary, as determined by the Reserve Bank of India; and

(2) the decision to make a public sector injection of capital, or equivalent support, without which the bank or the subsidiary would have become non-viable, as determined by the Reserve Bank of India. Such a decision would invariably imply that the write-off or issuance of any new shares as a result of conversion or consequent upon the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

[11] The cost to the parent of its investment in each subsidiary and the parent's portion of equity of each subsidiary, at the date on which investment in each subsidiary is made, is eliminated as per AS-21. So, in case of wholly-owned subsidiaries, it would not matter whether or not it has same characteristics as the bank's capital. However, in the case of less than wholly owned subsidiaries, minority interests constitute additional capital for the banking group over and above what is counted at solo level; therefore, it should be admitted only when it (and consequently the entire capital in that category) has the same characteristics as the bank's capital.

3.15 In such cases, the subsidiary should obtain its regulator's approval/no-objection for allowing the capital instrument to be converted/written-off at the additional trigger point referred to in paragraph 3.14 above.

3.16 Any common stock paid as compensation to the holders of the instrument must be common stock of either the issuing subsidiary or the parent bank (including any successor in resolution).

3.17 The conversion / write-down should be allowed more than once in case a bank hits the pre-specified trigger level subsequent to the first conversion / write-down which was partial.

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