CENTRAL BANK OF THE U.A.E.

Guidance re Tier Capital Instruments

INTRODUCTION

This guidance explains how banks should comply with the Standard re. Tier Capital Instruments. It must be read in conjunction with the Capital Regulation and Capital Standards. It also ensures that banks issue robust and simple Tier capital instruments.

A bank needs to take into consideration the below points when issuing capital publicly or privately:

1. CBUAE expects that issuers will formulate the terms and conditions so that they are not complex, but as simple and as clear as possible.
2. Prudential clauses of importance from a prudential point of view should not be written in italics. They should also not be worded in a way that makes it unclear whether they do actually apply (e.g. 'it is expected that', 'if required by the regulation', etc.). Terms and conditions must be worded clearly.
3. The wording used must be in accordance with that in the Capital Standard/ Guidance.
4. Wording should avoid making references to 'as determined by the bank' or to regulatory reporting dates. All requirements must be fulfilled at any time.
5. It is not desirable to specify the reference to say 'under applicable law' or 'if required by the applicable banking rules' when it is clear that legal requirements come directly from the Central Bank as Union law, Capital Regulation, Standards or as Guidance.
6. A detailed list may easily create the impression that the list maybe exhaustive. The bank has to clearly note when a list is not exhaustive.

Distributable Items:

The definition of distributable items may change when CBUAE introduces the solo level concept.

Subordination:

Additional Tier 1 instruments will rank below Tier 2 instruments under subordination.

Redemption Notices:

Where a notice has not been revoked as of the relevant date, it follows that a payment is due to the holder. Any non-payment thereafter may trigger an Enforcement Event. Any notice for redemption should become void and null as soon as the CBUAE declares that a PONV trigger has occurred.

Call of Instruments:

1. **Optional Call**:
   CBUAE does not prohibit the issuer to call the instrument at their option but only after a period of 5 years.

2. **Regulatory Call**:
   CBUAE does not prohibit the issuer to call the instruments in case of a Capital Event so that they become or, as appropriate, remain, qualified regulatory capital. Details of Capital Event are provided in the Standards re Tier Capital Instruments in Article 4. However, the amount in case of a Capital Event can be the outstanding amount or the amount that qualifies as regulatory capital, if some amount of the capital securities is held by the issuer or whose purchase is funded by the issuer save where such non-qualification is only as a result of any applicable limitation on the amount of such capital.
3. **Tax Call**:
   CBUAE does not prohibit the issuer to call the instruments in case of a Tax Event. A Tax Event may occur at any time on or after the issue date. A Tax Event can occur as a result of a change in the applicable tax treatment of those instruments.

Note that any the optional call and the tax call require CBUAE approval.

Changes of Terms and conditions:

1. **Insignificant Changes to Terms and Conditions (Variation):**

The issuer may vary the capital instruments subject to the condition of redemption in the Standards of Tier capital instrument under Article 6 Redemption. Variation of the instruments can occur on optional call, regulatory call, or tax call. Changes must be legally enforceable.

2. **Significant Changes to Terms and Conditions:**

Significant changes in the terms and conditions of the contract will require investors' approval. Every instrument that undergoes significant changes needs to meet all requirements of the Standard re Tier Capital Instruments.

Every instrument with changed terms and conditions need to be re-approved by the CBUAE by applying Stage 2 of the Approval Process in Appendix B of the Standard re Tier Capital Instruments (Stage 1 of the Approval Process can be omitted in this case).

Coupon Payments:

No provision should link a change in payments to contractual, statutory or other obligations, as payments are fully discretionary. Payments should also not be linked to payments on other AT1.

Dividend and Redemption Restrictions:

Dividend stopper arrangements that stop for example dividend payments on common shares are not prohibited by the CBUAE. Furthermore, dividend stopper arrangements that stop dividend payments on other Additional Tier 1 instruments are not prohibited by CBUAE. However, stoppers must not impede the full discretion that bank must have at all times to cancel distributions/payments on the Additional Tier 1 instrument, nor must they act in a way that could hinder the recapitalization of the bank. For example, it would not be permitted for a stopper on an Additional Tier 1 instrument to:

i. attempt to stop payment on another instrument where the payments on this other instrument were not also fully discretionary;
ii. prevent distributions to shareholders for a period that extends beyond the point in time that dividends/coupons on the Additional Tier 1 instrument are resumed;
iii. impede the normal operation of the bank or any restructuring activity (including acquisitions/disposals).

A Dividend Stopper may act to prohibit actions that are equivalent to the payment of dividend, such as the bank undertaking discretionary share buybacks. The Dividend Stopper will remain until one coupon following the Dividend Stopper Date has been made in full or an amount equal to the same has been duly set aside or provided for in full for the benefit of the holders of the capital securities.

Maximum Distributable Amount (MDA):
To further clarify the MDA's calculation, below is an example of the calculation:

Bank Capital Holdings	**14.0%**
Bank Capital Requirements	**%**
CET1	7.0%
AT1	1.5%
Tier 2	2.0%
Pillar 2	0.0%
Capital Conservation Buffer	2.5%
Countercyclical Buffer	0.000%
D-SIB Buffer	1.5%
Total	14.5%
Combined Buffer	4.0%
Quartile of Buffer	1.0%
Bank Capital Gap	**0.5%**

Quartile 1		Quartile 2		Quartile 3		Quartile 4	
0.0	1.0%	1.0%	2.0%	2.0%	3.0%	3.0%	4.0%

The bank first will need to fulfill all minimum requirements. As the bank only has CEt1 capital available, it needs to use CET1 capital to fulfill all minimum capital requirements (10.5%=7%+1.5%+2%). After fulfilling the minimum capital requirements, the bank has still 3.5% (=14.0%-10.5%) CET1 capital available to fulfill the combined buffer requirements of 4%. Hence, the Bank's capital gap is 0.5%.

From the table above 3.5% means that the bank is in the fourth of the buffer requirements. Therefore, the MDA is restricted to 60% of the bank's earnings, which means the bank may distribute no other restrictions and limitations considered, up to 40% of the earnings in the form of dividend, AT1 payments, and variable remuneration.

Note that items considered to be distributions include dividends and share buybacks, discretionary payments on other Tier 1 capital instruments and discretionary bonus payments to staff. Payments that do not result in a depletion of Common Equity Tier 1, which may for example include certain scrip dividends, are not considered distributions.

Note also that earnings are defined as distributable profits calculated prior to the deduction of elements subject to the restriction on distributions. Earnings are calculated after the tax, which would have been reported had none of the distributable items been paid. As such, any tax impact of making, such distributions are reversed out. Where a bank does not have positive earnings and has a Common Equity Tier 1 ratio less than 9.5%, it would be restricted from making positive net distributions.

Gross-up Clauses:

Gross-up clauses for Additional Tier 1:

Gross up clauses are acceptable only if:

i. It is activated by decision of the local tax authority of the issuer and not the investor,
ii. The increased payments do not exceed distributable items,
iii. The gross-up is in relation to the dividend and not the principal.

Gross up Clauses for Tier 2:

The second condition related to distributable items is not relevant for T2 instruments, as Tier 2 coupons are not restricted by the amount of available distributable items. Therefore, Tier 2 gross-up clauses can be considered as acceptable if they are activated by a decision of the local tax authority of the issuer, and if they relate to dividend and not on principal. The other two conditions on gross-up clauses are, however, activation is still required by a local tax authority of the issuer and not the investor, and the gross-up is in relation to the dividend payments only not principal.

Point of Non-Viability (PONV):

The issuance of any new shares as a result of the Point of Non-Viability must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

Further guidance on grandfathering:

If a T2 instrument eligible for grandfathering begins its final five-years amortisation period prior to 1st January 2018, the base for grandfathering in this case must take into account the amortised amount, not the full nominal amount. As for the rate, if a T2 instrument eligible for grandfathering begins its final amortisation period on 1st January 2018, then individual instruments will continue to be amortised at a rate of 20% per year while the grandfathering cap will be reduced at a rate of 10% per year. Note that each tranche needs to be treated as a separate tranche.

Amortisation of Tier 2 instruments:

During the last 5 years the eligibility before maturity, the eligibility of Tier 2 instruments is written down by 20% per year, i.e. the eligible amount is calculated by multiplying:

i. The nominal amount of the instruments on the first day of the final five year period of their contractual maturity divided by the number of calendar days in that period;
ii. The number of remaining calendar days until the contractual maturity of the instruments.

Documents required to be submitted for the application to issue new Tier Capital Instruments

1. **The CN-01 form** should be completed, filled and signed by the bank Chief Executive Officer (CEO), Chief Financial Officer (CFO), Internal Audit, Compliance and Risk.

2. **Full contract/ prospectus,** alongside risk factors need to be available.
   i. Instruments of Islamic banks issued through an SPV must also provide the contract between the bank and the SPV

3. **Annual General Meeting (AGM) Approval**
   i. Tier capital instruments require an AGM approval.
   ii. The approval shall relate to an issuance of the specific planned Tier capital instrument (Additional Tier 1 or subordinated Tier 2). Moreover, the approval should clearly mention that the instrument is subordinated; coupon payments may not be paid under certain circumstances, and contains a Point Of Non-Viability (PONV) clause.

4. **Capital planning, forecast and Stress testing:**

The Business As Usual (BAU) case should be formulated, such as:

a) Amount of assumed Tier issuance and the expected issuance date (e.g. Q1 2018).
b) Capital structure: % in CET1, AT1, T2 and deductions (using Basel 3 capital components)
c) Five (5) year forecast of the Balance sheet, Profit & loss P&L, Risk Weighted Assets RWA.
d) Amortization of Tier Capital Issuances: Subordinated Tier 2 in the last 5 years prior to maturity and Additional Tier 1 Instruments, if they fall under a grandfathering rule, for example, 10% per year.
e) Key assumptions and analysis (e.g. on balance growth, asset structure, conversation factors CCF for off balance, operational and market risk, total assets growth, of which businesses that will be the main driver for such growth) and CRWA (i.e. on balance sheet exposure in different industry) in numerical as well as qualitative aspect.

The Stress Testing should be submitted in form of a presentation including the underlying data in Excel sheet.

5. **Stress Testing Scenarios:**

Two Scenarios should be provided as part of the presentation:

a) Top 2 customers defaulting (point in time analysis permitted: End of Year): Definition of top 2 customers; name of top 2 customers; exposure (including on and off balance exposures); what type of eligible collateral and value of collateral, with two sub-scenarios:

i. With average provisioning level of similar assets, and
ii. 75% provisioning level

b) CBUAE Macro-Economic Stress Test

- Assumptions and results of the latest Macroeconomic stress tests performed by CBUAE.

6. **Non-Funding Notice:** Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.

Private Placements

- Offer letter is required for private placements, including risk factors and the banks financial and risk situation.
- **Market Conformity Analysis**: The bank has to provide evidence on why the pricing of the Tier Capital Issuance is conform to the market rate.