Banking Regulation and Policy Department
Bangladesh Bank
Head Office
Dhaka.

BRPD Circular No. 13

Date: October 14, 2009 / Ashwin 29, 1416

Chief Executives
All Scheduled Banks in Bangladesh

Dear Sir,

<u>Guidelines on Subordinated Debt for inclusion in Regulatory Capital</u>

Please refer to BRPD Circular No. 10 dated November 25, 2002 regarding 'Capital Adequacy of Banks' and BRPD Circular No. 09 dated December 31, 2008 regarding Guidelines on 'Risk Based Capital Adequacy for Banks' (Revised regulatory capital framework in line with Basel II). In partial modification of the aforesaid circulars, it is advised that henceforth 'Subordinated Debt' will replace 'Perpetual Subordinated Debt' as a component of Regulatory Capital (Tier 2 or Tier 3).

To ensure transparency and uniformity in raising subordinated debt as well as for inclusion in Regulatory Capital, Banks are advised to follow the guidelines enclosed herewith.

Please acknowledge receipt.

Yours sincerely,

(Abu Hena Mohd. Razee Hassan)
General Manager
Phone: 7117825

Encl: As above.

Guidelines on Subordinated Debt

1. Introduction

The scheduled banks should have capital plan approved by their Board of Directors. To attain the capital plan, the banks may issue subordinated debt to qualify as regulatory capital (Tier 2 or Tier 3). However, prior approval of Bangladesh Bank (BB) is needed to issue and repay subordinated debt.

2. Criteria to Qualify as Regulatory Capital

a) Subordinated debt eligible to be considered as Tier 2 capital must -
   - have maturity of more than five years ;
   - state on the instrument that it is not a deposit and is not insured by the Deposit Insurance Scheme;
   - may be convertible into equity subject to approval of BB and Securities and Exchange Commission (SEC) where necessary;
   - be subordinated to the claims of depositors and other creditors;
   - be unsecured;
   - the instrument should be rated and it would be BB rating grade at least 2 (two) ;
   - be ineligible as collateral for a loan made by the issuing bank;
   - provide that once any scheduled payments of principal begin, all payments shall be made at least annually and the amount repaid each year shall be no less than in the prior year;
   - subordinated debt shall be limited to a maximum of 30% of the amount of Tier 1 capital.

b) The total of Tier 2 (supplementary capital) elements will be limited to a maximum of 100% of the total of Tier 1 elements;

c) The amount of subordinated debt eligible for inclusion as Tier 2 capital will be reduced by 20 percent from the original amount of the instrument (net of any redemption) at the beginning of each of the last five years of the instrument’s life. In other words, during the last five years to maturity, a discount (or amortization) factor of 20 % per year must be applied to reflect the diminishing value of this instrument as a continuing source of strength. Thus, subordinated debt with less than one year to maturity will not be included in Tier 2 capital.

d) In addition to Tier 2 capital, certain subordinated debt may qualify as Tier 3 capital. Tier 3 capital will be limited to 250% of a bank's Tier 1 capital that is available after meeting credit risk capital requirement to support market risk. This means that a minimum of about 28.5% of market risk to be supported by Tier-1 capital.

To be considered as Tier 3 capital, subordinated debt must:

- be unsecured and fully paid up;
- have an original maturity of at least two years;
- include a provision that the subordinated debt is not redeemable before maturity without prior BB approval.
- include a lock-in clause precludes payment of either interest or principal (even at maturity), if the payment would cause the issuing bank's risk-based capital ratio to fall or remain below the minimum as required under Risk Based Capital Adequacy for bank (RBCA).
- neither contains nor is covered by any covenant, terms, or restrictions that are inconsistent with safe and sound banking practices.

3. Application Process

The application for issuing subordinated debt shall include:

- A copy of the subordinated note format and agreement;
- The amount and date on which the reduction will be occurred;
- A statement that the change in the bank's capital structure complies with applicable laws and regulations;
- Statement on trustee or warranty and
- Application should be enclosed with the SEC clearance certificate to issue the instrument.

4. Reciprocal Holdings

In case of reciprocal holding/issue of subordinated debt by banks the amount of such holding/issuance will not be eligible for capital treatment.

5. Restriction on Holdings:

Sponsor shareholders of the issuing bank shall not be allowed to participate in or hold the subordinated debt instruments of the issuing bank directly or through their affiliates. The same restriction will also apply to the employees' retirement benefit funds of the issuing bank.

6. Mandatory Provisions of the Instrument:

The following language, which has been drafted to comply with the requirements of applicable rules, regulations, and policies, must appear in every note, debenture, or note agreement.

A. On the face of the note: "THIS OBLIGATION IS NOT A DEPOSIT AND IS NOT INSURED BY ANY DEPOSIT INSURANCE SCHEME."

B. On the face of the note: "THIS OBLIGATION IS SUBORDINATED TO CLAIMS OF DEPOSITORS AND OTHER CREDITORS, IS UNSECURED, AND IS INELIGIBLE AS COLLATERAL FOR A LOAN BY THE (NAME OF ISSUING BANK)."

(Note: This clause may be combined with the required language set forth in (A), above.)

C. A general subordination clause must be added that specifies the subordination of the note. The clause must be in substantially the following form:

"The indebtedness of the bank evidenced by this note, including the principal and premium, if any, and interest shall be subordinate and junior in right of payment to its obligations to its depositors, its obligations under bankers' acceptances and letters of credit, and its obligations to its other creditors, including its obligations to the Bangladesh Bank, Deposit Insurance Trust Fund (DITF). In the event of any insolvency, receivership, conservatorship, reorganization, readjustment of debt or similar proceedings or any liquidation or winding up of or relating to the bank, whether voluntary or involuntary, all such obligations shall be entitled to be paid in full before any payment shall be made on account of the principal of, or premium, if any, or interest, on the note. In the event of any such proceedings, after payment in full of all sums owing on such prior obligations, the holder, of the note, together with any obligations of the bank ranking on a parity with the note, shall be entitled to be paid from the remaining assets of the bank the unpaid principal thereof and any unpaid premium, if any, and interest before any payment or other distribution, whether in cash, property, or otherwise, shall be made on account of any capital stock or any obligations of the bank ranking junior to the notes. Nothing herein shall impair the obligation of the bank, which is absolute and unconditional, to pay the principal of and any premium and interest on the note according to its terms."

7. Provision of Protection and Covenants:

Subordinate debt will be supported by agreement of trust or warranties stating that the bank is a duly organized banking company, that there has been no material adverse change in its condition since the date of the agreement and is not in default on any agreement or in violation of its charter or by laws. The agreement will assure repayment of the benefit of the instrument holders. By their nature, subordinated debt must be subordinate to all but equity holders.

8. Reserve Requirements:

The total amount of subordinated debt is to be reckoned as liability for the calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will attract CRR/SLR requirements.

9. Disclosure

The total amount of subordinated debt shall be disclosed in the balance sheet under the head 'subordinated debt' in the nature of long term borrowings.

10. Head Office borrowings in foreign currency by Foreign Banks operating in Bangladesh

Foreign banks operating in Bangladesh may raise subordinated debt with prior approval of BB in the form of (i) subordinated debt in foreign currency and (ii) subordinated debt in the form of foreign currency borrowings from Head office for inclusion in Tier-2 capital.

a) Amount of borrowing: The total amount of HO borrowing in foreign currency will be at the discretion of the foreign bank. However, the amount eligible for inclusion in Tier-2 capital as subordinated debt will be subject to a maximum ceiling as stated above.

b) Maturity period: Head Office borrowings should have a minimum initial maturity of 5(five) years. If the borrowing is in tranches, each tranche will have to be retained in Bangladesh for a minimum period of five years.

c) Features: The HO borrowings should be fully paid up, i.e. the entire borrowing or each tranche of the borrowing should be available in full to the branch in Bangladesh. It should be unsecured, subordinated to the claims of other creditors of the foreign bank in Bangladesh, free of restrictive clauses and should not redeemable at the instance of the HO.

d) Rate of interest: The rate of interest on HO borrowings should not exceed the on-going market rate. Interest should be paid at yearly rests.

e) Withholding tax: The interest payments to the HO will be subject to applicable withholding tax.

f) Repayment: All repayments of the principal amount will be subject to prior approval of BB

g) Documentation: The bank should obtain a letter from its HO agreeing to give the loan for supplementing the capital base for the Bangladesh operations of the foreign bank. The loan documentation should confirm that the loan given by Head Office would be subordinated to the claims of all other creditors of the foreign bank in Bangladesh. The loan agreement will be governed by, and construed in accordance with the Bangladesh law. Prior approval of the BB should be obtained in case of any material changes in the original terms of issue.

11. Other Eligibility Criteria:

a) A bank would be eligible to issue subordinated debt which has composite CAMELS rating at least 2 (two) and BB Rating Grade at least 2 (two) as mentioned in the guidelines on RBCA.