

# OFFICIAL INFORMATION OF THE CZECH NATIONAL BANK

of 29 December 2010

regarding the prudential rules for banks, credit unions and investment firms

## **Instruments included in Hybrid Tier 1 capital**

The Czech National Bank hereby provides the following information with regard to Articles 55b, 63 (6), 65b and 73 (6) of Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms, as amended (hereinafter the “Decree”):

### **I. Scope of Application**

1. This Official Information applies to situations where banks, credit unions or investment firms pursuant to Article 8a (1), (2) or (3) of the Act on Capital Market Undertakings (hereinafter the “liable entity”) notify the Czech National Bank of their intention:
  - a) to include an instrument pursuant to Article 55b or 65b of the Decree (hereinafter the “instrument”) in Hybrid Tier 1 capital on an individual or consolidated basis; or
  - b) to redeem an instrument.

### **II. Intention to Include an Instrument in Capital**

2. When discussing the intention of the liable entity to include an instrument in Hybrid Tier 1 capital, the Czech National Bank shall assess the instrument in terms of:
  - a) permanence;
  - b) terms and conditions governing the payment of appurtenances (yield), share in profit or of equivalent deliveries;
  - c) ability to absorb losses;
  - d) compliance with quantity limits; and
  - e) issuance of the instrument via a special purpose vehicle (“SPV”).
3. The Czech National Bank applies the aspects referred to in paragraph 2 above in a manner appropriate to the nature of the instrument.

### **Permanence**

4. The primary purpose of Tier 1 capital is to enable the liable entity to continue as a going concern in case of incurring a financial loss. The precondition for the accomplishment of this purpose is the permanence of the quality of Tier 1 capital over time. Another important fact is that its composition and amount are both known on an ongoing basis and easily foreseeable with respect to the future.
5. The Czech National Bank expects to receive detailed information on every instrument.
6. In particular, the information pursuant to paragraph 5 above shall include information on:
  - a) the liable entity, enabling its identification;
  - b) the legal status of the instrument and the governing law;
  - c) the persons who provided deliveries, facilitating their proper identification;

- d) the amount of the delivery received, which the liable entity intends to include in the capital;
  - e) the intended extent of including the instrument in Tier 1 capital;
  - f) the interest rate;
  - g) the maturity of the instrument;
  - h) the fact whether the instrument will or can be converted into an equity security of the liable entity, if certain pre-defined circumstances occur;
  - i) the right of the liable entity to redeem the instrument prior to the stipulated maturity<sup>1</sup> (call option);
  - j) the circumstances the occurrence of which facilitates a redemption of the instrument<sup>2</sup>; and
  - k) the tax and accounting context.
7. An instrument can be included solely up to the amount of the actually received delivery. This means that the delivery shall be available for the stipulated purpose at any time and without restraint.
  8. Every act of the liable entity that is not in accordance with the principles pursuant to paragraph 4 above may result in a breach of the prudential rules laid down in applicable laws, unless the liable entity intends to assert its right to redeem an instrument prior to the stipulated maturity or unless an event has occurred that enables the liable entity to redeem an instrument (hereinafter the “incentive to redeem”).
  9. Any circumstance that duly justifies an expectation that the instrument will be redeemed upon its occurrence may be regarded as an incentive to redeem. In particular, incentives to redeem include an interest-rate step-up or the capitalization of a liability (principal stock settlement) in conjunction with exercising a call option. However, the acquisition of a participation in the liable entity by means of a mandatory convertible security shall not be regarded as an incentive to redeem.
  10. In respect of a particular instrument, the interest-rate step-up may be carried out only once and must not exceed:
    - a) 1 % (100 basis points) less the swap spread between the initial index basis and the stepped-up index basis; or
    - b) 50 % of the initial credit spread less the swap spread between the initial index basis and the stepped-up index basis.
  11. The swap spread shall be fixed at the relevant day and reflect the difference in the value of the underlying instrument before and after the interest-rate step-up.
  12. In the case of principal stock settlement, an appropriate conversion ratio must be defined for the acquisition of a participation in the liable entity, providing that the conversion ratio as at the day of acquisition of the participation must not exceed 1.5 times the conversion ratio as at the day of issuance of the instrument.

**Payment of appurtenances, share in profit or equivalent deliveries (flexibility of payments)**

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<sup>1</sup> Article 55b (3) or Article 65b (3) of the Decree.

<sup>2</sup> Article 55b (4) or Article 65b (4) of the Decree.

13. The terms and conditions governing the payment of interest, default interest, share in profit or of equivalent deliveries and other incomes (hereinafter “yield”) shall be set up in a manner to support the ongoing maintenance of capital adequacy (including the internally assessed capital<sup>3</sup>) and solvency of the liable entity and compliance with the liquidity rules.
14. The yield may be paid out solely from distributable items and the payment must not result in a deterioration of the financial situation of the liable entity. It must be assessed on an ongoing basis whether the payment of yield might not result in a breach of the prudential rules.
15. Any non-payment of the yield must not be regarded as an event of default.
16. An instrument may also contain a feature that supports the maintenance of the legal status (ranking) of the beneficiary of the instrument (hereinafter the “instrument holder”) with respect to a shareholder, partner or any other person, or that supports the maintenance of stipulated levels of subordination<sup>4</sup> among instrument holders, namely by means of interrelatedness of the payment of the yield with the payment of a share in profit (dividend pusher/stopper). If the instrument contains such a feature, the liable entity has an unlimited right to decide at any time that this feature shall not be applied.
17. If an instrument provides the liable entity with a right to substitute the payment of yield by acquisition of its equity securities (alternative coupon satisfaction mechanism), the assertion of such a right must not result in a deterioration of its financial situation. This fact might occur primarily in a situation where the liable entity acquires its own equity securities against a payment in order to subsequently transfer them to the instrument holder.
18. The fair value of equity securities acquired by the instrument holder must not exceed the amount of the yield being substituted by these equity securities.
19. If the instrument holder subsequently conveys, against payment, the equity securities and if the conveyance proceeds are less than the amount of the yield substituted by these equity securities, it must not be compensated by the liable entity. Furthermore, there must be no compensation in case the instrument holder does not acquire the relevant equity securities unless the liable entity has breached its obligation.

#### **Ability to absorb losses**

20. Timely and sufficient loss absorption enables the liable entity to continue as a going concern and contributes to the protection, certainty and maintenance of confidence on the part of creditors holding senior (unsubordinated) claims.
21. Loss absorption may be carried out through the application of:
  - a) a condition of subordination, while different levels of subordination may be defined among instrument holders;
  - b) a right not to pay the yield to the instrument holder;
  - c) conversion of the instrument into an equity security;

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<sup>3</sup> Article 12c of the Act on Banks.

<sup>4</sup> Article 34 of the Act on Bonds.

- d) write-down of the debt with respect to the instrument holder; and
- e) the fact that the obligation arising from the instrument shall be disregarded for the purposes of bankruptcy identification.

22. The write-down of a debt may be permanent or temporary.
23. It is appropriate to combine the measures pursuant to paragraph 21 above, while the terms and conditions governing their application must be set up so as to enable maintenance or timely rectification of deteriorated capital adequacy and solvency.
24. Measures consisting in the conversion of an instrument into an equity security or in a debt write-down shall be applied primarily in situations where the losses incurred result in insufficient capital adequacy.
25. If a measure consisting in the conversion of an instrument into an equity security is applied, the conversion ratio shall be derived from the market value of the relevant equity security on the day of its issuance.
26. The measures pursuant to paragraph 21 above must be applied to such an extent that also supports easy replenishment of capital at least to the required level.
27. The contractual or issuing terms and conditions of an instrument shall unambiguously and comprehensively define which measures pursuant to paragraph 21 above may be applied, at what time and to what extent.

#### **Compliance with quantity limits**

28. Depending on its nature, every instrument shall be categorized and reported within the relevant group pursuant to Article 63 (6) or Article 73 (6) of the Decree.
29. An instrument containing an incentive to redeem must be reported within the same group for the entire period of its inclusion in capital.

#### **Instruments issued through an SPV**

30. An instrument may be issued by an entity established especially for this purpose (special purpose vehicle, hereinafter the “SPV”). However, this fact must not restrict immediate and unlimited availability of thus acquired capital to the liable entity.
31. The Czech National Bank considers it prudent for an instrument issued through an SPV to contain an option of being converted into an equity security or an option to temporarily or permanently write down the debt with respect to the instrument holder.

#### **II. Intention to Redeem the Instrument**

32. When discussing the intention of the liable entity to redeem an instrument, the Czech National Bank shall assess the intention primarily in terms of the immediate and future impacts on the liable entity’s:
  - a) capital adequacy;
  - b) solvency;
  - c) liquidity risk management; and

- d) profitability.
33. The procedure consisting in notification, justification and discussion of the intention to redeem an instrument shall also be applied in situations where an instrument with stipulated maturity has become mature.
34. The Czech National Bank expects that the notification of the liable entity's intention to redeem an instrument shall include, in particular:
- a) proper justification of this intention;
  - b) information on the impacts pursuant to paragraph 32 above, including their estimated development over at least the following 3 to 5 years, providing that the information on the estimated development shall be based on the business plan and supported by real economic calculations;
  - c) information on the impacts on the amount of the internally assessed capital; and
  - d) the result of an evaluation of all the risks which the liable entity shall or may be exposed to in relation to the intention to redeem the instrument; the evaluation shall also include the result of stress testing of the main risks for different developments, focusing on the amount of potential losses.

### **Buy-back of an instrument**

35. The Czech National Bank regards the intention of the liable entity to acquire its own instrument as an analogy to the assertion of the right to redeem an instrument, unless the purpose of the acquisition of its own instrument is the replacement of such instrument by some other instrument the inclusion of which in the capital shall bring about demonstrable improvement of the liable entity's capital adequacy or financial situation. In this case, the liable entity may acquire its own instrument earlier than 5 years after its issuance.
36. The replacement of an instrument shall be assessed in a manner equivalent to the assessment of the intention to include a new instrument in capital.

### **III. Final Provisions**

37. If the liable entity determines capital on a consolidated basis, this Official Information shall be appropriately applied also to the person from the regulated consolidated group which is formed by the liable entity.
38. At the same time, the Czech National Bank hereby draws the liable entity's attention to the draft amendments to the prudential rules for credit institutions and investment firms (so-called "Basel III"), which can also have significant and fundamental impacts on the terms and conditions under which instruments may be included in capital pursuant to the rules applicable as at the effective date of this Official Information.
39. Within the meaning of Article 9 of the Decree, the *Implementation Guidelines for Hybrid Capital Instruments* issued by the Committee of European Banking Supervisors (CEBS) in December 2009 ([www.c-eps.org](http://www.c-eps.org)) are considered by the Czech National Bank to rank among the acknowledged standards for the purposes of the determination of capital on an individual or consolidated basis.
40. This Official Information shall be followed from 31 December 2010.

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