



**Financial Services
Commission**

Administrative Notice No. 2a Subordinated Loan Capital

Date of Paper : 1 July 1994

Version Number : V1.00

File Location : document4



Table of Contents

Notice To Institutions Licensed Under The Banking Ordinance 1992 3

General Conditions..... 3

Subordination..... 3

Trigger clauses 4

Repayment..... 4

Gibraltar Law 5

Hybrid capital instruments 5

Term subordinated loan capital 5

Inclusion Of Subordinated Debt In An Institution's Capital Base 6

Amortisation..... 6

Procedures and requirements for raising loan capital 6

Prior submission of documentation 7

Published by:

Financial Services Commission
PO Box 940, Suite 943, Europort, Gibraltar
Tel (+350) 40283
Fax (+350) 40282
E-Mail: info@fsc.gi
www.fsc.gi



Notice To Institutions Licensed Under The Banking Ordinance 1992

- 1 This Notice sets out the Commissioner's policy in respect of subordinated loan capital issued¹ by Gibraltar-incorporated licensed institutions. The terms of the Notice will apply to loan capital issued after the date of its publication, and have immediate effect.
- 2 The Commissioner's earlier Administrative Notice Number 2 remains in force for loan capital issued before the date of this notice, and is not therefore being withdrawn.
- 3 The Administrative Notice Number 2, "Implementation in Gibraltar of the Directive on Own Funds of Credit Institutions" issued in September 1992, identifies two types of subordinated debt which are eligible for inclusion in capital base. These are:
 - (i) **Hybrid Capital Instruments**
 - Qualifying perpetual subordinated debt, including such debt which is convertible into equity.
 - (ii) **Term subordinated debt**
 - Perpetual subordinated debt which does not qualify as a hybrid capital instrument;
 - Subordinated term debt with a minimum original term to maturity of over five years.

This Notice sets out the general conditions that all subordinated debt must meet in order to qualify as capital. These conditions apply to subordinated debt issued by Gibraltar institutions directly, and issued by their domestic and overseas subsidiaries for inclusion in the institution's consolidated capital base. The Notice further identifies the special conditions that must be satisfied in order for the debt to qualify as either a hybrid capital instrument or as term subordinated debt eligible for inclusion in the capital base. Any references in Administrative Notice Number 2 should now also be understood to be references to this Notice for issues made after 1st July 1994.

General Conditions

Subordination

- 4 The terms of any agreement governing the raising of subordinated loan capital ("the debt agreement") must ensure that the claims of the lender are fully subordinated to those of all unsubordinated creditors.
- 5 The Commissioner is more concerned that subordination provisions should be effective than that they should follow a particular form. Subordination provisions should therefore ensure that:
 - (a) in a liquidation of, or other insolvency proceeding relating to, the institution the subordinated creditor(s) would not be entitled to receive and retain from the institution any amounts in respect of the subordinated debt until all unsubordinated creditors of the institution

¹ There is a range of terminology that can be used depending on the form of loan capital (eg loan, bond or note or private issue). This notice refers to loan capital or subordinated debt, borrower (rather than issuer), lenders or subordinated creditors (rather, than noteholders). However, the notice applies to all loan capital irrespective of its description.



have been paid the amounts owing to them in full or these amounts have been fully provided for. The Commissioner would regard any set-off of amounts outstanding between the subordinated creditor(s) and the institution as a payment for these purposes. As a term of the debt agreement, the subordinated creditor should, to the fullest extent possible, waive any rights to set off amounts owed to the institution against amounts owing by the institution under the debt agreement, or to institute proceedings in respect of such amounts.

- (b) the remedies available to the subordinated creditor in the event of default in respect of the subordinated debt should normally be limited to:
 - (i) petitioning for the winding up of the institution (and the borrower where this is not the same, i.e in circumstances where the borrower is a subsidiary of the institution or some other related company but the institution is acting as guarantor of the debt)², and
 - (ii) proving for the debt and claiming in the liquidation of the institution (and the borrower where this is not the same);
- (c) the only events of default³ should be:
 - (i) non-payment of any amount due and payable under the debt agreement (or guarantee); and
 - (ii) the winding-up of the institution (or borrower where this is not the same);
- (d) the Commissioner recognises that in some jurisdictions it may be legally impossible to limit the remedies available to lenders in the way described in sub paragraph (b) above⁴; in such jurisdictions, the lender may have a right to sue for unpaid principal which is due and payable under the debt agreement provided the institution has an option to defer repayment for at least six months after the contractual repayment date.

Trigger clauses

- 6 The debt agreement must not include any clauses which might trigger early repayment of the debt. This will not, however, prejudice any right to petition for the winding-up of the borrower; for example, in the event of non-payment of interest on the debt (other than that which is deferred in accordance with paragraph 9 below).

Repayment

- 7 No early repayment of the debt, including purchases of capital notes by the institution or its subsidiaries for cancellation, may be made without the prior written consent of the Commissioner. Consent will depend on the Commissioner being satisfied that the institution's capital is adequate and is likely to remain so.

² This requirement may be relaxed where the issuing company is a single purpose vehicle which meets the criteria for solo-consolidation.

³ The occurrence of an event of default does not imply acceleration of the debt. See also paragraph 7.

⁴ For example, where issues are regulated by the US Trust Indenture Act.

Gibraltar Law

- 8 The debt agreement must normally be subject to Gibraltar Law. However, the Commissioner will accept law other than Gibraltar law throughout, or in parts of, a debt agreement provided he is satisfied that an equivalent degree of subordination can be achieved as under Gibraltar law, meeting the requirements set out in paragraphs 4-5 above. In all cases the Commissioner must give his prior consent where law other than Gibraltar law is to apply.

Hybrid capital instruments

- 9 Perpetual subordinated debt can be structured so as to bring it close to equity in terms of the protection that it offers depositors. The principal features which give it this quality are that it can absorb losses and leave an institution able to continue to trade, that it has no fixed servicing costs (i.e. that there are circumstances in which the borrower can defer a payment of interest without bringing itself into default) and that the proceeds of the loan are made permanently available to the borrower. In order to qualify as a hybrid capital instrument, a perpetual subordinated loan must satisfy the following conditions, in addition to those set out above in paragraph 4-5:
- (a) it is undated;
 - (b) no repayment may be made without the prior consent of the Commissioner. The Commissioner would not normally expect to give such consent within five years and one day from the date of draw-down, and only when the Commissioner is satisfied that the institution's capital is likely to remain adequate after repayment;
 - (c) the debt agreement must provide for the institution to have the option to defer an interest payment on the debt (e.g. if it has not paid or declared a dividend in a preceding period);
 - (d) the debt agreement must provide for the debt and unpaid interest to be able to absorb losses, whilst leaving an institution able to continue trading. This can be achieved by providing for automatic conversion of the perpetual debt, and unpaid interest, into share capital should reserves become negative and where a capital reconstruction has not been undertaken. In such a case, the institution will be required to maintain a sufficient margin of authorised but unissued share capital in order to allow a conversion of the debt into equity to be made at any time. Alternatively, instead of providing automatic conversion, the debt agreement can expressly provide for the principal and interest on the debt to absorb losses where the institution would not otherwise be solvent, and for the subordinated creditors to be treated as if they were holders of a specified class of share capital in any liquidation of the institution. In this case, the debt agreement will provide for the debt to be treated as if it had been converted into share capital either on the day immediately preceding the presentation of a petition for the commencement of a winding-up of the institution or on the date of the creditors' or shareholders' meeting at which the relevant resolution for a winding-up was passed. The debt agreement must contain an explicit warning to lenders that the debt can be treated in this way.

Term subordinated loan capital

- 10 In order to qualify to be treated as capital, term subordinated debt must meet the conditions set out in paragraphs 4-8. In addition, the debt must have a minimum original maturity of five years and one day from draw-down. Where the debt agreement provides for the loan to be drawn down in a series of tranches, the minimum original maturity of each tranche must be five years and one day from the date of its draw-down.



- 11 Where a debt agreement provides for the lender to have the right to demand repayment, the Commissioner will regard the first possible repayment date as the maturity date of the loan. Consequently this repayment date must be more than five years and one day from the date of draw-down if the loan is to be eligible for inclusion in the institution's capital base.

Inclusion Of Subordinated Debt In An Institution's Capital Base

- 12 The details of the limits on the amount of subordinated debt that can be included in an institution's capital base are set out in the Commissioner's Administrative Notice 2. Any subordinated loan capital which does not qualify for inclusion will be treated in the normal way as part of an institution's long term funding.

Amortisation

- 13 The amount of term subordinated loan capital included in the capital base will be subject to a straight line amortisation during its last five years to repayment. In the case of loans which are repayable in separate tranches (e.g in five tranches in line with the amortisation schedule), the Commissioner will amortise each tranche individually, as if it were a separate loan. However, where the institution only has the option (as opposed to the obligation) to repay in separate tranches, the Commissioner will not amortise the tranches individually provided his limits on 'step ups' (see paragraph 14 below) are not exceeded.
- 14 Where a bank has an option to repay early (as described in paragraph 7 above), the Commissioner will not normally assume early repayment for amortisation purposes. However, where the decision not to exercise the option leads to an unacceptably large increase in the interest rate paid on the loan (a 'step up'), the loan will be amortised over the five years preceding the exercise date of the option. Institutions should discuss proposed 'step ups' with the Commissioner to establish whether they are acceptable in this context. Loans should not contain 'step ups' within five years and one day from the date of draw-down.

Procedures and requirements for raising loan capital

- 15 In view of the complex nature of subordination provisions, the Commissioner will in future require borrowing institutions to confirm to him in writing that they have obtained legal advice that the subordination provisions in the debt agreement will be effective and specifically that they address the issues raised in paragraph 4-5 above. This advice should be obtained from independent legal advisers with sufficient expertise and experience in this area of the law. In the case of loans which are subject to law other than English law, the opinion must be obtained from lawyers with sufficient expertise and experience in this area of the law in the country whose law has been selected as governing law.
- 16 No early repayment of any subordinated loan capital may be made without the Commissioner's prior consent. Consent will only be given where the Commissioner is satisfied that the institution's capital will be adequate after repayment. A letter to the Commissioner, giving effect to this condition and undertaking to seek the Commissioner's prior consent to any material variation in the terms and conditions of a loan, will be required from the institution concerned. The Commissioner considers it essential that lenders should be made fully aware of the restriction on early repayment. Notice of the restriction should be given either in the loan agreement or in the offer documents or through other information sources commonly used in the markets.



Prior submission of documentation

- 17 In view of the change to existing arrangements set out in paragraph 15 above, the Commissioner will no longer require to be given the opportunity to consider and agree the legal aspects of loan documentation in advance; he will instead require to be sent a confirmation in the form referred to in paragraph 15 and copies of the executed loan documentation. However, in order to avoid any misunderstanding of the Commissioner's policy requirements, institutions may approach the Commissioner with drafts of the documentation prior to the completion of a transaction. In addition, where an issue involves novel commercial aspects (e.g relating to interest rate structures etc), institutions are strongly advised to consult the Commissioner in good time in order to discuss any policy implications.