

Tier 2 Capital Subordinated Financing for Banks in Emerging Asia: Lessons Learned Across Vietnam, Mongolia, and Sri Lanka

Introduction

It is a truth universally acknowledged that banks in Asian emerging markets are in need of capital.

On one level, this statement is a testament to the dynamic growth of Asian economies and the role of capital in fuelling consumer-driven businesses, infrastructure projects, and educational institutions – amongst others. On the other hand, it points to the lack of predictable capital market funding in these emerging economies. The regulatory dimension to this statement, however, cannot be ignored, as capital market funding is predicated on a sound regulatory structure. Regulators in Asia are forging ahead to drive banks into compliance with the ever evolving Basel Accords which seek to harmonize global banking standards with respect to credit, market, and operational risk.

Against this regulatory backdrop, banks are looking to raise additional capital as efficiently - and creatively - as possible. Bancassurance distribution agreements, under which insurers leverage a bank's customer network to distribute insurance products, have become key products in emerging markets. These structures enable banks to earn revenue from sources other than lending and may enable them to ultimately book this revenue as retained earnings so as to boost capital.

Many emerging economies in Asia have insufficient liquidity in the local market to meet the insatiable capital demands of larger banks, requiring the banks to turn to international investors to raise capital. This presents its own challenges given that certain jurisdictions - such as Vietnam - impose foreign ownership limits on equity in banks (30 percent aggregate cap on foreign ownership in Vietnamese banks with single investor ownership caps of 20 percent for strategic investors and 15 percent for other institutional investors). Emerging Asian markets often

feature bureaucratic regulatory procedures for foreign investors to become significant shareholders in a bank. Moreover, in the Vietnamese context, stronger banks are being instructed by regulators to absorb weaker banks through merger, further straining their capital base.

This article will review subordinated long-term debt constituting Tier 2 Capital in three Asian markets that are culturally and geographically distinct from one another: 1) Vietnam, 2) Mongolia, and 3) Sri Lanka and explore the practical negotiation and deal hurdles on transactions in those markets.

The Basics: The Basel Accords

The Basel Accords constitute a series of three banking regulations agreed in 1998 (Basel I), 2004 (Basel II) and 2013 (Basel III) set by the Basel Committee on Bank Supervision (BCBS), which provides recommendations on banking regulations in regards to capital risk, market risk and operational risk. A brief overview of the BCBS approach to credit risk is important to understanding the importance of Tier 2 Capital subordinated debt financing and the different approaches taken across jurisdictions.

The Basel II Accords were introduced to stem the perception of poor risk management practices in international banking, and to ensure the liquidity of credit institutions by defining minimum levels of capital.

Basel I introduced the concept that banks were required to hold capital (classified as Tier 1, Tier 2 and Tier 3 to clarify the strength or reliability of such capital held) equal to 8 percent of their risk-weighted assets. Basel II makes it mandatory for credit institutions to use standardized measurements for credit, market risk, and operational risk and provides for three tiers of capital:

TIER 1 CAPITAL	TIER 2 CAPITAL	TIER 3 CAPITAL
Tier 1 Capital (also known as ‘core capital’) absorbs losses as a going-concern. Examples include common equity, disclosed reserves and certain types of preferred shares.	Tier 2 Capital (also known as supplementary capital) absorbs losses as a gone concern. Examples include: <ul style="list-style-type: none"> • Undisclosed reserves • Revaluation reserves • General provisions or general loan-loss reserves • Hybrid debt capital instruments • Subordinated term debt (with a minimum maturity of five years) 	Tier 3 Capital to cover market risks may be used only at the discretion of the national authorities, and includes only short-term subordinated debt that satisfies the specified conditions.

Basel II introduced a minimum capital adequacy ratio (CAR) which measures the amount of capital that a bank must hold commensurate to the risk of its

investments. CAR forms the basis for the capital requirements promoted in Basel II and is calculated as:

$$\text{Capital Adequacy Ratio} \leq \frac{\text{Tier 1} + \text{Tier 2}}{\text{Risk Weighted Assets Capital}}$$

Risk-weighted assets comprise the total of all those assets held by the bank which are weighted for credit risk according to a formula determined by the relevant regulator.

Banks are required to maintain a minimum CAR of 8 percent under Basel II; however, many regulators require a higher compliance standard. With reference to the jurisdictions discussed in this article, Vietnam currently requires a 9 percent CAR, Sri Lanka requires a 12 percent CAR, and Mongolia a 12.5 percent CAR.

Basel II also provides limits on how much Tier 2 Capital can be relied upon for capital adequacy, so as to ensure a sufficient amount of Tier 1 Capital. Generally Tier 2 Capital cannot exceed Tier 1 Capital, which means that effectively at least 50 percent of a bank’s capital base should consist of Tier 1 Capital.

Subordinated Debt under the Basel Accords: Experiences from Emerging Markets in Asia

(A) VIETNAM

Regulatory Overview

The State Bank of Vietnam (SBV) regulates the banking activities of all credit institutions¹ licensed to operate in Vietnam. Circular 36 dated 20 November 2014,² as amended by Circular 06, applies the general framework of Basel II to Vietnamese credit institutions. Circular 36 sets the minimum CAR of credit institutions (excluding foreign bank branches) at 9 percent. Credit institutions with at least one subsidiary are also required to maintain a consolidated group CAR equal to or greater than 9 percent.

¹ “Credit Institutions” include local commercial banks and foreign banks operating in Vietnam, but also consumer finance and leasing companies.

² Circular 36/2014/TT-NHNN dated 20 November 2014 as amended by Circular 06/2016/TT-NHNN dated 27 May 2016.

The lifespan of the Circular 36 regime, however, is short-lived with Circular 41 looming on the horizon to take effect on 1 January 2020³. Circular 41 will actually reduce CAR to 8 percent but introduces more stringent and detailed standards for measuring credit risk. Circular 41 is generally considered to be more in line with Basel II standards than Circular 36. In an unusual step, the SBV issued Circular 41 three years before its effective date, in recognition of the challenges that Circular 41 will pose to Vietnamese banks from a regulatory compliance perspective.

Requirements for Tier 2 Subordinated Debt

Under Circular 36, subordinated debt that qualifies as Tier 2 Capital should have the following features:

- i. subordinated debt creditors are entitled to payment after the credit institution had paid-out all other creditors;
- ii. the tenor of the subordinated debt must be at least 5 years;
- iii. subordinated debt is not secured by the assets of the credit institution;
- iv. the credit institution is permitted to suspend payments of interest and carry forward accumulated interest if payment of interest would result in a loss;
- v. payments before maturity (acceleration, voluntary and mandatory prepayments) are only permissible provided that all regulatory prudential ratios are met on a pro-forma basis; and
- vi. an increase in the interest rate is permitted only after 5 years after the execution date of the facility and a one-time interest rate adjustment is permitted during the term of the loan which must be pre-approved by the SBV.

Real World Negotiation Issues on Vietnam Tier 2 Facilities

From our experience on negotiating Tier 2 Capital facilities in Vietnam, there are a number of issues to consider which stem from the above requirements:

- *No Specific regulatory approval for Tier 2 Capital status:* Whilst the SBV registers foreign loans, it does not grant a specific approval for the debt to constitute Tier 2 Capital over the life of the facility. The SBV may review and informally

approve mandatory subordination language in the facility agreement but there is no legal requirement for it to do so, and the registration of the Tier 2 Capital facility as an offshore loan is a standard process for foreign exchange management and should not be construed as any approval or endorsement of the debt constituting Tier 2 Capital. Consequently, there is a risk that due to a change in law (or interpretation of law by the SBV), the facility may no longer constitute Tier 2 Capital. This leaves the borrower therefore with expensive debt, when compared against the comparative borrowing cost of senior unsecured debt, which does not serve the intended regulatory purpose. Borrowers must therefore pay careful attention to prepayment fees and penalties that apply and a lender can expect fierce negotiations on this point.

- *Prepayment and Acceleration:* Vietnamese law provides that the facility may be prepaid or accelerated without SBV consent, *only if* the prudential ratios would be fulfilled on a pro forma basis after giving effect to the payment. Practically, in most cases, this condition will not be fulfilled for a borrower that is in default or that has triggered a mandatory prepayment clause. Therefore, it remains unclear whether the SBV would grant an approval for a foreign lender to accelerate the facility or for a borrower to make either a prepayment. In the absence of clear precedent, foreign lenders may be reluctant to commit to a structure in which they are to a large extent ceding their right to accelerate a defaulted loan.
- *Financial Covenants:* A common thread through Tier 2 Capital facilities across jurisdictions is that financial covenants, if breached, will generally not trigger an event of default. The logic is clear – a breach of financial covenants indicates health concerns for the borrower, which is exactly when Tier 2 supplementary capital may be required to support the bank. In Vietnam, for example, the financial covenants (which track the required prudential ratios under law) are generally used for benchmarking purposes only.

³ Circular 41 regulating Capital Adequacy Ratios Applicable to Banks and Foreign Bank Branches dated 30 December 2016.

(B) TIER 2 CAPITAL FINANCING IN MONGOLIA

Mongolian regulators have not fully adopted the Basel framework. However, the Bank of Mongolia has tightened asset classification and other prudential requirements through the Decree Of The Governor Of The Bank Of Mongolia No. 460 dated 30 July 2010 on the Regulation On Setting And Monitoring Prudential Ratios To Banking Operation (the “Decree”). This requires ‘systematically important banks’⁴ to maintain CAR above 14 percent and other banks are required to maintain a minimum CAR of 12.5 percent. In addition, the Decree provides that the Tier 1 Capital/risk-weighted assets ratio for systematically important banks should be 9 percent.

Features of Subordinated Debt in Mongolia

‘**Subordinated debt**’ is defined in the Decree to mean “*the debt obligation which, upon its maturity to be converted into stocks by the approval of investors’ meeting and the provisions of which must be clearly stipulated in the relevant agreement.*” The amount of subordinated debts acceptable to be included in the Tier 2 Capital is limited up to 50 percent of Tier 1 Capital⁵.

One of the unique features about subordinated Tier 2 Capital financing facilities in Mongolia is that the facility is required to contain a lender option to convert the debt into equity, even if the lenders are not interested in, and have not negotiated, a conversion option.

Comparison of Tier 2 Capital financings in Mongolia and Vietnam

Prepayments and Acceleration: In contrast to Vietnamese law permitting repayments if prudential ratios are met on a pro forma basis, Mongolian law provides that acceleration or prepayment is only permitted where the bank is liquidated, declared or insolvent, or upon the prior written approval of the Bank of Mongolia.

Financial Covenant Breaches and Margin Step-up: Lenders may include a step-up margin in the event that financial covenants are breached, which would be problematic in the Vietnam context due to the limitation on adjustments to the interest rate.

Floating Interest Rates: A Mongolian Tier 2 Capital financing may refer to a floating interest rate, whereas the Vietnamese restriction on a “one-time interest increase” makes this uncertain in the Vietnam context.

(C) TIER 2 CAPITAL FINANCING IN SRI-LANKA

The Central Bank of Sri Lanka introduced the Internal Capital Adequacy Assessment Process in 2013, which facilitated the introduction of Basel III in the country. The local capital requirements related to the global Basel III regulatory framework⁶ issued in late 2016 were expected to come in force between 2017 and January 2019.

Under these regulations, the Minimum Tier I Capital Adequacy Ratio was lifted to 7.25 percent for banks with assets less than Rs 500 billion with effect from June 2017. However, this is expected to increase further in two stages to 8.5 percent by 2019. The total capital (i.e. Common Equity Tier 1, additional Tier 1 Capital and Tier 2 Capital) ratio is expected to be 12.5 percent by the start of 2019.

In our recent experience on Tier 2 Capital financings in Sri Lanka, the state of flux as relates to the regulations resulted in a lack of clear guidance from the regulators on the requirements for subordinated debt to constitute Tier 2 Capital. As such, it was not possible to obtain any pre-approval for the structure. Our experience taught that the best approach is for a lender to refer to prior Tier 2 Capital structures that have been successfully adopted on other projects in the region, with respect to mandatory subordination language, conversion, and prepayment/acceleration rights.

⁴ Defined in the Decree as banks that have a market share of 5% or above of the banking sector’s assets in the last 6 months.

⁵ Article 2.6.3 of the Decree

⁶ These include regulations relating to Common Equity Tier I, Capital Conservation Buffer and Capital Surcharge for Domestic Systemically Important Banks.

Future of Tier 2 Capital Instruments in Emerging Asia

The implementation of the Basel Accords has been a slow process in emerging Asian markets. In Vietnam, as banks will be pressed to be fully compliant with Basel II under Circular 41 by 1 January 2020, it is only a matter of time before they will be expected to comply with Basel III standards. The regulatory uncertainty – both in terms of local laws and the mutations of the Basel Accords themselves – adds a significant layer of regulatory risk to Tier 2 Capital financings.

Nonetheless, the difficulty for emerging Asian market credit institutions in raising sufficient capital through equity, and the relative high yield on Tier 2 Capital instruments, will continue to garner investment interest with borrowers and lenders alike taking a leap of faith that the Tier 2 Capital facilities that they negotiate will indeed constitute Tier 2 Capital.

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