



**BASEL II-TIER 2
CAPITAL TREATMENT
UNDER EGYPTIAN
LAW**

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01

BASEL II-TIER 2 CAPITAL TREATMENT UNDER EGYPTIAN LAW

The Central Bank of Egypt (the “CBE”) has implemented an extensive banking reform program since 2004, which aimed at strengthening the Egyptian banking sector and increasing its robustness to face global and regional competitiveness and help achieve economic growth.

The first wave of this program aimed at consolidation of the banking sector, addressing the issue of non-performing loans, and financial and managerial restructuring of state-owned banks. The CBE successfully completed this first wave in December 2008.



In December 2016, the CBE announced the beginning of a new phase of the financial sector reform program, which involves implementing the Basel III regulations. Banks are expected to fully comply by 2019.

The CBE circulars indicate that banks are required to abide by certain liquidity regulations since 2016 in implementation of Basel III standards. However, so far, no regulations have been issued specifically in relation to the system of tiered capital.

Until this date, the CBE’s regulations with respect to tier 2 capital remain based on Basel II.

In this publication, we focus on Basel II treatment of Tier 2 capital, as implemented by the CBE for the Egyptian banking sector.

We also discuss the restrictions to the lender’s rights under the subordinated loan.

02



IMPLEMENTING BASEL II IN THE EGYPTIAN BANKING SECTOR



As part of the second wave of the banking reform program, which started in 2009, the CBE set out to implement Basel II in the Egyptian banking sector.

What is Basel II?

Basel II is the agreement signed by an international group of bank supervisors in June 2004, on convergence of capital measurement and capital standards. The overall target of Basel II is a better management of risks inside banks, on convergence of capital measurement and capital standards.

Basel II is based on three pillars, namely, regulatory minimum capital requirements (pillar I), supervisory review process (pillar II) and, lastly, market discipline (pillar III). Mainly, we are going to discuss pillar I, specifically Tier 2 capital Requirements.

What is the difference between Tier 1 and Tier 2:

Basel II classifies capital using a tiered system. Tier 1 capital is the core capital, i.e. the bank's basic equity ("Tier 1"), which contains permanent shareholders' equity, i.e. issued and fully paid ordinary shares/common stock, non-cumulative preference shares and disclosed reserves.

On the other hand, Tier 2 capital ("Tier 2") is supplementary capital that can be considered part of the bank's capital base upon meeting certain requirements. Under Basel II, it includes:

- A. Undisclosed reserves;
- B. Asset revaluation reserves;
- C. General provisions/general loan-loss reserves;
- D. Hybrid (debt/equity) capital instruments; and
- E. Subordinated debt.



03 : THE CBE APPROACH TO BASEL II AND TIER 2 CAPITAL

The CBE has approved during its meeting on 18 December 2012 the Minimum Capital Adequacy Ratio Standards (the "Standards") in application of Basel II. The Standards apply to all banks in Egypt as well as branches of foreign banks starting from December 2012 & June 2013 according to the end of the financial year of each bank.

What Are the General Requirements for Tier 2 Capital Instruments?

The Standards set out certain general requirements that apply to all forms of Tier 2 capital. The Standards seem to be mostly discussing debt instruments, rather than



other specific forms of debt (such as loans or deposits). We discuss below in this section these general requirements applicable to all debt instruments. In the next section, we will apply these criteria to subordinated loans in specific. In December 2016, the CBE announced the beginning of a new phase of the financial sector reform program, which involves implementing the Basel III regulations. Banks are expected to fully comply by 2019.

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Until this date, the CBE's regulations with respect to tier 2 capital remain based on Basel II.

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We also discuss the restrictions to the lender's rights under the subordinated loan.



TO BE INCLUDED IN TIER 2 CAPITAL, A DEBT INSTRUMENT MUST COMPLY WITH THE FOLLOWING CRITERIA:

- A. Be fully issued and paid-in;
- B. Be subordinated to the rights of the bank's depositors and creditors upon liquidation;
- C. Be unsecured and not guaranteed by the issuing bank or its affiliates, and not subject to any legal or economic arrangements that cause it to have priority in repayment over ordinary depositors and creditors;
- D. As for maturity, a debt instrument must:
 - i. Have a minimum original term to maturity of over five years;
 - ii. Be amortized over the last five years of the original term to maturity in fixed instalments; and
 - iii. Not include any conditions or incentives that would make it repayable before the agreed repayment date;
- E. Be redeemable at the sole initiative of the holder only after the original term to maturity of over five years, and subject to the following conditions:
 - i. Obtaining the consent of the CBE prior to redemption;
 - ii. Upon issuing such debt instrument, the bank must refrain from any action that would result in its redemption by its holder;
 - iii. The holder cannot redeem the debt instrument unless the debt instrument is replaced with capital of an equivalent or higher grade, and the replacement process is suitable to the bank's revenue levels; and the capital adequacy ratio after the redemption of the debt instrument is higher than the required minimum capital adequacy ratio;



- F. The holder shall not be able to accelerate the repayment of the principal and/or the interest before the agreed repayment date except in cases of bankruptcy or liquidation, and the subordinated instrument shall continue to be subordinated in such bankruptcy or liquidation proceeding;
- G. The holder of the debt instrument shall not get any preference in the yield upon a change in the credit rating of the bank; and
- H. The bank and/or its affiliated parties (upon which the bank has actual control) may not purchase such debt instrument or finance its purchase, whether directly or indirectly.





LEGAL AND REGULATORY RESTRICTIONS TO THE LENDER'S RIGHTS AS APPLIED TO THE SUBORDINATED LOAN

In our reading of the Standards issued by the CBE for the elements of capital that may be included in Tier 2 (as described above), we believe that to be included in Tier 2 of the borrower, a subordinated loan must satisfy the following conditions:

- A. The subordinated loan must be fully committed by the lender and drawn down by the borrower;
- B. The lender's rights must be subordinate to the rights of the borrower's depositors and other creditors upon liquidation;
- C. The lender's rights must be unsecured and not guaranteed by the borrower or its affiliates, and must not be subject to any legal or economic arrangements that cause it to have priority in repayment over the borrower's ordinary depositors and other creditors;
- D. The subordinated loan must be unconditional, i.e. not allocated for a specific activity or to cover certain assets;
- E. The subordinated loan must have a minimum original term to maturity of over five years, and the subordinated loan cannot include any conditions or incentives that would make it repayable before the agreed repayment date;
- F. The subordinated loan must be amortized over the last five years of the original term to maturity in fixed instalments;
- G. The lender must not be able to accelerate the repayment of the principal and/or the interest before the agreed repayment date except in cases of bankruptcy or liquidation;
- H. The subordinated loan must not include any provisions that would make it redeemable/callable by the bank before an original term to maturity of five years, and in any case the consent of the CBE must be obtained prior to redemption;



I. The lender must not receive any preferential interest upon a change in the credit rating of the bank; and

J. The borrower and/or its affiliated parties (upon which the borrower has actual control) may not purchase such subordinated loan or finance its purchase, whether directly or indirectly.



Who Can Provide Tier 2 Loans?

While the wording of the Standards only mentions subordinated loans from the bank's shareholders or from the CBE, we believe subordinated loans from other lenders also qualify for inclusion in Tier 2 based on previous regulations issued by the CBE. Specifically, for development finance institutions ("DFIs"), the CBE has issued its circular on 11 January 2017 to add DFIs to the list of lenders of Tier 2 loans to explicitly allow DFIs to grant Tier 2 loans to Egyptian banks and branches of foreign banks in Egypt.

Is the CBE Approval Required Before the Inclusion of an Element into Tier 2?

Although the Standards do not require the approval of the CBE before the inclusion of an element into Tier 2, a discussion paper issued by the CBE to banks discussing the implementation of Basel II suggests that this may be the case. Given the ambiguity in relation to this point, we recommend that lenders require that the borrower to obtain the explicit prior approval of the CBE on the subordinated loan and its inclusion in the borrower's Tier 2 capital. This is usually granted in practice by the CBE.



04



WHO
WE
ARE



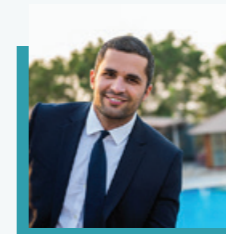
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- Advising Attijari Wafa Bank on the acquisition of Barclays Egypt from Barclays PLC.
- Advising Societe Generale on the USD 2 billion sale on its entire stake in its listed Egyptian National Societe Generale Bank to Qatar National Bank.
- Advising BNP Paribas on the USD 500 million sale of BNP Paribas Egypt to Emirates NBD Bank.
- Advising Eni on the USD 1.125 billion sale of 30% stake in Shorouk offshore concession, where Zohr gas field is located, to Rosneft.
- Advising Eni also on the USD 275 million sale of 10% stake of the same concession to BP.
- Our clients include IFC, EBRD, Shell, ENI, GE, Google, Amazon, Nestle, WPP, DEA, DP World, Galileo, Rapiscan, Amgen, EFG Hermes, KUFPEC and Air Liquide.



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