Flash Alert

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PKF

Issue of Perpetual Non-Cumulative Preference Shares (PNCPS) by Banks and Financial Institutions

The Nepal Rastra Bank vide circular number 09/80/81 has provided an option to the Banks and Financial Institutions to issue Perpetual Non-Cumulative Preference Shares (PNCPS) to ease out their capital position and meet the minimum capital adequacy requirement as per Capital Adequacy Framework 2015 (CAF). The provision applies to all 'A' class commercial banks and national-level development banks within the ambit of CAF 2015.

1. Basic features of PNCPS

Perpetual Non-Cumulative Preference Share is a type of preference share that has the following characteristics:

a) **Perpetual Nature**:

- It does not have a fixed maturity date.
- The issuing Bank does not commit to redeeming or buying back these shares at any specific future date.
- As long as the issuing Bank remains in existence, PNCPS pays a fixed dividend to investors indefinitely.

b) **Non-Cumulative Feature:**

- Unlike cumulative preference share, non-cumulative preference share does not accumulate unpaid dividends from prior years.
- If the bank skips paying dividends in a particular year, shareholders of PNCPS do not have the right to claim those missed dividends in the future.

c) **Fixed Dividend:**

- Perpetual non-cumulative preference shares pay a fixed dividend rate.
- This fixed dividend is typically specified at the time of issuance and remains constant over time.

d) **Similarities to Bonds:**

- Although not identical, PNCPS shares some characteristics with bonds or debt instruments that have extremely long maturity dates.
- Investors receive a steady income stream from the fixed dividends, similar to bond interest payments.

2. Conditions imposed by NRB for the issue of PNCPS

a) The redeemable period cannot be specified.

b) The issuer of PNCPS shall ensure that it is held only by institutional investors.

c) The BFIs shall issue these shares and they shall be fully paid.

d) The PNCPS should be neither secured nor covered by a guarantee of the issuer.

e) The issuing bank must have full discretion at all times for the distribution or non-distribution of dividends. This should be mentioned in the prospectus along with the rate of dividend.

f) The dividend (if any) has to be paid only out of the current year's profit after all appropriations. Retained earnings or any other reserve should not be utilized for the distribution of dividends.

g) The issuing Bank should issue a Risk Disclosure Statement (RDS) disclosing potential risks that may arise after the occurrence of the trigger point *(further clarified in point no 3 below).*

h) The issuer Bank should obtain written confirmation from all investors that they have obtained RDS, read and understood all the provisions of the prospectus, and understood the underlying risk of PNCPS.

i) In the event of liquidation of the issuing Bank the PNCPS holders have a claim before ordinary shares but after instruments included in Tier 2 Capital and regulatory capital instruments as per CAF 2015.

j) NRB may prescribe additional conditions while providing approval for the issuance of PNCPS.

3. Trigger Point and Loss absorption through PNCPS

Trigger point is a situation when the Common Equity Tier I Capital (CET1) of the Bank is less than 5.125% of Risk Weighted Exposure (RWE). The existing minimum CET1 requirement as per CAF 2015 is 4.5% excluding Capital Conservation Buffer (CCB) and 7% including CCB.

On the occurrence of a trigger point i.e. CET1 falling below 5.125%, the issuer bank has to convert PNCPS to ordinary shares after getting approval from NRB. The method of determination of the number of ordinary shares on conversion of PNCPS should be specified in the prospectus. On the occurrence of trigger point, PNCPS shall be converted to promoter shares of the Bank.

4. Potential benefits of PNCPS to issuing BFIs

a) **Capital Adequacy**: These shares are considered Additional Tier 1 Capital under Basel III and CAF 2015, helping banks meet capital adequacy requirements.

b) **Cost of Capital**: They typically have lower dividend rates compared to common equity, reducing the overall cost of capital.

c) **Flexibility**: Banks can defer dividend payments without penalty, preserving cash in difficult times.

d) **No Dilution**: Issuing preference shares does not dilute the voting power of existing common shareholders.

e) **Loss Absorption**: In the event of financial distress, preference shares can absorb losses, providing an additional buffer

PKF Comment

As per quarterly unaudited financial statements published by the BFIs for Q3 of FY 2023-24, 5 commercial banks are under stress to maintain minimum primary capital. In the absence of options to generate additional capital, these banks were forced to limit their business growth and focus on the recovery of overdue loans.
In light of the prevailing capital stress of the BFIs, this initiative by NRB may be a relief and an option for a way out.
However, on a detailed review of the provision the option may not seem attractive from an investor's point of view unless BFIs are ready to commit a high rate of dividend.

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