Investment Product Guide –
High Yield Bonds, Subordinate Debt Securities, Perpetual Securities, Contingency Convertible Securities (Cocos), High Yield Bond Funds

I have read the Investment Product Guide of the above products, and I acknowledge that I understand its features and risks

Signature: ____________________
Print Name: ___________________
Date: ________________________
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The Bank will provide Product Issuing Programme / Offering Memorandum / Pricing Supplement / Offering Circular / Base Prospectus.
High Yield bonds

Product Description:

- Referred to bonds (corporate, government or municipal) that have credit ratings below minimum investment grade (BBB- (S&P’s, Fitch) or Baa3 (Moody’s))
- Some may have investment grade but still classified as high yield bonds if such instruments are issued by so-called emerging countries
- Issuing companies usually issue bonds for growth (M&A) or working capital. Companies are increasingly issue for general corporate use.
- Also known as “speculative grade” or “junk” bond

Common characteristics:

- Credit rating usually below minimum investment grade or capped by the domicile sovereign rating
- Issue sizes tend to be smaller, implying weaker liquidity in the form of wider bid-ask spreads
- Usually pay higher yields due to its higher risk of default (i.e., seize to pay coupon interest or the principal amount at maturity)
- Coupon can be in fixed or floating rate
- Dated maturity or perpetual
- Call date with Issuer discretion (coupon interest can be fixed-for-life OR coupon reset)
- Call premium – come into effect once the period of call protection ends. Usually the premium on the first call date is par plus 50% of the coupon, declining ratably thereafter each year
- Bullet – full-term call protection with no call date
- Usually embedded covenants related to financial performance
- Lower correlation/sensitivity to changes in interest rate but highly sensitive to the economic and sector outlook, and the issuer’s financial profiles
High Yield bonds

Target investors:

- Institution
- Hedge Fund
- Pension Fund
- Sovereign Wealth Fund
- Insurance Companies
- Central Bank
- Fund Manager
- Individual investor with high risk profile

Risk Factors:

- **Issuer risk**
  - Investors’ principal may be at risk if Issuer defaults or fails to meet its debt obligation
- **Re-investment risk**
  - Investors may not be able to reinvest at yield they currently receive if issuer chooses to early redeem the note on the first call date or in any subsequent call date
- **Interest rate risk**
  - Bond price may adversely affect if interest rate moves higher
- **Liquidity risk**
  - Liquidity may be limited or even cease to exist especially under distressed market environment
- **Currency risk**
  - Investors may incur loss if the denominated currency of the bond is not the same as the investors’ domicile currency

**Risk Level** → 4 or 5 (1 to 5, with 5 being the highest)
High Yield bonds

Suitability:
- Suitable for investors aiming for higher yields by taking credits with weaker credit profiles and possibly lower secondary market liquidity

Worst-case scenario:
- Investors will lose 100% of the investment should the Issuer default
High Yield bonds

Example:

- Rating: below investment grade (B1/B+/B+)
- Call Date: 02/18/2017 (call @ 104.188 <PAR + 50% coupon>)
- Coupon: pay fixed semi-annually (8.375%)

Source: Bloomberg
Subordinated Debt Securities

Product Description:

- Subordinated debts generally refers to debt securities that have secondary or lower priority to claim the issuer’s assets compared to senior debts, when issuer defaults on its obligations or bankruptcy.

Basic Characteristic:

- Subordinated debt ranks below senior unsecured debt holders in the case of the issuer’s liquidation.
- Subordinated debt will have lower credit ratings compared to senior unsecured debt, usually by one to three notches depending on the subordinated debt structure.
- Subordinated debt can basically be grouped in two classes: Lower Tier 2 and Upper Tier 2 (Please refer to the chart on page 10).
- Perpetual or AT1 are also classified as subordinated debts or some market participants call “junior subordinated debt”
Subordinated Debt Securities

Suitability:

- Suitable for investors aiming for higher yields by taking additional risk over other Senior Unsecured credits. Investors should also understand that the Issuer may choose to omit the interest payment at any time without consents from the note holders.

Worst-case scenario:

- Investors will lose 100% of the investment should the Issuer default

Risk Factors:

- **Credit risk** - investors are subject to the risk of the issuer defaulting on its obligations. It should also be noted that credit ratings assigned by credit rating agencies do not guarantee the creditworthiness of the issuer
- **Liquidity risk** - some bonds may not have active secondary markets and it would be difficult or impossible for investors to sell the bond before its maturity (if applicable)
- **Deferrable Interest payment risk** - issuer has the right to defer the interest payment of the bond (if applicable)
- **Early redemption risk** – the bond can be redeemed early by the issuer and investors will get the payout for the period of time invested. Investors are exposed to “reinvestment” risk to the extent that investors cannot reinvest in a similarly attractive new investment
- **Interest rate risk** - bonds are more susceptible to fluctuations in interest rates and generally prices of bonds will fall when interest rates rise
- **Contingent write-down/loss absorption risk** - the Issuer has the right to either write-off fully or partially or converted to common stock on the occurrence of a trigger event (In the case of AT1)

Risk Level → 4 or 5 (1 to 5, with 5 being the highest)
Perpetual Securities – with special feature

What is Perpetual

Product Features:

- Perpetual is an investment instrument that carries periodic coupon payment without fixed maturity date.
- Perpetual securities usually embedded with a call option which will only be solely exercisable on discretion by the issuer on the first call date and anytime thereafter (or callable on every of its coupon payment date).
- On the residual claims basis, perpetual will rank below senior unsecured debts depending on the status of perpetual (please see chart 1 for priority ranking). Therefore, perpetual is usually classified as a subordinated securities.
- A typical fixed income structure that involves bond issued with conditional coupon payment.
- Tier 1 perpetual usually issue by banks, as banks require to comply with the criteria of maintaining minimum % of capital adequacy ratio. Hence, banks will issue either Tier 1 perpetual or common shares to meet the required capital adequacy ratio. Tier 1 perpetual usually viewed as hybrid securities instead of debt instruments given its optional coupon deferral and subordinated claim status. Coupons will usually be higher for perpetual in order to compensate the underlying risks.
- In regard to the coupon deferral feature, issuer can choose to skip the coupon payments on Tier 1 perpetual and the missed coupons will not reimburse even issuer resume the coupon payment on the subsequent coupon payment date (non-cumulative). However, issuer will not be allowed to pay dividends on common shares or coupon payment to other Tier-1 perpetual that rank pari passu to the “affected Tier 1 perpetual” (dividend stopper).
- Perpetual usually enclosed with a call option. Under a Tier 1 perpetual category, this is usually classified as non-innovative Tier 1 Perpetual. Innovative Tier 1 perpetual also include step-up clauses that allow the coupon payment to “step-up” usually after the first call date if issuer declines to call the bond back. The purpose of such arrangement usually used to enhance the attractiveness of the securities. On the flip side, some perpetual also carry languages that maybe of a disadvantage to noteholders such as loss absorption, which coupon payment will continue to be paid at the then applicable rate but on the reduced principal amount if certain preset events occur. In the worse case scenario, a principal write-down is also highly possible.
## Perpetual Securities - vs. others Fixed Income Securities

### Chart 1

<table>
<thead>
<tr>
<th>Category</th>
<th>Coupon Type</th>
<th>Maturity Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior Unsecured</td>
<td>Mandatory</td>
<td>Fixed Maturity</td>
</tr>
<tr>
<td>Senior Subordinated (Lower Tier 2)</td>
<td>Mandatory</td>
<td>Fixed Maturity (with a minimum maturity of 5 years)</td>
</tr>
<tr>
<td>Junior Subordinated (Upper Tier 2)</td>
<td>Optional (cumulative)</td>
<td>Perpetual*</td>
</tr>
<tr>
<td>Junior Subordinated (Tier 1)</td>
<td>Optional (non-cumulative)</td>
<td>Perpetual</td>
</tr>
</tbody>
</table>

Can be cumulative through ACSM (Alternative Coupon Satisfactory Mechanism)
Perpetual Securities

Suitability:

- Suitable for investors aiming to enhance return by taking additional risk over other Senior Unsecured credits and share the view that the Issuer will obligate the interest payment during the lifetime of the Perpetual.

Worst-case scenario:

- Investors will lose 100% of the investment should the Issuer default

Risk Factors:

- Credit risk - investors are subject to the risk of the issuer defaulting on its obligations. It should also be noted that credit ratings assigned by credit rating agencies do not guarantee the creditworthiness of the issuer
- Liquidity risk - some bonds may not have active secondary markets and it would be difficult or impossible for investors to sell the bond before its maturity (if applicable)
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Risk Level → 4 or 5 (1 to 5, with 5 being the highest).
Contingent Convertible securities (CoCos)

- Type of instrument that the issuer (financial institution) used to fulfill the requirement of Basel III capital ratio
- CoCos can be in the form of “Dated” (LT2) or “Perpetual” (Tier 1)
- Key difference of “Old Style” and “New Style” (CoCos) perpetual

<table>
<thead>
<tr>
<th></th>
<th>Old Style (Non Basel III)</th>
<th>CoCos</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coupon</td>
<td>Issuer discretion</td>
<td>Issuer discretion</td>
</tr>
<tr>
<td></td>
<td>Non-cumulative (unless specify with ACSM)</td>
<td>Non-cumulative</td>
</tr>
<tr>
<td>Coupon Step Up</td>
<td>Allow</td>
<td>Not Allow</td>
</tr>
<tr>
<td>Loss Absorption</td>
<td>Selective issues</td>
<td>“Must have” for all issues</td>
</tr>
<tr>
<td>Form of Loss Absorption</td>
<td>Principal writedown (if applicable)</td>
<td>Principal writedown or Equity conversion</td>
</tr>
<tr>
<td>Trigger event</td>
<td>Issuer discretion (under condition when making losses) (if applicable)</td>
<td>Threshold breached OR Point of Non-Viability (PONV)</td>
</tr>
<tr>
<td>Ranking</td>
<td>Subordinated (just senior to equity)</td>
<td>Subordinated (just senior to equity)</td>
</tr>
</tbody>
</table>
Contingent Convertible securities (CoCos)

Loss Absorption Clause

Principal will either writedown or being converted into equities at pre-set price if

1) **Issuer’s Core Tier 1 Capital Ratio (CET1) drop below a pre-set threshold. For example:**
   - Credit Suisse 7.5% Perp (XS0989394589) – Principal writedown if CET1 < 5.125%
   - Barclays 8.25% Perp (US06738EAA38) – Equity conversion if CET 1 < 7%

2) **Point of Non-Viability (PONV)** - means the earlier of a) a decision that a write-off, without which the relevant bank would become non-viable, is necessary as determined by the relevant authority; and b) the decision to make a public sector injection of capital, or equivalent support, without which the relevant bank would become non-viable, as determined by the relevant authority. **For example:**
   - eg. ICBCAS 4.5% 10/10/2023
   - eg. All CoCos with pre-set trigger threshold also have PONV
Basel III

- Introduce after the “Lehman Catastrophe”
- The implementation of Basel III is aimed to improve financial institutions’ resistance to any future shocks and prevent the bailout needs by tapping taxpayers' money.
- Financial Institutions will need to comply to stricter (higher) capital requirement
- Common Equity (Core) Tier 1 increased from 2% to 4.5%

### Calibration of the Capital Framework

<table>
<thead>
<tr>
<th></th>
<th>Common Equity Tier 1</th>
<th>Tier 1 Capital</th>
<th>Total Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum</td>
<td>4.5</td>
<td>6.0</td>
<td>8.0</td>
</tr>
<tr>
<td>Conservation buffer</td>
<td>2.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum plus conservation buffer</td>
<td>7.0</td>
<td>8.5</td>
<td>10.5</td>
</tr>
<tr>
<td>Countercyclical buffer range*</td>
<td>0 – 2.5</td>
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</tbody>
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Source: BIS
### Basel III phase-in arrangements

(All dates are as of 1 January)

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<tbody>
<tr>
<td>Leverage Ratio</td>
<td>Parallel run 1 Jan 2013 – 1 Jan 2017</td>
<td>Disclosure starts 1 Jan 2015</td>
<td>Migration to Pillar 1</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Minimum Common Equity Capital Ratio</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td></td>
<td></td>
<td></td>
<td>4.5%</td>
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<tr>
<td>Capital Conservation Buffer</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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</tr>
<tr>
<td>Minimum common equity plus capital conservation buffer</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>5.125%</td>
<td>5.75%</td>
<td>6.375%</td>
<td>7.0%</td>
</tr>
<tr>
<td>Phase-in of deductions from CET1*</td>
<td>20%</td>
<td>40%</td>
<td>60%</td>
<td>80%</td>
<td>100%</td>
<td></td>
<td>100%</td>
</tr>
<tr>
<td>Minimum Tier 1 Capital</td>
<td>4.5%</td>
<td>5.5%</td>
<td>6.0%</td>
<td></td>
<td></td>
<td></td>
<td>6.0%</td>
</tr>
<tr>
<td>Minimum Total Capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>8.0%</td>
</tr>
<tr>
<td>Minimum Total Capital plus conservation buffer</td>
<td>8.0%</td>
<td>8.625%</td>
<td>9.25%</td>
<td>9.875%</td>
<td></td>
<td></td>
<td>10.5%</td>
</tr>
<tr>
<td>Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Phased out over 10 year horizon beginning 2013</td>
</tr>
<tr>
<td>* Including amounts exceeding the limit for deferred tax assets (DTAs), mortgage servicing rights (MSRs) and financials.</td>
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<tr>
<td>* -- transition periods</td>
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</tbody>
</table>
Example of CoCos

Bloomberg DES page will show “Capital Type: CoCo” for any Basel III complied bonds

Source: Bloomberg
Example of CoCos

- Writedown of principal may occur on more than one occasion but not less than zero
- Writedown will be permanent (no writeup)
- Equity Capital Ratio < 8% (consist of 1) Member Certificates, and 2) Retain Earning)

Source: Bloomberg
Example of CoCos

- Writedown of principal may occur on more than one occasion but not less than zero
- Writedown can be temporary (with writeup)

Source: Bloomberg
Example of CoCos

Equity conversion if threshold trigger (CET 1 ratio < 7%)

Source: Bloomberg
Example of CoCos

- Example for Basel III compliable Lower Tier 2 Capital
- Principal writedown with low trigger level (< 5%)

Source: Bloomberg
CoCos

- CoCos usually offer higher yield than conventional perps (old style) given greater risk on principal
- Emerging as major class within fixed income universe as financial institutions are required to issue such notes to boost its capitals

**Credit rating on new Basel III instruments:**

- New Basel III complied instruments will have credit rating usually below its conventional sub-debt
- Moody’s will rate CoCos at a maximum of Baa3 rating
CoCos

Suitability:

- Suitable for investors aiming for higher yields by taking additional risk over other Senior Unsecured credits and risk on the principals in the form of writedown. Investors should also understand that the Issuer can omit the interest payment at any time without consents from the note holders.

Worst-case scenario:

- Investors will lose 100% of the investment should the Issuer default

Risk Factors:

- **Credit risk** - investors are subject to the risk of the issuer defaulting on its obligations. It should also be noted that credit ratings assigned by credit rating agencies do not guarantee the creditworthiness of the issuer
- **Liquidity risk** - some bonds may not have active secondary markets and it would be difficult or impossible for investors to sell the bond before its maturity (if applicable)
- **Deferrable Interest payment risk** - issuer has the right to defer the interest payment of the bond
- **Early redemption risk** – the bond can be redeemed early by the issuer and investors will get the payout for the period of time invested. Investors are exposed to ‘reinvestment” risk to the extent that investors cannot reinvest in a similarly attractive new investment
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Risk Level ➔ 4 or 5 (1 to 5, with 5 being the highest)
High Yield Bond Funds

Product Description:

Seeking higher returns, high yield bond funds typically allocate a significant portion of the underlying investments to one or more of the following types of debt securities:

- below investment grade securities which are sometimes referred to as "junk bonds" (e.g. below BBB- for Standard & Poor's or below Baa3 for Moody's);
- unrated debt securities;
- high yield instruments issued or guaranteed by corporate or sovereign issuers that are unrated or below investment grade;
- distressed securities (i.e. securities issued by a company that is in financial difficulty or in default); and
- selective default securities (i.e. securities rated as such by credit rating agency where the issuer has selectively defaulted on a specific issue or class of obligations but will continue to meet its payment obligations on other issues or classes of obligations in a timely manner);
- may invest in convertible bonds and/or structured products with underlying exposure to fixed income securities e.g. mortgage backed securities or asset backed securities.

Issuers of these bonds and/or debt securities are generally subject to higher credit or default risk.

These funds tend to make regular distribution to investors and such distribution may be paid out of capital.

Target investors:

- Institutions
- Pension Funds
- Sovereign Wealth Funds
- Insurance Companies
- Central Banks
- Fund Managers
- Individual investors with high risk profile

Source: Investor Education Center – www.hkiec.hk
High Yield Bond Funds

**Risk Factors:** in addition to the risk factors for High Yield Bonds (refer to slide 4),

- **Credit/Default risk**
  - Investing in below investment grade bonds and/or unrated bonds may be subject to a higher default risk than investing in investment grade bonds. An issuer of high yield debt securities may be highly leveraged and the issuer's ability to meet its debt obligations may be adversely affected by the issuer's business and financial conditions or unavailability of additional financing.
  - If the issuer defaults, or the below investment grade bonds or other underlying assets cannot be realised, investor may suffer substantial losses by investing in the high yield bond funds.

- **Volatility risk**
  - Investments in below investment grade or unrated bonds involve greater price volatility. These types of bonds are more sensitive to adverse changes in general economic conditions and financial conditions of the issuers. As such, the risk of loss of principal and income is much higher than investing in investment grade bonds.

- **Liquidity risk**
  - The market for below investment grade bonds or unrated bonds generally has lower liquidity. As a result, a high yield bond fund may not be able to purchase or liquidate its holdings in response to changes in the economy or the financial markets. This in turn may have an adverse impact on the value of the fund.

- **Risk of distribution out of capital**
  - In order to ensure and maintain a high distribution rate as well as a regular income stream for investors, a lot of high yield bond funds may pay dividends out of capital or gross income and/or charge / pay all or part of the fund's fees and expenses to / out of capital. This amounts to a return or withdrawal of part of an investor's original investment or from any capital gains attributable to that original investment, and may result in an immediate reduction of the net asset value per unit of the fund.
  - One should thus be aware that high distribution yield of a fund does not imply a positive or high return on the investments. In addition, there is no guarantee of a dividend payout or the dividend rate for these high yield bond funds.

- **Derivative instruments risk**
  - A high yield bond fund which uses derivatives (such as futures, options and swaps etc.) for hedging or enhancing return is subject to additional risks associated with these derivative instruments. These risks include market volatility risk, credit risk, counterparty risk, liquidity risk, valuation risk, leverage risk as well as the default risks of the derivatives' issuers.

**Risk Level** → 4 (1 to 5, with 5 being the highest)

*Source: Investor Education Center – www.hkiec.hk*
Suitability:

- Suitable for investors aiming for higher yields by taking credits with weaker credit profiles and possibly lower secondary market liquidity

Worst-case scenario:

- The net asset value of a high yield bond fund may suffer significant decline when there is a default of any of the high yield bonds and/or securities in which it invests. Investments in the high yield bond fund will, as a result, be adversely affected and investors suffer significant losses.

Source: Investor Education Center – www.hkiec.hk
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