

CIRCULAR TO SHAREHOLDERS ON PROPOSED DEBENTURE ISSUE

THIS DOCUMENT IS OF VALUE – If you are in any doubt as to the action you should take, you should consult your stockbroker or other professional adviser immediately.



Dear Shareholder/s

The Commercial Bank of Ceylon PLC (“the Bank”) made a profit of Rs. 16,581.244 Mn. for the year ended December 31, 2017 (Group Rs. 16,626.507 Mn.). Total shareholders’ funds increased to Rs. 107,099.360 Mn. (Group Rs. 108,866.706 Mn.) as of December 31, 2017 from Rs. 78,353.664 Mn. (Group Rs. 79,815.423 Mn.) as of December 31, 2016. Figures shown herein are extracted from published Financial Statements.

The Board of Directors of the Bank, having identified the need to strengthen the Tier 2 Capital Base of the Bank as per Basel III requirements, and in order to facilitate expansion and to reduce maturity mismatches, at their meeting held on January 26, 2018 decided to initiate, and also to recommend to shareholders,

AN ISSUE OF BASEL III COMPLIANT – TIER 2 LISTED RATED UNSECURED SUBORDINATED REDEEMABLE 5 YEAR AND 10 YEAR DEBENTURES WITH A NON-VIABILITY CONVERSION TO ORDINARY VOTING SHARES TO BE ISSUED BY THE BANK, SOLELY IF INSTRUCTED TO DO SO BY THE MONETARY BOARD OF SRI LANKA ON OCCURRENCE OF A TRIGGER EVENT.

The proposed issue is to raise a sum of Rupees Five Billion (Rs. 5,000,000,000/-) through the issuance of up to 50,000,000 Debentures, each with a par value of Rs. 100.00, with an option to raise up to a further Rupees Five Billion (Rs. 5,000,000,000.00) through the issuance of up to a further 50,000,000 Debentures, each with a par value of Rs. 100.00 in the event of an over-subscription of the initial issue (hereinafter collectively called “the Debentures”).

The proposed Debentures will be redeemed after 5 years and after 10 years from the date of allotment of such Debentures and the principal sum and accrued interest (if any) payable on the redemption of such Debentures will be paid not later than three (3) market days from the date of redemption, unless a Trigger Event occurs as described in this Circular.

The proposed issue of Debentures is subject to the approval of the Colombo Stock Exchange and the Central Bank of Sri Lanka and are to be issued under rules and regulations promulgated by the Colombo Stock Exchange and the Central Bank of Sri Lanka, including guidelines issued in relation to Basel III compliance in the Banking Act Direction No. 1 of 2016 issued by the Central Bank of Sri Lanka.

The final rating for the proposed Debenture Issue with a convertibility feature in compliance with Basel III requirements will be issued by Fitch Ratings Lanka Limited. Issuance of this rating will be subject to the adoption of a Special Resolution by the shareholders of the Bank, at the Extraordinary General Meeting (“EGM”) that is being convened, and receipt of approval of the Central Bank of Sri Lanka (CBSL). The final Rating Report will be incorporated in the Debenture Prospectus.

1. Objectives of the Proposed Debenture Issue

Funds raised through this Debenture Issue are expected to improve the Capital Adequacy of the Bank. The medium to long-term duration of the Debentures

and the subordinated nature of the instrument issued in compliance with Basel III requirements will enable the Bank to strengthen the Tier 2 Capital Base as per Basel III requirements. Approval will be obtained from the Central Bank of Sri Lanka to include the Basel III compliant Debentures under Tier 2 capital.

The Bank expects to use the funds raised through the Debentures to expand the lending portfolio of the Bank. Since the Debentures proposed to be issued are of a medium to long-term nature, being of tenures of 5 and 10 years, the raising of funds through Debentures can be expected to reduce the mismatch between shorter term liabilities and medium to long-term assets.

The Bank intends to lend the proceeds of the Issue and thereby expand the Bank’s loan book in the ordinary course of business over a period of three (3) months. The Bank has recorded net loans and advances growth of Rs. 121,428 Bn. in 2017, and therefore based on an expectation of similar credit demand in 2018 it is unlikely that a situation of not lending the Debenture proceeds within a period of three (3) months will arise.

The Bank as at date of this circular has not recognised related parties for the lending of the Debenture proceeds and therefore plans to disburse the Debenture proceeds in the ordinary course of business. However, in the event if the Bank lends funds raised through this Debenture Issue to related parties, the Bank will comply with the requirements stipulated under Section 9 of the CSE Listing Rules (as applicable). Further, in the event these Debentures are allotted to related parties, the Bank shall comply with all applicable laws/regulations in this regard.

Capital and Current Capital Adequacy Status

The Bank is in compliance with the Basel III requirements as at December 31, 2017.

Current CAR position of the Bank as at 31.12.2017		15.75%
Minimum CAR requirement to be maintained as at 01.01.2018 as per Basel III Direction No. 01 of 2016		12.875%
Minimum amount of funds the Bank is required to raise from the Debenture Issue which will have a convertible option in compliance with Basel III CAR requirements		Nil
Expected CAR position, subsequent to the Basel III compliant Debenture Issue	As at 31.12.2017 with Rs. 5 Bn.	16.32%
	As at 31.12.2017 with Rs. 10 Bn.	16.89%

The minimum Capital Adequacy requirements under Basel III are as follows:

Components of Capital	01.07.2017	01.01.2018	01.01.2019
Common Equity Tier 1 Capital with Buffers (CCB and Surcharge on D-SIB)	6.250%	7.375%	8.500%
Total Tier 1 Capital with Buffers (CCB and Surcharge on D-SIB)	7.750%	8.875%	10.000%
Total Capital Ratio (Tier 1 + Tier 2) with Buffers (CCB and Surcharge on D-SIB)	11.750%	12.875%	14.000%

CCB – Capital Conservation Buffer

D-SIB – Domestic Systemically Important Bank

Subordinated funds raised through this Debenture Issue in compliance with requirements under Basel III, are expected to further improve the Capital Adequacy of the Bank's Balance Sheet by increasing its Tier 2 Capital base thus strengthening its Total Eligible Capital as per Basel III requirements.

2. Proposed Issuance of Basel III Compliant Debentures

Regulatory aspects regarding Basel III compliant subordinated debt

As per Banking Act Direction No. 1 of 2016 issued by the Central Bank of Sri Lanka, subordinated debt issued by licensed commercial banks needs to be compliant with Basel III requirements effective from July 1, 2017 in order to qualify as Tier 2 capital. According to Basel III guidelines, all subordinated debt issuance should have either a conversion feature allowing conversion to equity or a write-down feature. The Bank is therefore of the view that a non-viability conversion feature should be included in the proposed Debentures, and that such conversion, if applicable, should be to ordinary voting shares of the Bank upon occurrence of a Trigger Event.

The conversion of Debentures to ordinary voting shares will be in accordance with the applicable laws and regulations of Sri Lanka

and the new shares will, subject to the approval of the Colombo Stock Exchange, be listed and will be subject to the instructions of the Monetary Board of the Central Bank of Sri Lanka with regard to application of the Single Holder Limit at the time of conversion of the Debentures into ordinary voting shares of the Bank.

3. Benefits for the Bank in Issuing Basel III Compliant Debentures

- Issuance of Basel III compliant Debentures will improve the capital adequacy ratios of the Bank.
- Issuance of Basel III compliant Debentures will raise funds for expansion of the lending portfolio.
- The funds raised through the proposed Debenture Issue being of a medium to long-term nature will reduce maturity mismatches in the assets and liabilities portfolios of the Bank.
- The cost of capital attributable to Debentures is less than the cost of capital attributable to equity and issuance of Debentures thereby enables a reduction in the overall cost of capital relative to the situation that would prevail if an equity issuance were made instead of an issuance of Debentures.
- Upon the occurrence of a Trigger Event, any outstanding balance of these Debentures including the total par value of the Debentures and Debenture

Interest accrued and unpaid as at that date will be converted to ordinary voting shares of the Bank. As a result, the non-viability conversion has the effect of acting as a buffer by reducing outstanding claims from liability holders (Debenture holders) in the event of an occurrence of a Trigger Event.

- Voting rights of existing ordinary voting shareholders are not altered as long as the Non-viability conversion Debentures are not converted into ordinary voting shares of the Bank, and to the extent that a Trigger Event does not occur the issuance of these Debentures is a suitable instrument to improve capital adequacy and fund growth without resorting to a new issue of equity.

4. Issuance of Basel III Compliant Debentures

In order for the Debentures to be recognised as Tier 2 Capital of the Bank under Basel III as described in the Banking Act Direction No. 1 of 2016 issued by the Central Bank of Sri Lanka, the Debentures are required to have the following minimum features:

- Issued and fully paid in cash
- Listed on a recognised stock exchange
- Redeemable
- Subordinated to the claims of depositors and general creditors

- Unsecured and not covered by a guarantee or any other arrangement that legally or economically enhances the seniority of the claim above the depositors and general creditors of the Bank
 - Issued with the prior approval from the Monetary Board of the Central Bank of Sri Lanka for inclusion in Tier 2 capital
 - A minimum tenure of 5 years
 - Rated by an acceptable Rating Agency
 - Have a feature through which, in the event that the Monetary Board of the Central Bank of Sri Lanka determining that it is appropriate and in the best interest of the Bank and therefore so directs the Bank to convert the Debentures into ordinary voting shares of the Bank such that through issuance of these new ordinary voting shares the new shares issued will cover the total outstanding under the Debentures (resulting from the “Trigger Event” referred to in this Circular)
 - The investors in the Debentures have no rights to accelerate the repayment of future scheduled coupons, except in bankruptcy and liquidation of the Bank
 - Neither the Bank nor a banking group over which the Bank exercises control or significant influence can have purchased the instrument and the Bank cannot directly or indirectly have funded the purchase of the instrument
- A venture capital fund/company and private equity company
 - A finance company licensed by the Central Bank of Sri Lanka in terms of the Finance Business Act No. 42 of 2011 (as amended)
 - A company licensed by the Central Bank of Sri Lanka to carry on finance leasing business under the Finance Leasing Act No. 56 of 2000 (as amended)
 - A company licensed by the Insurance Board of Sri Lanka to carry on insurance business in terms of the Regulation of the Insurance Industry Act No. 43 of 2000 (as amended)
 - A corporate (listed or unlisted) which does not fall under the above categories and is incorporated under the Companies Act No. 07 of 2007
 - An investment trust or investment company
 - A non-resident institutional investor
 - An individual with a minimum initial investment of Rs. 5,000,000.00

6. Specific Risks Considering the Objectives of the Issue

Since the proposed Debenture Issue is to raise up to Rs. 10 Bn. which is a relatively small amount as compared to the overall assets and liabilities base of the Bank, there is no specific risk factor that may lead to non-achievement of the objectives as per the stipulated timeliness, since the reliance on the Debenture proceeds for asset growth is marginal. However, an adjustment in asset growth and in maturity mismatch reduction may result to the extent that capital adequacy is not improved due to an under-subscription of the issue.

Until full disbursement of the Debenture proceeds, the funds raised through the Debenture Issue will be invested in Government Securities. Such investments in Government Securities are expected to generate a return of 7.80% p.a. at current market rates. In the event the Debenture proceeds are not fully utilized as per stated objectives, such non-utilisation can be expected to lead to a reduction in Net Interest Spread as undisbursed Debenture funds would be invested in Government Securities as opposed to being utilised in lending activities which can be expected to generate a higher Net Interest Spread.

In the event the proposed Debenture Issue is under-subscribed, the Bank may have to adjust asset growth to comply with Basel III requirements. However, under-subscription is not envisaged since there has been reasonable demand for recent Debenture Issues of the Bank. No further shareholder approval will be needed in the event the proposed Debenture Issue is not fully subscribed for or if the timeliness stated above are amended as thought fit by the Bank.

7. Continuing Disclosure Requirements

The Bank undertakes to disclose the progress of the utilisation of the proceeds of the proposed Debenture Issue in the Annual Report/s and future interim financial statements until funds raised through the proposed Debenture Issue are fully utilised. The format of the relevant disclosures to be made shall be disclosed in the Prospectus.

8. Terms and Method of Conversion

Occurrence of “Trigger Event”

A “Trigger Event” is determined by and at the sole discretion of the Monetary Board of the Central Bank of Sri Lanka (i.e. conversion of the said Debentures upon occurrence of the Trigger Event will be effected by the Bank solely upon being instructed by the Monetary Board of the Central Bank of Sri Lanka), and is defined in the Banking Act Direction No. 1 of 2016 of Web Based Return Code 20.2.3.1.1.1 (10) (iii) (a and b) as a point/event being the earlier of:

- “A decision that a write-down, without which the Bank would become non-viable, is necessary, as determined by the Monetary Board. OR
- The decision to make a public sector injection of capital, or equivalent support, without which the Bank would have become non-viable, as determined by the Monetary Board”.

The Banking Act Direction No. 1 of 2016 dated December 29, 2016 on the web-based returns specify in index reference 20.2.3.1.1.1 (10) (i) that, for such Debentures to be qualified as Tier 2 Capital (under Basel III guidelines) they should have a convertibility clause which enables

The Bank may consider allotting up to seventy-five per centum (75%) of the issue value on a preferential basis to identified Qualified Investors of strategic importance.

5. Eligible Investors for Basel III Compliant Debentures

Investment and trading in Basel III compliant Debentures will be limited to Qualified Investors.

A Qualified Investor for the purpose of determining eligibility to invest in issuances of Basel III compliant Debentures shall be:

- A commercial bank licensed by the Central Bank of Sri Lanka in terms of the Banking Act No. 30 of 1988 (as amended)
- A specialised bank licensed by the Central Bank of Sri Lanka in terms of the Banking Act No. 30 of 1988 (as amended)
- A mutual fund, a pension fund, Employees Provident Fund or any other similar pooled fund

the Debenture to be converted to ordinary shares in the occurrence of a Trigger Event. Furthermore, the Bank is of the view that any conversion of debt to equity upon conversion should have the same rights and privileges of the existing ordinary voting shareholders (ranking equal and *pari passu* with existing ordinary voting shares) and hence consider it appropriate to effect conversion of the proposed Debentures to ordinary voting shares.

The Bank on receipt of a Trigger Event notification from the Monetary Board of the Central Bank of Sri Lanka will immediately make a market announcement of such notification and thereafter announce the “price” and “dates” (such as the Trigger Event date and the date of allotment) pertaining to the pending conversion of Debentures to ordinary voting shares.

Conversion Ratio

Upon the occurrence of the Trigger Event, the Bank shall be required and entitled to issue and allot within twenty (20) days, ordinary voting shares of the Company ranking equal and *pari passu* with the existing ordinary voting shares, to the Debenture holders up to the outstanding balance of such Debentures, including the total par value of the Debentures and the Debenture interest accrued and unpaid. This will be at a conversion price which will be based on the Simple Average of Volume Weighted Average Price of ordinary voting shares of the Bank as published by the Colombo Stock Exchange, during the three (3) month period, immediately preceding the date of the Trigger Event. The CDS upload pertaining to ordinary voting shares will be completed within ten (10) market days from the date of allotment of such ordinary voting shares. In the event if any Debenture holder being entitled to a fractional allotment of an ordinary voting share on such issuance and allotment, the Bank shall settle the resulting sums in cash, based on the conversion price within fourteen (14) market days from the date of allotment of the said ordinary voting shares.

Conversion and Trigger

The Bank has decided to use the simple average of the Volume Weighted Average Price (VWAP) as indicated above due to its practicality and equitability as a pricing formula for conversion. This formula takes into account the market price over a three month period preceding the date of the

Trigger Event thereby lessening the impact of short-term price volatility and the volume impact in pricing. Due to the formula being applied using publicly available data published by the Colombo Stock Exchange, there is a high degree of transparency that results from the adoption of this method.

Ordinary voting shares arising from the non-viability conversion will be listed on the CSE.

If there is an issuance of ordinary voting shares to the Debenture holders upon the occurrence of the Trigger Event, a Debenture holder would cease to be a Debenture holder and would become a shareholder of the Bank to the extent of such issuance and will rank equal and *pari passu* with existing ordinary voting shareholders with voting rights after the allotment of new shares to such shareholders (being the previous Debenture holders) and will rank superior to the ordinary non-voting shareholders in respect of the voting rights attaching to the shares issued upon conversion.

Subsequent to the Debenture holders becoming shareholders of the Bank, due to the occurrence of the Trigger Event and the resultant conversion, they would be entitled to exercise such rights as are exercisable by the other shareholders of the Bank holding ordinary voting shares. Once the conversion of Debentures is concluded, the convertible Debentures will cease to exist.

Dilution of Shareholding upon a Conversion of Debentures

In the event of conversion to ordinary voting shares, there would be a dilution of the existing shareholding percentage held by the existing shareholders. However, the extent of the dilution will be dependent on several factors that cannot be determined at this point, due to the following:

The number of shares to be issued resulting from such a conversion will be determined by the “Conversion Price” at the “Trigger Point” as detailed below:

There will be a dilution impact on the shareholdings of the existing shareholders.

If the simple average of the Volume Weighted Average Price (VWAP) at the point of conversion is low compared to the prevailing share price, it would result in the

allocation of a comparatively higher number of ordinary voting shares by the Bank to the Debenture holders, which will dilute the shareholding of existing shareholders.

If the simple average of Volume Weighted Average Price (VWAP) at the point of conversion is high compared to the prevailing share price, it would result in the allocation of a comparatively lower number of ordinary voting shares by the Bank, which will dilute the shareholding of existing shareholders to a lesser extent than in the former instance described above.

In order to avoid dilution of the shareholding of the existing shareholders due to a conversion, in the event of there being a likelihood of the occurrence of the Trigger Event, prior to conversion of the said Debentures into ordinary voting shares, the then existing shareholders will be first called upon to infuse additional share capital and if such infusion is not forthcoming the proposed Debenture (i.e. Tier 2 Capital) will get converted into ordinary voting shares of the Company upon the determination of the “non-viability” point by the Monetary Board of the Central Bank of Sri Lanka and upon instructions being issued to the Bank in this regard.

The extent of dilution of existing shareholders will have to be determined by reference to the number of shares that are in issue at the time of such a conversion. The number of shares that are in issue at the time of a conversion can vary during the tenure of the Debentures due to the issuance of new shares by way of scrip dividends, rights issues, capitalisation of reserves, and/or any other relevant corporate action.

However, it is unlikely that the Trigger Point would occur given the AA (Ika)/Stable credit rating of the Bank by Fitch Ratings Lanka Limited and the strong performance of the Bank.

Pre-emptive Subscription Rights and Risk Associated with Debentures

Waiver of Pre-emptive Rights

In keeping with the Central Bank regulation, it is the Bank’s intention to obtain shareholder approval for the issuance of ordinary voting shares [which may be required to be issued due to the Monetary Board of Central Bank of Sri Lanka instructing the Bank to exercise

the convertible feature attached to these Debentures (the occurrence of the "Trigger Event") and to waive the pre-emptive rights of the existing ordinary voting and non-voting shareholders.

Non-occurrence of a Trigger Event

In the event of a non-occurrence of a Trigger Event these Debentures will be redeemed after 5 and 10 years from the date of allotment of such Debentures and the principal sum and unpaid and accrued interest (if any) payable on the redemption of Debentures will be paid not later than three (3) market days from the date of redemption, unless otherwise a Trigger Event occurs.

9. Reason for Convening an Extraordinary General Meeting

As per rule No. 2.2.1.k of the Listing Rules of the Colombo Stock Exchange, the Company is required to obtain the approval of the shareholders for the proposed Debenture Issue by way of a Special Resolution. It will also be necessary to obtain, by means of a duly passed Special Resolution, approval of the shareholders for the proposed share issue which arises pursuant to the conversion of Debentures, which may affect the rights attached to the Company's existing ordinary voting and non-voting shares, in compliance with Section 99 of the Companies Act No. 07 of 2007.

Therefore, an Extraordinary General Meeting of the Bank is being convened in accordance with the Notice of Meeting attached hereto, for the purpose of passing the Special Resolutions set out therein.

Shareholders who are unable to attend the meeting in person are kindly requested to complete the enclosed Form of Proxy (in accordance with the instructions specified therein) and to deposit it at the Registered Office of the Company not less than 48 hours before the time appointed for the meeting.

By Order of the Board of
Commercial Bank of Ceylon PLC



Ranjani Gamage (Mrs.)
Company Secretary

March 6, 2018
Colombo