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CONTINGENT CAPITAL SECURITIES: EVOLUTION OR DISRUPTION?

Anna T. Pinedo, Morrison & Foerster LLP

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Long before taxpayer-sponsored bailouts or state-sponsored "resolutions" of financial institutions came to occupy such a prominent place in our collective consciousness, financial institutions relied on hybrid capital securities as an important component of their funding plans.

Hybrid securities have certain equity and certain debt characteristics and provided an attractive, cost-efficient capital-raising tool. Trust preferred securities, mandatorily convertible debt securities, and various other forms of preferred stock were viewed by issuers as non-dilutive and had tax and ratings advantages.

Although the regulatory treatment varied by jurisdiction, many bank regulators recognized some component of these instruments as qualifying for Tier 1, or the most desirable form of, capital. The financial crisis changed perceptions of these securities. The securities did not prove to be sufficiently "loss-absorbing" for their financial institution issuers and failed to provide a capital cushion. In many cases, regulators were required to intervene to cause financial institution issuers to defer payments on these securities as part of recapitalization transactions or as a condition of receipt of state aid.

This experience has led to an emerging market for new securities, known as contingent capital instruments. Contingent capital securities are intended to provide a financial institution issuer with "buffer" capital during stress scenarios when it would be difficult for the financial institution to raise new capital and thereby forestall or avoid a failure or state-sponsored capital injection. This article provides a brief overview of hybrid securities and the emerging market for contingent capital securities.

Hybrid securities

As mentioned above, hybrid securities combined certain elements typically associated with equity securities with elements associated with debt securities. In designing a hybrid security, the objective generally was to develop a financial instrument that was sufficiently equity-like that it would be considered "loss absorbent" and would qualify as Tier 1 capital for the bank holding company issuer and receive equity credit from rating agencies. An equity security has certain basic characteristics, such as, for example, no fixed maturity debt, no obligation on the issuer's part to make ongoing payments which if not made would trigger a payment default, and loss absorption for creditors.

However, if the instrument had sufficient debt-like traits, then it might be considered debt for tax purposes and payments on the instrument would be tax deductible for the issuer. A debt security usually has fixed payments and a stated maturity date. In a liquidation, debt holders have a right to receive payments prior to equity holders.

The most "efficient" hybrid securities, like trust preferred securities which were widely used by U.S. banks, attained the right balance between equity and debt. Payments on the securities were tax deductible for the issuer, and the issuer usually was permitted to defer payments on the instruments for some period. The ability to defer payments was believed to provide the issuer with some flexibility in a downturn so the issuer could restructure its obligations. Hybrid investors who purchased these securities had come to treat them as bonds and expected that the issuers would exercise their early redemption options on the securities.

Payment deferral was not viewed as a real possibility. A financial institution is dependent on investor confidence; a lack of confidence in the strength of the institution could lead to a bank run. Exercise of a discretionary payment deferral right by a financial institution would erode investor confidence and have severe repercussions.

As a result, the deferral and other loss-absorbing features did not help the financial institution issuer during the crisis. Rating agencies revised their view of these securities, and the resulting downgrades also contributed to a loss in value. Investors became increasingly skeptical of the value of any structured security and became quite focused on tangible common equity levels as the principal indicator of the strength of a financial institution's capital base.

This skepticism and focus on tangible common equity underlies the Basel III bank regulatory framework. Basel III emphasizes the quality, consistency and transparency of the capital base. In order to restore confidence and address perceived deficiencies relating to regulatory capital, the Basel III framework emphasizes that:

- Tier 1 capital must help a bank remain a going concern; regulatory adjustments must be applied to the common equity component of capital;
- regulatory capital must be simple and harmonized for consistent application across jurisdictions; and
- regulatory capital components must be clearly disclosed by financial institutions in order to promote market discipline.

Tier 1 capital must consist predominantly of "common equity," which includes common shares and retained earnings, and must satisfy particular prescriptive criteria.

In addition, capital securities must contain certain loss absorbency features at the point of non-viability of an institution. The principal requirement is that upon a specified trigger event, which may be the institution's failure or the point at which a state injection of capital would be required (i.e., once the entity is a "gone concern"), the relevant instrument must be subject to a write-down or conversion into equity. This "bail-in" type feature is intended to avoid future taxpayer supported injections of capital, and require stakeholders in a financial institution to be the principal bearers of risk of loss.

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Contingent capital securities

Contingent capital securities include non-viability, gone-concern or "bail-in" type instruments, as well as "going concern" instruments. A contingent capital instrument is intended to provide loss absorbency to an institution and, in the case of a going concern, intended to absorb losses in order to strengthen the institution's capital base without requiring the institution to seek new financing.

The role of contingent capital in an institution's capital structure differs by jurisdiction. In certain jurisdictions, in order for an instrument to qualify for Tier 1 treatment it must be an equity security. In such case, a contingent capital instrument may provide buffer, or surplus, capital but may not be used to satisfy the minimum capital requirements. In addition, there are various types of contingent capital instruments.

A contingent capital instrument may consist of a debt instrument that automatically converts to equity or the principal of which is written down upon certain the occurrence of certain trigger events. Automatic conversion removes discretion from an issuer and thereby would avoid the impediments associated with discretionary deferral features in old hybrids. There also are other types of contingent capital instruments, including some, like committed capital facilities, that have been used by insurance and reinsurance companies and by financial guarantee companies.

Although there have been a number of issuances of contingent capital securities since 2009, a standardized market for these securities has not yet developed despite indications of investor interest. A number of questions relating to the design of these securities and their treatment must be addressed in order for market practice to settle.

Trigger events

The contingent capital securities that have been issued to date have been structured as debt securities and incorporate one of two features: either a conversion of debt to equity upon breach of the relevant trigger or a write-down of debt upon the breach of the relevant trigger. Lloyds and Credit Suisse have issued contingent capital instruments that convert to equity upon the breach of specified triggers. Rabobank has issued contingent capital instruments that employ the principal write-down feature.

Academics, regulators and market participants have contemplated various possible triggers, including a trigger based on capital ratios, a trigger based on the exercise of regulatory discretion and a trigger based on certain market-based metrics. A trigger based on capital ratios requires conversion or write-down once the issuer's Tier 1 capital ratio falls below a threshold either specified in advance (at issuance) or by the regulator. A regulatory trigger permits the issuer's principal regulator to determine when conversion or write-down is necessary in order to prevent the institution's failure. A market-based trigger might rely on the issuer's stock price, public float, or CDS spreads.

Each of these formulations has distinct advantages and disadvantages for the issuer, regulator, and investor. A regulatory capital-based trigger is clear and objective, which may be preferable for an investor. A regulator may prefer to preserve its discretion and a regulator may well be in the best position, given its knowledge of the issuer and the sector and its appreciation of the possible systemic impacts; however, an investor is unlikely to be as comfortable with a discretionary trigger. A market-based trigger may prove capable of market manipulation and result in unintended consequences, such as shorting activity.

To date, most contingent capital instruments have incorporated a regulatory capital trigger. A few incorporate a dual trigger, which includes a discretionary trigger to supplement the regulatory capital trigger. Even once the issuer and its advisers have determined the appropriate triggering event, setting the right level may prove challenging. In the case of a capital ratio, if the contingent capital is to be going-concern capital, then the trigger must be set at a high enough capital level so that it is not triggered while the issuer remains fully viable, but not so high that it is likely to be triggered in only a mild downturn. At the other end of the spectrum, the trigger also cannot be so low that it allows losses to mount for too long, leaving little or no value left in the issuer and effectively making the contingent capital the gone-concern kind.

Legal and tax considerations

An institution that is contemplating issuing a contingent capital instrument also must take into account any required approvals and corporate governance matters. The institution must obtain the requisite corporate approvals to issue the security. Particularly in the case of a contingent capital instrument that is structured as a debt security that converts to equity, the issuer will want to consider whether equity issuances are subject to pre-emptive rights.

Also, the issuer will want to confirm that it has sufficient authorized stock reserved for a future conversion. If the issuance may result in significant dilution to existing shareholders, the institution also may be required to obtain additional approvals from shareholders and from the securities exchange on which its equity securities are listed or quoted.

The issuer also will want to consider whether the proposed instrument will be characterized as debt for tax purposes. The tax treatment of contingent capital products differs by jurisdiction as there is no uniformity across national tax laws in characterizing such products for tax purposes. Generally, payments made by the issuer on a security are deductible for tax purposes if the instrument is characterized as indebtedness. Such a deduction will render the instrument more cost-efficient for the issuer.

In making the debt for tax assessment, regulators typically will consider whether the financial product represents an unconditional obligation on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future. With an instrument that converts to equity, it may not be clear that the holder would have the rights of a debt holder for the life of the security

Ratings, index eligibility and other considerations

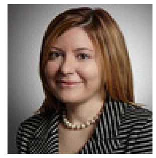
Finally, an issuer also will want to consider whether the security will be rated by one of the credit rating agencies. Since rating agencies generally rate only debt securities, there has been some ambiguity concerning the approach for contingent capital instruments.

Standard & Poor's has published a proposal regarding bank capital in which it notes that instruments that qualify as Tier 1 capital and meet all other applicable S&P criteria would be eligible for intermediate equity content, even without a contingent capital feature. Going-concern contingent capital instruments would be eligible to receive intermediate equity content if they are classified as Tier 1 or Tier 2 capital and meet all other applicable S&P criteria because they are viewed as having strong capacity to absorb losses on a going-concern basis through write-down or conversion.

Moody's has published a request for comment that discusses ratings approach for bank hybrids and contingent capital. Based on the proposal, Moody's would rate contractual non-viability securities and junior securities that may be subject to bail-in, but would not rate "high trigger" contingent capital securities.

Given that some traditional bank investors may only be able to purchase securities that have been rated, the ability to obtain at least one rating may affect the marketability of a security. Similarly, many bank investors that measure their performance against indices focus on whether a particular debt security will be eligible for inclusion in one of the major bond indices. There also has been some ambiguity as to whether a contingent capital security with a conversion feature would be eligible for inclusion in an index.

Despite these unresolved issues, many European banks that seek to strengthen their capital base have found extraordinary investor interest for their contingent capital securities. Given that the new capital rules required to implement Basel III are only just now being phased-in, and that the market for contingent capital securities has not yet become standardized, it may be premature to speculate as to the ultimate role that these securities will have in the capital structure of financial institutions and the role that these securities will play in mitigating the effect of future crises or downturns



ABOUT THE AUTHOR

Anna Pinedo has concentrated her practice on securities and derivatives. She represents issuers, investment banks/financial intermediaries, and investors in financing transactions, including public offerings and private placements of equity and debt securities, as well as structured notes and other hybrid and structured products.