MORRISON | FOERSTER

Contingent Capital and Related Developments

June 28, 2013

NY2 717584

©2013 Morrison & Foerster LLP | All Rights Reserved | mofo.com

Agenda

We will address:

- Basel III guidance and status of implementation;
- Going-concern and gone-concern capital;
- Contingent capital structures;
- Market experience; and
- Ratings, tax and legal considerations.

Basel III

Basel III – A Brief History

- BCBS consultative document – December 2009
- BIS announcement and annex – July 2010
- August 2010 consultation on “gone concern” capital requirements
- BCBS agree calibration of capital standards – September 2010
- BCBS proposals endorsed in November 2010
- Final Basel III rules published in December 2010
- Basel Committee Decision on loss absorbence at Point of Non Viability in January 2011
- Basel III revised and republished in June 2011

Basel III Capital Requirements

- **Common equity**: minimum requirement raised gradually from 2% to 4.5% of risk weighted assets, phased in during 2013 and 2014
- **Overall Tier 1 capital**: requirement raised gradually from 4.5% to 6%, phased in during 2013 and 2014
- **Minimum total capital**: requirement remains at 8%
- **Capital conservation buffer**: 2.5%, phased in during 2016, 2017 and 2018
- **Countercyclical buffer**: range of 0% to 2.5%
  - Both buffers to consist of common equity only

Basel III Capital Requirements (cont'd)

- Tier 1 capital components and qualification:
  - Common equity
  - Non-common equity instruments meeting specific criteria
- Tier 2 capital: Qualifying subordinated equity and debt instruments
- Regulatory adjustments and deductions from capital
  - Mostly made to/from common equity Tier 1 capital
- Write-off/conversion of capital instruments
  - Going-concern
  - Gone-concern

Basel III Capital Requirements (cont'd)

- Phase-in requirements
  - Minimum capital requirements fully phased in by 2015
  - Regulatory adjustments and deductions beginning in 2014
  - Grandfathering of certain instruments
- Applicability
  - Internationally active banks subject to the Basel II Accord (2004-2006)
  - Will be made applicable to all EU banking organisations and certain investment firms under the proposed revised European Capital Requirements Directive and new Capital Requirements Regulation (CRD 4)
  - Will be made applicable to U.S. banks that are subject to minimum capital requirements, including Federal and State savings banks, to bank and savings and loan holding companies other than "small bank holding companies" and to top-tier U.S. bank and savings and loan holding companies of non-U.S. banks. It will not apply to non-U.S. banks, but will apply to U.S. subsidiaries and holding companies of non-U.S. banking groups

Basel III Capital Requirements (cont'd)

- In U.S. Basel III proposals published by OCC, FRB and FDIC in June 2012
  - Comment deadline passed in October 2012 with over 2000 comments. In November 2012, the Federal banking agencies announced that the Basel III implementation date would be delayed, due to the level of comments expressing concerns and have not suggested any revised date for U.S. Basel III implementation
- In Europe, European Commission published CRD4 legislative proposals in July 2011
- Ongoing discussions between U.S. and EU authorities as to harmonizing implementation dates for Basel III. In November 2012, the European Banking Federation sent a letter to Commissioner Barnier, requesting a 1 year delay in implementation of CRD4 in the light of the indefinite U.S. delay in implementation

Basel III Consistency

- U.S. Basel III proposals are broadly consistent with Basel III
- In E.U., proposed form of CRD4 legislation differs from Basel III in several respects, earning it only a "C+" on its report card from the Basel Committee ("A's" given to U.S. and Japan)
- Key differences in E.U. implementation, affecting capital:
  - Going-concern loss absorption
  - Gone-concern loss absorption
  - Global SIFI surcharge
  - Timetables for phase-in of capital requirements and regulatory adjustments/phase-out timetables of non-qualifying instruments may be accelerated by national regulators

Going-Concern Capital and Loss Absorption

Going-Concern Loss Absorption

- Basel III mandates that Tier 1 capital must have the ability to absorb losses on a going-concern basis
- Bank must have full discretion at all times to cancel distributions (coupons/dividends) on non-common equity Tier 1 capital without giving rise to an event of default or restrictions on the bank (other than as to distributions to holders of common equity)
- Consequently, "dividend/coupon pushers" (whereby the issuer is obliged to pay a coupon/dividend on the Tier 1 instrument if it pays a coupon/dividend on common equity or other instruments ranking equally or junior to such Tier 1 instrument) cannot be contained in Tier 1 instruments, nor alternative coupon satisfaction mechanisms

Going-Concern Loss Absorption (cont'd)

- However, Basel III specifically envisages that "dividend stoppers" (whereby if the issuer does not pay a coupon/dividend on the Tier 1 instrument, it is obliged not to pay coupons/dividends on its common equity or other instruments ranking equally or junior to such Tier 1 instrument) are not a prohibited restriction for this purpose
- This, despite the additional Basel III requirement that a non-common equity Tier 1 instrument must contain no feature that would hinder a recapitalization

Going-Concern Loss Absorption – Ongoing Payments

- CRD4 legislation reflects the "no hindrance to recapitalisation" requirement, but interprets it as prohibiting dividend stoppers
- Has the effect of reversing the usual priority of payments between instruments on the debt/equity continuum, by allowing the payment of distributions to common equity holders, while more senior Tier 1 instruments are not being kept current
- U.S. Basel III proposals do not prohibit dividend stoppers in relation to common stock, but U.S. regulators are considering limited prohibition to permit payment of one-penny dividends to common shareholders

Going-Concern Loss Absorption – Principal

- Basel III requires all non-common equity Tier 1 instruments which are classified as liabilities for accounting purposes to absorb losses on a going-concern basis by either being converted to common shares, or by a principal write-down or write-off, in each case at a pre-specified trigger point
- Any write-down must have the effect of:
  - Reducing the claim on the instrument in liquidation
  - Reducing the amount repaid when a call option is exercised
  - Partially or fully reducing coupon/dividend payments on the instrument
- Draft CRD4 legislation requires such loss absorption capacity for all Additional Tier 1 instruments, whether accounted for as debt or equity
- U.S. Basel III proposals do not include instruments classified as liabilities in Additional Tier 1, even with a going-concern loss-absorption feature
- Divergence potentially significant for regulatory capital market, given that it will be increasingly difficult (impossible?) to obtain debt accounting treatment for Tier 1 instruments in a post-Basel III world

Going-Concern Loss Absorption – Principal (cont'd)

- Draft CRD4 legislation specifies that the trigger point for conversion/principal write-down should be a Common Equity Tier 1 capital ratio lower than 5.125%, or such higher percentage that may be specified in the instrument's documentation
- U.S. Basel III proposals do not address a minimum capital ratio trigger point
- Basel III does not specify whether any principal write-down must be permanent or whether it can be temporary i.e. it can be reversed by the principal amount being "written-up" again in certain circumstance

Gone-concern Loss Absorption

- January 2011 paper of Basel Committee on loss absorbency at point of non-viability mandates that all non-common equity Tier 1 and Tier 2 instruments must be fully loss-absorbing at the point a bank becomes non-viable
- Loss absorbency is to be achieved by way of permanent write-down of principal of the instrument or its conversion to equity
- PONV is either:
  - A decision to make a public sector injection of capital, without which the bank would be non-viable; or
  - A decision that a write-down/conversion is necessary and that the bank would be non-viable without the write-down/conversion
- Loss absorption may be effected by either:
  - Terms and conditions of relevant instrument requiring write-off/conversion at the PONV at the option of the relevant resolution authority; or
  - The jurisdiction whose laws govern the instrument having provisions (as confirmed by a peer group review) requiring such loss absorption at the PONV, and there is disclosure that such instruments are subject to loss pursuant to such provisions of law

Gone-concern Loss Absorption—European Position

- Draft CRD4 legislation does not provide for PONV loss absorption for Tier 1/Tier 2 instruments
- Loss absorption intended to be dealt with by way of the second alternative proposed by the Basel Committee, in the terms of the draft Recovery and Resolution Directive intended to be enacted and implemented in EU member states
- Draft RRD provides inter alia for regulators to have “bail-in” powers, as part of overall action taken to resolve a bank with minimum systemic instability/ cost to tax payers. These would allow resolution authorities to compel the write-down or conversion of a broad range of liabilities of a failing bank/financial institution
- Such liabilities are proposed to include non-common equity Tier 1 instruments, Tier 2 instruments, other subordinated debt and most senior unsecured debt (excluding guaranteed deposits and very short term debt)

Gone-concern Loss Absorption—European Position (cont'd)

- RRD (when enacted) to be implemented by member states by 31 December 2014, except that implementation of bail-in provisions may be delayed until 31 December 2017
- Therefore, depending on their jurisdiction, many European banks' CRD-4 compliant Additional Tier 1 and Tier 2 capital may not be subject to compulsory write-down/conversion until 2018, potentially leading to an uneven playing field between different jurisdictions both inside and outside of the EU
- Banks will be required to maintain minimum levels of own funds and liabilities that can be bailed-in where required, expressed as a percentage of their total (non-own funds) liabilities. The report of the Rapporteur for the European Parliament on the RRD proposes this be expressed as a percentage of risk weighted assets

Gone-concern Loss Absorption—European Position (cont'd)

- Minimum levels of bail-inable debt are proposed to be set by regulators in the headquarter jurisdiction of the bank.
- Therefore there is a lot of scope here for divergence between different member states. The European Banking Authority is to report to the European Commission by 2018 as to the amounts prescribed by different member state regulators
- In addition to discretion over levels of bail-inable debt, member state regulation authorities are to have the power to apply different rates of debt to equity conversion at PONV for different classes of liability

European Banking Authority — Recommendation on Temporary Capital Buffers

- As part of efforts to increase market confidence in E.U. banks, and in conjunction with its stress tests on banks, EBA published a recommendation in December 2011 as to creation of temporary capital buffers by banks, which could include newly-issued contingent capital securities complying with a suggested term sheet
- These Buffer Convertible Capital Securities could count, along with common equity, towards a minimum 9% Core Tier 1 capital ratio prescribed by the EBA
- Term sheet for the BCCS prescribed certain minimum features:
  - subordinated to all depositors and unsubordinated creditors and also to other subordinated creditors, other than those ranking pari passu. Therefore, they would rank senior to holders of common equity but pari passu with other Tier 1 capital
  - perpetual (in line with Basel III AT1 requirements) and not callable prior to 5 years

European Banking Authority – Recommendation on Temporary Capital Buffers (cont'd)

- redeemable only if replaced by equal or better quality capital and if Core Tier 1 ratio would continue to be at least 9% (or to meet minimum CRD4 requirements when finalised). Also specifically redeemable or amendable if they fail to qualify as AT1 capital after CRD4 implementation
- loss absorption triggered at Core Tier 1 ratio (including BCCS as well as other CET1 capital) below 7% (pre-CRD4 implementation) or CET1 capital ratio below 5.125% (post-CRD4 implementation)
- PONV loss absorption to be prescribed in the instrument's terms and conditions unless legislated for by bank's home member state

- Coupon provisions consistent with Basel III AT1 capital requirements, though no express mention of "no credit-sensitive coupon feature", nor any mention of coupon pushers, dividend stoppers or alternative coupon satisfaction mechanisms
- For loss absorption effected by conversion to equity, EBA leaves national regulators to decide on conversion rates, periods and permitted amounts of conversion

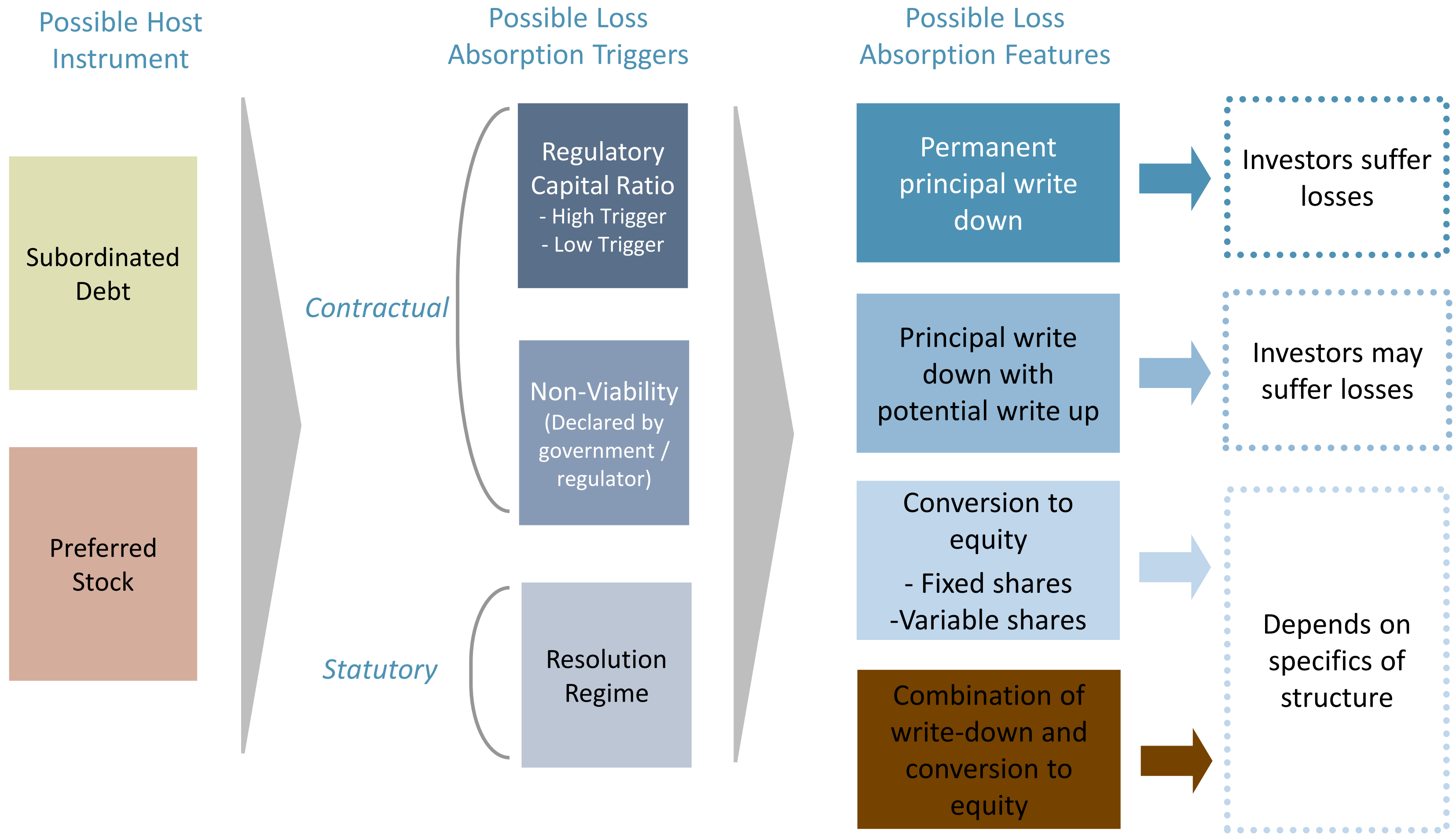
Non-viability loss absorption frameworks (select jurisdictions)

Regulators around the globe have approached non-viability differently

	US	Canada	China	Switzerland	Japan	Europe
Statutory versus contractual	• Statutory	• Contractual	• Contractual	• Contractual	• Contractual	• Statutory via EU-RRD
Non-Viability Assessment	• "Non-viability" is not expected to be defined in any statute or regulation • Traditional measures of viability, e.g., regulatory capital ratios, liquidity metrics, etc., will remain the relevant indicators of a firm's financial health	• Regulator determines bank ceased / is about to cease to be viable and, after conversion of all contingent instruments and considering other factors, it is reasonably likely bank's viability will be restored/maintained; or • Government announces bank has agreed to accept a gov. capital injection or equivalent support without which bank would have been determined by regulator to be non-viable	• Decision that a write-off or equity conversion, without which the Bank would become non-viable, as determined by the CBRC; or • Decision to make a public sector injection of capital, or equivalent support	• Measures to improve capital adequacy are inadequate to prevent firm from becoming i. insolvent; or ii. bankrupt; or iii. unable to pay a material part of its debts as they fall due; or iv. unable to carry on its business; or • Firm received direct or indirect extraordinary support from the Public Sector	• Unless measures under Deposit Insurance Act are taken, serious impediment could be caused to financial system; and i. Bank has / or at risk of suspending deposit repayments; or ii. Bank holds liabilities in excess of assets	• The firm is, or there are objective elements to support in the future: i. a breach of requirements for continuing authorisation (e.g. depletion of own funds); or ii. assets < liabilities; or iii. unable to pay its obligations as they fall due; or • Firm requires extraordinary public financial support
Comments	• Under the Dodd-Frank Act's Orderly Liquidation Authority, regulators were given new tools to use in connection with the liquidation of systemically important firms without the need for taxpayer injections of capital • Regulators are discussing the possibility of requiring systemically important firms to maintain minimum amounts of unsecured debt at the holding company that could, by statute, be written down and/or converted to common equity in connection with an OLA proceeding	• Compliant securities must satisfy 10 "principles" in order to qualify as capital • Requires loss absorption in the form of conversion to equity, not principal write-down	• The definition of "non-viability" remains open at this stage • Given potential approval issues with conversion, the write-down route appears more feasible	• Swiss rules require specific triggers (at 5% and 7%) for the large banks • Structures may include either principal write-down or conversion to equity	• Regarding valuation risk, we understand JFSA would reconfirm existing valuation methodologies rather than mark to market assets and liabilities	• Current proposal seen to reduce regulatory discretion compared to prior texts • Key risks relate to "conditions for authorisation" and the required "fair and realistic valuation of assets and liabilities"

Contingent Capital

Structural Alternatives



No Standardized Market Yet

- Common Features
  - **Term**:
    - Lloyds ECN (11/2009) – 10, 12 or 15 years
    - Rabobank SCN (3/2010) – 10 years
    - Rabobank Perpetual Non-Cumulative Capital Securities (1/2011) – Perpetual
    - Credit Suisse Tier 1 Buffer Capital Notes (2/2011) – Perpetual
    - Credit Suisse Tier 2 Buffer Capital Notes (2/2011) – 30 years

No Standardized Market Yet (cont'd)

- Common Features, Cont.
  - **Coupon**:
    - Lloyds ECN (11/2009) – Fixed premium between 1.5%-2.5% above the interest rate or dividend rate of the existing securities
    - Rabobank SCN (3/2010) – Fixed rate of 6.875%
    - Rabobank Perpetual Non-Cumulative Capital Securities (1/2011) –
      - 8.375% Rabobank Perpetual -- Initial rate of 8.375% to (but excluding) the first reset date (July 26, 2016); thereafter reset every five years based on the U.S. Treasury benchmark rate plus 6.425%
      - 8.40% Rabobank Perpetual -- Initial rate of 8.40% to (but excluding) the first reset date (June 29, 2017); thereafter reset every five years based on the U.S. Treasury benchmark rate plus 7.49%
    - Credit Suisse Tier 1 Buffer Capital Notes (2/2011) – Initial rate of USD 9.5% or CHF 9.0%, as applicable, to (but excluding) October 2013, which is the first call date of the Tier 1 capital notes; thereafter reset every five years

No Standardized Market Yet (cont'd)

- Common Features, Cont.
  - **Coupon**:
    - Credit Suisse Tier 2 Buffer Capital Notes (2/2011) – Initial rate of USD 7.875% to (but excluding) August 2016; thereafter reset every five years based on the mid market U.S. dollar swap rate LIBOR basis having a five year maturity plus 5.22%
  - **Ranking**:
    - Lloyds ECN (11/2009) – Direct, unsecured and subordinated obligations and rank at least *pari passu* with all other subordinated obligations, junior to all unsubordinated obligations and senior to all undated/perpetual obligations and all share capital
    - Rabobank SCN (3/2010) – Unsecured and senior to all subordinated capital of the issuer, but rank junior to all unsubordinated obligations
    - Rabobank Perpetual Non-Cumulative Capital Securities (1/2011) – With respect to payment obligations, the capital securities and coupons constitute direct, unsecured and subordinated obligations and rank pari passu and without any preference among themselves

No Standardized Market Yet (cont'd)

- Common Features, Cont.
  - **Ranking**:
    - Credit Suisse Tier 1 Buffer Capital Notes (2/2011) – Direct, unsecured and subordinated obligations of the issuer and rank *pari passu* and without any preference among themselves
    - Credit Suisse Tier 2 Buffer Capital Notes (2/2011) – Direct, unsecured and subordinated obligations of the issuer and rank *pari passu* and without any preference among themselves

No Standardized Market Yet (cont'd)

- Conversion vs. Write Down
  - **Conversion**:
    - Lloyds ECN (11/2009) – Automatically converted into ordinary shares (if core Tier 1 ratio falls below 5%)
    - Credit Suisse Tier 1 Buffer Capital Notes (2/2011) – Automatically converted into ordinary shares if: (i) Credit Suisse's reported Basel III common equity Tier 1 ratio falls below 7% or (ii) FINMA determines that Credit Suisse requires public sector support to prevent it from becoming insolvent, bankrupt or unable to pay a material amount of its debts, or other similar circumstances
    - Credit Suisse Tier 2 Buffer Capital Notes (2/2011) – Same conversion terms as CS Tier 1 Buffer Capital Notes

No Standardized Market Yet (cont'd)

- Conversion vs. Write Down, Cont.
  - **Write Down**:
    - Rabobank SCN (3/2010) – Automatic and permanent write-down of original principal amount to 25% of par and automatic redemption of write-down amount plus accrued and unpaid interest one business day after the second of two observation dates approximately 23 business days apart on which the equity capital ratio (equity capital divided by risk weighted assets of the Rabobank Group) falls below 7%; however, the occurrence of an event of default will temporarily delay the write-down

No Standardized Market Yet (cont'd)

- Conversion vs. Write Down, Cont.
  - **Write Down**:
    - Rabobank Perpetual Non-Cumulative Capital Securities (1/2011) – Loss absorption is triggered if: (i) equity capital ratio (equity capital divided by risk weighted assets) falls or remains below 8% or (ii) either the issuer or the Dutch Central Bank believes that there has been such a significant reduction in the issuer's retained earnings or similar reserves causing a significant deterioration in the issuer's financial and regulatory solvency position that the equity capital ratio will fall below 8% in the near term
    - If loss absorption is triggered, the issuer will cancel any accrued but unpaid interest and write-down the prevailing principal amount of the capital securities

No Standardized Market Yet (cont'd)

- **Triggers**:
  - Lloyds ECN (11/2009) – If core Tier 1 ratio falls below 5%, automatically converted
  - Credit Suisse Tier 1 Buffer Capital Notes (2/2011) – If Credit Suisse's reported Basel III common equity Tier 1 ratio falls below 7% or FINMA determines that Credit Suisse requires public sector support to prevent it from becoming insolvent, bankrupt or unable to pay a material amount of its debts, or other similar circumstances
  - Credit Suisse Tier 2 Buffer Capital Notes (2/2011) – Credit Suisse's reported Basel III common equity Tier 1 ratio falls below 7% or (ii) FINMA determines that Credit Suisse requires public sector support to prevent it from becoming insolvent, bankrupt or unable to pay a material amount of its debts, or other similar circumstances

2012/3 CoCos

2012 Offerings

- UBS Tier 2 Subordinated Notes
- Barclays Bank Plc Contingent Capital Notes

UBS Tier 2 Subordinated Notes – August 2012

- US$2 billion issue
- Section 3(a)(2) issuance from Jersey branch
- 10 Year Term
- 7.25% Coupon
- Direct, unsecured and subordinated
- Coupon non-cancellable, non-deferrable
- Not callable at issuer's option; however there are special event call rights for change of tax treatment/ regulatory re-classification of the notes

UBS Tier 2 Subordinated Notes – August 2012 (cont'd)

- Call option at 101% of principal plus accrued interest exercisable if (i) Swiss regulations change to reduce the amount of Progressive Capital Component required of Swiss banks, or (ii) Swiss regulations change to permit different features of notes as part of Tier 2/ Progressive Capital Component from the notes being offered
- Trigger Ratio is Core Tier 1 at 5% under Basel 2.5 (until 12/31/12) and CET1 at 5% per phased-in Basel III thereafter
- Contingency Trigger Event results in permanent write-off of principal
- In addition, express point of non-viability (PONV) write down in case of Viability Event

UBS Tier 2 Subordinated Notes – August 2012 (cont'd)

- Viability Event is the point at which, without such write-down or extraordinary state support to improve the bank's capital adequacy, the bank would otherwise be bankrupt, insolvent or unable to pay its debts, as determined by FINMA
- Rating BBB- (S&P)/BBB- (Fitch)
- Tier 2 capital
- Not dilutive

Barclays Bank Plc Contingent Capital Notes – November 2012

- US$3 billion issue – SEC Registered Offering
- Term of 10 years
- Coupon of 7.625%
- Direct, unsecured and subordinated
- Coupon non-cancellable, non-deferrable
- Call option at 100% of principal plus accrued interest exercisable at anytime (with 1 month's prior notice to the FSA) but if within 5 years of issue date, only if:
  - FSA approves in advance
  - There is a change of tax treatment/ regulatory re-classification of the notes
  - Barclays is (and would be post-redemption) in compliance with the FSA's Pillar 1 requirements

Barclays Bank Plc Contingent Capital Notes – November 2012 (cont'd)

- Write-down: Automatic transfer of the contingent capital notes to the issuer's parent or other issuer group company if the issuer's equity capital ratio (core Tier 1 capital to risk weighted assets of the Barclays Bank Group) falls below 7% as of any quarterly financial period end date or any day the equity capital ratio is calculated upon the instruction of the FSA.
- In the event of an automatic transfer, holders will no longer have any rights against the issuer with respect to repayment of the principal amount of the contingent capital notes or the payment of interest.
- Same effect for noteholders as a write-off of principal
- Should constitute Lower Tier 2 capital
- Not dilutive
- Little to no share price impact

KBC Contingent Capital Securities – January 2013

- Bear interest at the initial interest rate of 8.00% to January 25, 2018, payable semi-annually, and thereafter at a fixed rate based on the initial credit spread and the then prevailing USD 5-year mid-swap rate
- Constitute direct, unconditional, unsecured and subordinated obligations of the issuer, ranking *pari passu* among themselves without any preference
- Mature on January 25, 2023
- May be redeemed by the issuer, in whole but not in part, at any time prior to maturity, at their aggregate principal amount, together with any accrued but unpaid interest thereon, (a) on the reset date, (b) for taxation reasons and (c) upon the occurrence of a regulatory event
- Interest payments will not be discretionary or deferrable

KBC Contingent Capital Securities – January 2013 (cont'd)

- Subject to a contingent write-down if the CET1 ratio for KBC Group as of any quarterly financial period end date (or date on which the relevant regulator calculates the CET1 ratio) is less than 7.00% (unless a regulatory event has occurred and is continuing)
  - In the event of a contingent write-down, the full principal amount is automatically written-down to zero and the contingent capital securities will cancelled
  - CET1 ratio is the ratio of CET1 capital (the sum of core Tier 1 capital and common equity Tier 1 capital) to risk weighted assets
- Intended to be treated as Tier 2 capital
- Expected to be rated BB+ by S&P

Barclays Bank Plc Contingent Capital Notes – April 2013

- Barclays priced $1bn issuance of contingent capital
- This was a 10 NC 5 structure, which priced at 7.75%
- Initially, there was speculation that the structure would not be as attractive to investors
- Reportedly, there was nearly $3.5bn of demand for the deal
- Write-down: same write-down structure at a 7% core Tier 1 trigger
- First to include specific bail-in language:
  - "By its acquisition of the Notes, each holder of the Notes acknowledges, agrees to be bound by and consents to the exercise of any U.K. bail-in power by the relevant U.K. resolution authority that may result in the cancellation of all, or a portion, of the principal amount of, or interest on, the Notes and/or the conversion of all, or a portion, of the principal amount of, or interest on, the Notes into shares or other securities or other obligations of the Issuer or another person (other than in respect of each of the foregoing, payments of principal and interest that have become due and payable prior to the exercise of the U.K. bail-in power), and the rights of the holders under the Notes are subject to the provisions of any U.K. bail-in power which are expressed to implement such a cancellation or conversion."

Ratings Considerations

S&P Proposal on Bank Hybrids

- 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 can receive intermediate equity content if they are classified as Tier 1 or Tier 2 capital and meet all other applicable S&P criteria. Viewed as having strong capacity to absorb losses on a going-concern basis via write-down or conversion
- Tier 2 instruments that do not have a contingent capital feature (gone-concern contingent capital) would receive minimal equity content. Will only absorb losses in a non-viability situation

Moody's proposal

- Moody's published a request for comment that discusses ratings approach for bank hybrids and contingent capital
- Moody's would rate contractual non-viability securities and junior securities that may be subject to bail-in but moratorium would continue as to "high trigger" contingent capital securities

Moody's proposal

Will Rate	Where loss absorption is tied to triggers that are credit-linked, objective and measurable	Non-existent to date
Will not Rate	Where loss absorption occurs: 1) at the bank's option or 2) is tied to triggers unrelated to the bank's financial health such as the bank's stock price	This practice will not change
May not Rate	Where loss absorption is subject to regulatory discretion and/or the breach of regulatory capital triggers	This category is the focus of the Request for Comment

Tax Considerations

UK Tax Treatment of Regulatory Capital

- Neither Basel III nor CRD4 make provisions regarding tax treatment of regulatory capital
- UK Government asked HMRC to identify specific tax issues regarding capital instruments arising from forthcoming implementation of CRD4 legislation
- HMRC published discussion paper in June 2011
- HMRC stated it had no initial set views on what appropriate tax treatment should be and would form views based on inputs from market participants and it convened an industry working group for this purpose
- HMRC has not yet made a final determination on tax treatment of Additional Tier 1 capital, but has set out some general views

UK Tax Treatment of Regulatory Capital (cont'd)

- Distinguishes between "truly perpetual debt" (where holder has no right of repayment only arises as result of contractual clause providing for return of principal on liquidation)
- In terms of tax deductibility of payments, HMRC considers that CRD4-compliant Additional Tier 1 instruments will be "special securities" for purposes of s. 1000(1)F and s. 1015(4) CTA 2010, and in particular that payments on these instruments will be considered results-dependent (i.e. "depends (to any extent) on the results of the company") and therefore not deductible
- As to instruments not expressly (by their terms) bail-inable, but nevertheless potentially covered by a future bail-in power exercisable by authorities, payments thereon likely not to be regarded as results-dependent due to lack of contractual term linking payments to any future statutory bail-in power

UK Tax Treatment of Regulatory Capital (cont'd)

- Once statutory bail-in regime in effect, HMRC considers Additional Tier 1 instruments are likely to become results-dependent from that time
- HMRC has made a determination in respect of Tier 2 capital which has been reflected in the Finance Bill 2013 (published for comment with no closing date)
- Coupons on Tier 2 capital, whether already in issue or to be issued, will be deductible for the issuer, at least under current law

Selected U.S. Tax Issues

Debt Versus Equity

Debt Characteristics:

- Debt under local law
- A fixed maturity date on which a sum certain is payable
- A right to receive fixed interest without deferral
- An unlikelihood of conversion at the time of issuance.

Issue:

- Depending on the specifics, the conversion feature may raise the question whether the holder has an entitlement to repayment regardless of the issuer’s financial circumstances.
- Does the Holder have creditor’s rights?

Note: stock received on conversion may have FMV significantly lower than principal of contingent capital instrument. Compare Rev. Rul. 85-119 (notes payable in stock or proceeds of stock sold in offering, where FMV of stock equals principal on notes, treated as debt) and Notice 94-47 (Rev. Rul. 85-119 limited to its facts).

Selected U.S. Tax Issues (cont'd)

Section 163(l)

- If debt, Section 163(l) of the Internal Revenue Code would have to be analyzed to see whether it could deny issuer's interest deductions.
- Applies to "disqualified debt instruments", including "indebtedness of a corporation which is payable in equity of the issuer…"
- Internal Revenue Code employs a "substantial certainty" standard for debt payable in equity at option of holder.
- If same "substantial certainty" principle applied to contingent capital conversion, Section 163(l) would not apply if likelihood of conversion was remote.

Selected U.S. Tax Issues (cont'd)

Cancellation of Debt (COD)

- If debt, conversion into stock generally tax-free to the holder under a number of theories.
- However, if principal amount exceeds FMV of stock, conversion could generate COD income under Section 108(e)(8) to the issuer.
- TAM 200606037 takes this position, citing Treas. Reg. § 1.61-12(c)(2) definition of "repurchase" to include conversion.

Foreign Investor/Issuer Concerns

- If equity:
  - No portfolio interest exemption from withholding for foreign holders
  - Potential application of the CFC and PFIC rules with respect to U.S. holders of foreign issuers.
- If debt: would portfolio interest exemption apply for interest paid to foreign investors?

Other Considerations

Legal Considerations

For the issuer there will be a number of considerations, including:

- Regulatory capital treatment
  - Obtaining certainty from principal regulator
- Tax considerations
- Ratings
- Constituent documents:
  - For instruments that are convertible, are there limitations imposed by the home country on the issuance of common equity? pre-emptive rights? need to approve additional authorized capital? restrictions that would limit dilution?
  - Will the instrument prove too dilutive?
  - An incentive to short?
  - Other effects on the issuer's capital structure?
- Setting the triggers
  - High/low trigger
  - Consultation with principal regulator on the regulatory trigger

Issuance Format

- For foreign banks issuing into the United States, what are the options:
  - 144A issuances
    - Limits to QIBs
    - 144A may not be available for certain foreign banks due to fungibility concerns
    - Requires at the least a U.S. paying agent and certain indenture issues to be addressed
  - 3(a)(2) issuances
    - Broader marketing
    - Only available if a US branch or agency issues or guarantees
  - SEC–registered
    - May not be available to most foreign banks
    - The SEC may have concerns about “novel” financial products