

Hybrid securities: an overview

Ze'ev D Eiger, Peter J Green, Thomas A Humphreys and Jeremy C Jennings-Mares
Morrison & Foerster LLP

global.practicallaw.com/1-517-1581

The history of hybrid securities may well be divided into two periods: pre-financial crisis and post-financial crisis. Before the crisis, hybrid issuances by financial institutions including banks and insurance companies, and corporate issuers, which are generally utilities, were quite significant. Such product structuring efforts resulted in a vast array of hybrid products, such as trust preferred securities, real estate investment trust (REIT) preferred securities, perpetual preferred securities and paired or stapled hybrid structures. Following the financial crisis, regulators have been focused on enhancing the regulatory capital requirements applicable to financial institutions and ensuring that there is greater transparency regarding financial instruments. Regulatory reform will continue to affect the future of hybrid capital. While financial institutions have focused in recent years on non-cumulative perpetual preferred stock and contingent capital instruments, "traditional" hybrids, such as trust preferred securities, remain popular with corporate issuers.

This article provides a brief overview of the principal structuring, legal, tax, regulatory and accounting considerations related to the issuance of hybrid securities. In particular, it:

- Provides a general overview of hybrid securities.
- Considers some specific examples of hybrid securities.
- Examines how hybrid securities performed during the financial crisis.
- Outlines the regulatory reform that has been introduced in the wake of the crisis.
- Considers the emergence of contingent capital instruments and their potential to replace hybrid securities like trust preferred securities.

The chapter is a summary and does not purport to be a full discussion of the regulatory and tax issues, which are quite complex and differ jurisdiction by jurisdiction.

OVERVIEW OF HYBRID CAPITAL SECURITIES

Hybrid capital securities, or securities that have some equity characteristics and some debt characteristics, have been popular for over a decade. Hybrid securities lie somewhere along the equity-debt continuum, but where exactly, is the subject of great debate, and depends largely on the terms of the instruments as well as the provisions of applicable national laws. In fact, over its life, a hybrid security may exhibit different proportions of equity-like or debt-like traits, sliding along the continuum.

This section outlines:

- The format that hybrid securities can take.
- The objectives associated with hybrid capital.
- Some common types of hybrid securities.
- The types of companies that have issued hybrid securities.
- The relevant legal framework to consider in structuring a hybrid capital security.

- The main bank regulatory requirements and how these differ by jurisdiction.
- The main tax considerations and how these differ by jurisdiction.
- The accounting considerations.
- The ratings considerations.
- How hybrid securities can be offered and how and to whom they are usually marketed.

Format

Hybrid securities include:

- Certain classes of preferred stock.
- Trust preferred securities (for non-bank issuers).
- Convertible debt securities (for non-bank issuers).
- Debt securities with principal write-down features.
- Mandatorily convertible instruments.

Objectives

Issuers like hybrid securities because they are considered an attractive, cost-efficient means of raising non-dilutive capital. Hybrid securities are issued by financial institutions, including banks and insurance companies, as well as by corporate issuers, which are generally utilities. Hybrid securities often receive favourable treatment by ratings agencies and regulators when they analyse an issuer's capital structure. Many hybrids also provide a lower after-tax cost of capital for issuers compared to common stock.

Hybrids are popular with financial institutions, including banks and insurance companies, mainly because they provide a tax efficient means of raising capital while qualifying for favourable regulatory treatment. Corporate issuers, particularly those with substantial funding needs such as utilities, issue hybrids mainly because of their favourable tax and rating agency treatment.

Historically, an issuer and its advisers sought to structure a hybrid security that:

- Qualified for favourable equity treatment from rating agencies.
- Allowed the issuer to make tax-deductible payments.
- Qualified as Tier 1 capital for banks or bank holding companies (*see below, Bank regulatory requirements*).

The benefits of a hybrid security depend on its "equity-like" or "debt-like" characteristics. From a rating agency and bank regulatory-perspective, more equity-like hybrids generally receive more favourable treatment. From a tax perspective, more debt-like hybrids offer more favourable tax treatment for issuers.

When structuring a hybrid security, it is helpful to identify the core elements of common equity and the core elements of debt. There are a number of characteristics associated with "pure equity", including no maturity, no ongoing payments that could trigger a default if unpaid, and loss absorption benefiting all creditors. For example, common stock has no compulsory or fixed repayment obligation or term.

In contrast, debt usually has fixed payments and a stated maturity. An issuer can elect not to pay dividends on its common stock, but non-payment of principal or interest on a debt security generally constitutes an event of default. Common stock provides "loss absorption" for an issuer, meaning that common stockholders are the last class of security holders to receive distributions in a liquidation. By contrast, debt holders have a right to receive payments before equity holders.

Preferred stock may entitle the holder to a dividend, subject to declaration by the issuer, and may entitle the holder to some voting rights. As with common stock, non-payment of a preferred stock dividend will not trigger an event of default. However, non-payment may breach a covenant or other contractual undertaking by the issuer. Dividend payments may be cumulative, or non-cumulative.

Preferred stock may be convertible, at the option of the issuer or the holder, or mandatorily on the occurrence of certain events. While senior to common stock in liquidation, preferred stock provides some measure of loss absorption, by ranking behind unsecured debt in terms of priority of payment, in a bankruptcy or other degraded financial situation.

Most hybrids contain a deferral feature (optional or mandatory) that permits the issuer to defer the payment of interest or dividends. Hybrids also generally are deeply subordinated within the issuer's capital structure. Like an equity security, non-payment of distributions does not result in an event of default. In fact, a hybrid security holder has limited rights against the issuer for deferred interest payments.

In certain structures, deferred interest may be permanently cancelled if certain conditions are satisfied and, as a result, the holder of the hybrid security may forfeit its claim for deferred interest amounts. In other structures, the treatment of deferred payments is bifurcated. After some deferral period, the issuer must pay deferred interest through the issuance of capital (an alternate payment mechanism) up to a cap.

An alternate payment mechanism requires that deferred distributions on the hybrid can only be paid out of the proceeds from the issuance of more junior or parity securities or through payment-in-kind. In bankruptcy, however, the security holder's claim is limited to a maximum deferred interest amount.

Common types

The most common hybrid securities has been preferred securities with additional features designed to achieve enhanced economics or other efficiencies, such as trust preferred securities, REIT preferred securities and perpetual preferred securities. These preferred securities were also popular because they qualified for Tier 1 regulatory capital treatment and, in the case of trusts preferred securities and REIT preferred securities, payments on such securities were tax-deductible by the issuer. Trust preferred securities remain popular with utilities and other non-bank issuers.

Types of issuers

Before the financial crisis, many banks and insurance companies relied on the issuance of hybrid securities as an important component of their funding plans. Financial institutions appreciated that hybrid securities provided a tax efficient means of raising capital, while at the same time qualifying for favourable regulatory treatment. In addition, hybrids typically are non-dilutive at issuance and contain limited or no voting rights.

Corporate issuers, including utilities, also continue to use hybrid securities. Since corporate issuers are not subject to regulatory capital requirements, the regulatory treatment of hybrids is less important and corporate issuers instead focus on the tax and rating benefits associated with them. In addition, the fact that hybrids typically are non-dilutive at issuance and contain limited or no voting rights also is helpful for corporate issuers.

Relevant legal framework

Any issuer contemplating the offer and sale of a hybrid security should consider whether it has the necessary corporate authority. The creation of a new hybrid security may require that the issuer designate a new class of securities, having special rights and preferences.

If the security will be issued directly or through a special purpose trust, additional actions are required. Potentially, there are ongoing reporting requirements that may be applicable to any new special purpose trust.

A hybrid security may be offered in a private or a public offering (*see below, Offer format and marketing*), and in either case, the issuer must consider disclosure matters. Structuring of the hybrid security should involve close collaboration with the issuer's tax and accounting advisers.

Where the instrument provides for its possible conversion into common stock, the issuer needs to consider the effect of this instrument on the rights of existing common stockholders, and the steps needed to effect such a conversion.

In the case of a regulated institution, the issuer should be in close touch with its principal regulator to ensure that the offered security will receive the intended regulatory capital treatment (*see below, Bank regulatory requirements*). The issuer should also consult with rating agencies.

Bank regulatory requirements

From a bank regulatory perspective, there has not been a standardised approach to the treatment of hybrid capital instruments. In fact, following the financial crisis, regulators have identified the fact that there was no common approach to hybrid instruments as a concern. The Basel framework of the time did not address the features of hybrid instruments. The only available guidelines for banks and regulators were contained in the so-called "Sydney Agreement" of 1998. The Sydney Agreement stated that internationally active banks or bank holding companies generally would be expected to limit restricted core capital elements to 15% of Tier 1 capital (*see below*).

Banks have particular concerns when it comes to hybrid securities. Bank hybrid capital instruments constitute capital for regulatory capital purposes, but are usually treated as debt for tax purposes.

The Basel Accord, or Basel I, sets criteria for measuring capital adequacy. Basel I divides bank capital into two categories:

- Tier 1, or core capital.
- Tier 2, or supplementary capital.

Tier 1 capital includes:

- Common stock.
- Non-cumulative perpetual preferred stock.
- Disclosed reserves.
- Minority interests in the equity accounts of consolidated subsidiaries.

Tier 2 capital includes:

- Undisclosed reserves.
- Asset revaluation reserves.
- General provisions/loan loss reserves.
- Hybrid (debt/equity) capital instruments (like mandatory convertible debt and cumulative perpetual preferred stock).
- Term subordinated debt.
- Intermediate term preferred stock.

Under Basel capital requirements, banks are required to maintain certain ratios between Tier 1 and total capital to assets.

Regulated insurance companies are also subject to regulatory capital limits for hybrids. Ratings agencies consider the insurance regulators' views in assessing equity credit for hybrid securities issued by insurance companies. Most insurance companies issue hybrid securities through their holding company, rather than through the regulated entity.

The international prudential framework for capital requirements was reformed (known as Basel III) following the financial crisis, which has implications for hybrid instruments (*see below, International reform: Basel III and Practice note, Basel III: an overview*).

Main tax considerations

The main tax consideration is whether interest-like payments made (or accrued) by the issuer with respect to any hybrid security are deductible for tax purposes. Such a deduction is necessary for any hybrid security to provide a lower after-tax cost of capital for the issuer. Whether payments are in fact deductible depends on the characterisation of the instrument for tax purposes and the particular terms of any offering.

The tax characterisation of hybrid securities differs by jurisdiction as there is no uniformity across national tax laws in this respect.

Accounting considerations

The accounting considerations differ depending on whether the issuer prepares its financial statements in accordance with US generally accepted accounting principles (GAAP), international financial reporting standards (IFRS) or other national accounting rules.

From an accounting perspective, there are a few key issues:

- First, for hybrid securities that involve the use of a trust or other special purpose vehicle, the issuer should consider the treatment of its interest in this entity and whether the entity will be consolidated or de-consolidated or treated as a variable interest entity.
- For hybrids that involve a forward contract or other derivative instrument, the issuer should consider the treatment of the derivative contract, especially given the evolving views on issuer derivatives.
- Finally, there are important differences under GAAP and IFRS regarding the treatment of instruments having certain characteristics of equity securities and certain characteristics of debt securities.

Ratings considerations

Hybrid securities receive varying degrees of "equity content" from rating agencies based on their features and their anticipated effect on the issuer's capital structure. Rating agencies limit the overall amount of traditional hybrids to which they give equity treatment when considered relative to the issuer's overall capital structure. Rating agencies have separate ratings methodologies for financial institutions, such as banks and insurance companies, that differ from their ratings methodologies for corporate issuers.

Historically, rating agencies viewed hybrids favourably, because hybrids were believed to have some of the loss-absorbing features associated with common equity securities. It was believed that, to varying degrees, hybrid securities would provide a "cushion" within an issuer's capital structure in bankruptcy or on the occurrence of other adverse events. Rating agencies also considered the effect of the hybrid security on the issuer's cash flows. The analysis of the hybrid security is separate and distinct from the rating agency analysis of the issuer's overall credit rating.

In 2005, Moody's published its "Tool Kit" relating to its methodology for analysing hybrid securities. Publication of the Tool

Kit led to greater certainty regarding the features of hybrid securities that would be viewed favourably from a ratings perspective, and, as a result, a wave of new hybrid products were introduced.

The Tool Kit featured a continuum of five baskets, from the A basket, which is 0% equity and 100% debt, at one extreme, to the E basket, which is 100% equity and 0% debt, at the other extreme. To assign a hybrid security to a basket, Moody's assesses the instrument's equity-like characteristics.

During the financial crisis, the rating agencies took a number of actions related to bank hybrid securities. In July 2010, Moody's published "Revisions to Moody's Hybrid Tool Kit" in which it reaffirmed the basket approach, but outlined "revised basketing guidance". Moody's stated that, in analysing a hybrid security, it would consider the following:

- Does the hybrid absorb losses for a "going concern"?
- Does the hybrid absorb losses for a "gone-concern"?
- Is the loss absorbing hybrid there when needed?

As a general matter, hybrids that absorb losses for a going concern are generally eligible for D basket classification, while hybrids that absorb losses for a gone-concern, depending on maturity, are generally eligible for a C basket classification. The July 2010 statement also provided a chart illustrating the features or characteristics present in most common hybrid securities and the manner in which these would be considered for the purposes of assessing basket categorisation.

Offering format and marketing

Hybrid securities can be offered in private or public offerings. In the US, for example, the securities can be issued pursuant to a registration statement or an exemption from registration, such as that provided by Rule 144A (Rule 144A) under the US Securities Act of 1933, as amended (Securities Act). If an offering relies on Rule 144A and involves the issuance of securities by a trust, the trust can rely on an exemption for offerings to an unlimited number of investors who are "qualified purchasers" to avoid registration as an investment company under the US Investment Company Act of 1940, as amended (*section 3(c)(7)*). The securities may also be offered outside of the US in reliance on Regulation S under the Securities Act (Regulation S).

The principal investors in hybrid securities include other banks, insurance companies, pension funds, bond funds, and other institutional investors. Small denomination hybrid securities are also offered to retail investors.

HYBRIDS DURING THE FINANCIAL CRISIS

Early on in the financial crisis, commentators noted that many hybrid securities absorbed "significant losses". Hybrid investors had become accustomed to purchasing these securities and thinking of them, or treating them, as bonds. Investors often assumed that hybrid issuers would exercise early redemption options on hybrids as they arose.

Hybrid issuers surprised the market when they opted (or were encouraged by regulators) not to exercise their option to redeem outstanding hybrids because alternative (or replacement) capital would have been more expensive or possibly unavailable. As the crisis worsened, and governments intervened in the banking sector, taking extraordinary measures to restore confidence in the financial system, hybrid investors became more concerned about their prospects. In certain instances, hybrids also suffered from principal write-downs.

However, commentators noted that these securities were less able to absorb losses on a going concern basis during periods of financial stress than common equity. Commentators also noted that many governments conditioned their aid to ailing banks on an agreement that the bank issuers would not pay hybrid coupons.

Many issuers were also forced (or chose) to undertake exchange offers or other liability management exercises in relation to their outstanding hybrid securities as part of recapitalisation transactions.

Commentators also raised concerns, particularly in relation to a number of Tier 2 instruments, that principal write-down features were never triggered as they were designed to kick-in only in an insolvency scenario, while most bail-ins and injections of public funds occurred in advance of an insolvency in view of the perceived systemic consequences of a failure – the "too big to fail" concern.

The remainder of this section considers how the rating agencies, investors and regulators reacted to concerns about hybrids during the financial crisis.

Rating agencies

Rating agencies downgraded a number of hybrids, noting increased risk of coupon deferral and the possibility that hybrid investors would bear losses. During this period, the rating agencies announced changes to their rating methodology. In its announcement regarding its new rating methodology for hybrid securities, Moody's noted that given these crisis-related developments, hybrid ratings should eliminate any assumption of systemic support and should instead focus on the intrinsic creditworthiness of the bank issuer. Moody's also noted that its ratings would take into account the special features of the particular hybrid security.

Investors

Investors were frustrated that there was a lack of comparability among the types of financial instruments used by banks organised in different jurisdictions that received Tier 1 treatment and by the difficulty of assessing the relative features of these securities.

As a result, investors became increasingly focused on tangible common equity and reserves as the true indicator of a bank's regulatory capital strength. (Tangible common equity equals common shareholders' equity (excluding non-controlling minority interests) minus goodwill, intangibles, preferred shares and mortgage servicing rights (MSRs).)

Regulators

The G20 leaders committed to working together toward implementation of regulatory reform, including adoption of stronger capital requirements. The Group of Central Bank Governors and Heads of Supervision agreed that the Basel Committee on Banking Supervision (BCBS) should raise "the quality, consistency and transparency of Tier 1 capital." This objective was a guiding principle in the formulation of the Basel III framework (*see below, International reform: Basel III*).

POST-FINANCIAL CRISIS: REGULATORY REFORM

In the wake of the financial crisis, legislative reform internationally, and in the US and the European Union (EU), has had an impact on hybrid capital. Basel III (also referred to in this article as the Basel III framework) is a comprehensive set of international reform measures for strengthening the regulation, supervision and risk management of the banking sector, which includes enhanced capital requirements. Individual countries, however, are responsible for their own implementation of the Basel III framework. In the US, the implementation of the Basel III framework differs in certain respects, as discussed in more detail below. Similarly, in the EU, the implementation of the Basel III framework, as reflected in CRD4 (as defined below, *see Europe*), differs in certain respects, as discussed in more detail below.

International reform: Basel III

On 16 December 2010, the Basel III framework was finalised and published by the BCBS. The Basel III framework is intended to be

implemented by countries into their national laws, so as to be effective from 1 January 2013 onwards.

The Basel III reforms:

- Emphasise the quality, consistency and transparency of the capital base.
- Provide for enhanced risk coverage through the implementation of enhanced capital requirements for counterparty credit risk.
- Introduce changes to a non-risk adjusted leverage ratio.
- Incorporate measures designed to improve the countercyclical capital framework.

To rectify perceived deficiencies relating to regulatory capital, the Basel III framework emphasises 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 harmonised for consistent application across jurisdictions.
- Regulatory capital components must be clearly disclosed by financial institutions to promote market discipline.

Tier 1 capital must consist predominantly of "common equity", which includes common shares and retained earnings. The new definition of Tier 1 capital is closer to the definition of "tangible common equity" (*see above, Investors*).

The Basel III framework sets criteria that must be satisfied for non-common equity to be classified as Tier 1. These criteria indicate that a non-common equity Tier 1 security:

- Must be subordinated to depositor and general creditor (including subordinated creditor) claims.
- Cannot be secured or guaranteed.
- Must be perpetual with no incentives to redeem.
- Must have fully discretionary non-cumulative dividends.
- Must be capable of principal loss absorption (including a mandatory conversion to common shares or principal write-down at a pre-specified trigger point).
- Cannot hinder recapitalisation.

Principal redemption can only be made, whether on redemption or buy-back, with prior regulatory approval. Several "innovative" Tier 1 instruments will be phased out, including, for example, step up instruments, cumulative preferred stock and trust preferred stock.

The new minimum capital requirements were to be phased in between 1 January 2013 and 1 January 2015 and regulatory adjustments were to be phased in between 1 January 2014 and 1 January 2018. The recognition of existing capital instruments that do not comply with the new rules was to be phased out from 1 January 2013, with their recognition capped at 90% from such date, the cap reducing by 10% in each subsequent year.

Instruments that do not qualify as Tier 1 capital may still constitute Tier 2 capital if they meet certain criteria, including:

- Having a minimum original maturity of at least five years with no incentive to redeem.
- Being callable only by the issuer after a minimum of five years with prior supervisory approval.

Such instruments must also have no credit-sensitive dividend feature and in liquidation must be subordinated to depositors and unsubordinated creditors.

In January 2011, the BCBS published minimum requirements for loss absorbency features at the point of non-viability of an entity to be included in all Tier 1 and Tier 2 capital instruments. The principal requirement is that, on a specified trigger event, the relevant instrument must be subject to a write-down or conversion into equity. The trigger event is when the relevant authorities, due to the entity's non-viability, either: decide that a write-off or conversion is necessary, or decide to make a public sector injection of capital (or equivalent support), whichever is the earliest.

The BCBS has proposed that instruments that are issued on or after 1 January 2013 must meet these minimum requirements as a pre-condition to receiving the relevant regulatory capital instrument.

The BCBS has published a set of FAQs on the Basel III definition of capital, most recently updated in December 2011 (*Basel III definition of capital – Frequently asked questions*, www.bis.org/publ/bcbs211.pdf).

US

In many respects consistent with the proposed Basel III framework, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) has the effect of raising the required level of Tier 1 capital for banks, as well as the proportion of Tier 1 capital that must be held in the form of tangible common equity.

The Collins amendment provisions (*section 171*) of the Dodd-Frank Act, which is applicable to all financial institutions, requires the establishment of minimum leverage and risk-based capital requirements. These are set, as a floor, at the risk-based capital requirements and Tier 1 capital to total assets standard currently applicable to insured depository institutions under the prompt corrective action provisions of the Federal Deposit Insurance Act. In addition, the Collins amendment provision limits regulatory discretion in adopting Basel III requirements in the US and permit additional capital requirements for activities determined to be "risky", including, but not limited to derivatives.

By virtue of applying the prompt corrective action provisions for insured depository institutions to bank holding companies, certain hybrid securities, including trust preferred securities, will no longer be included in Tier 1 capital. The legislation applies retroactively to trust preferred securities issued after 19 May 2010. Bank holding companies and systemically important non-bank financial companies will be required to phase-in these requirements from January 2013 to January 2016. Mutual holding companies and thrift and bank holding companies with less than US\$15 billion in total consolidated assets are not subject to this prohibition.

Led by the US Federal Reserve Board on 2 July 2013, the three US federal banking agencies approved a broad and comprehensive revision of the regulatory capital rules applicable to all US banks and bank holding companies (except those with less than US\$500 million in total consolidated assets). The new rules are intended to replace existing Basel I-based capital requirements, implement the Basel III capital standards, and comply with certain requirements under the Dodd-Frank Act, including the Collins amendment provision and the requirement that all references to external credit ratings be removed from federal agencies' regulations and replaced with new standards of creditworthiness (*section 939A*). The capital requirements under the new rules are more onerous than the requirements under the Basel III framework. In addition, in the US, a security that is treated as debt for accounting purposes will not receive Tier 1 capital treatment.

The effectiveness of the new rules will be phased in according to different start dates, ranging from 1 January 2014 to 1 January 2019, and different phase-in periods, ranging from two years to nine years. The new rules will not be fully implemented until 1 January 2022. The new rules consist of the following:

- The Basel III Capital Rule introduces the Basel III standards for the components of, adjustments to, and deductions from

regulatory capital (the numerator in risk-based capital and leverage ratios), as well as the new minimum ratios under the prompt corrective action framework. The Basel III Capital Rule, among other things:

- subjects US banks and bank holding companies to the following minimum regulatory capital requirements:
 - a common equity Tier 1 capital ratio of 4.5% (newly introduced requirement);
 - a Tier 1 capital ratio of 6% (increased from the current 4%);
 - a total capital ratio of 8% of total risk-weighted assets (unchanged from the current requirement);
 - a Tier 1 leverage ratio of 4%, and, for those US banks and bank holding companies subject to the Advanced Approaches Rule (those with US\$250 billion or more in total consolidated assets or US\$10 billion or more in foreign exposures);
 - an additional leverage ratio of Tier 1 capital to total leverage exposure of 3%; and
- introduces regulatory capital buffers above the minimum common equity Tier 1 ratio, including a capital conservation buffer of a further 2.5% of common equity Tier 1 capital to risk-weighted assets and, for those US banks and bank holding companies subject to the Advanced Approaches Rule, a countercyclical buffer of up to 2.5% of common equity Tier 1 capital to risk-weighted assets that may be deployed as an extension of the capital conservation buffer.
- The Standardised Approach Rule, generally introduces a modified version of the Basel II standardised approach for calculating risk-weighted assets (the denominator in risk-based capital ratios) and would, together with the Basel III Capital Rule, become the new Collins Amendment "floor" for certain US banks and bank holding companies.
- The Advanced Approaches Rule modifies the existing Basel II advanced approaches rules for calculating risk-weighted assets to implement Basel III and to comply with section 939A and also applies (along with the Market Risk Final Rule) to US savings associations and savings and loan holding companies that meet the applicable thresholds.
- The Market Risk Final Rule, modifies the existing market risk rules to implement rules for calculating capital charges for market risk (commonly known as "Basel 2.5") and to comply with section 939A. This rule applies to US banks and bank holding companies that have significant trading activity and became effective on 1 January 2013.

In April 2014, the US federal banking agencies also adopted final rules regarding an enhanced supplemental leverage ratio for US banking organisations that are global systemically important banks (G-SIBs), which will be fully effective beginning 1 January 2018. Under the final rules:

- Any insured subsidiary bank of a G-SIB must maintain a minimum supplemental leverage ratio of 6% of Tier 1 capital.
- G-SIBs must maintain at the holding company level a minimum supplemental leverage ratio of 3%, plus an additional "leverage buffer" of 2%, or a total 5% supplemental leverage ratio, of Tier 1 capital.

The minimum supplemental leverage ratio of 3% for those US banks and bank holding companies subject to the Advanced Approaches Rule will also apply beginning 1 January 2018.

In addition, in December 2014, the US Federal Reserve Board proposed for comment a methodology to identify whether a US bank holding company is a G-SIB and to apply to such firm identified as a G-SIB a risk-based capital surcharge that is

calibrated based on its systemic risk profile. Eight US firms would currently be identified as G-SIBs under the proposal (Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup Inc, The Goldman Sachs Group Inc, JPMorgan Chase & Co, Morgan Stanley, State Street Corporation, and Wells Fargo & Company). A firm identified as a G-SIB would calculate its G-SIB surcharge under two methods and use the higher of the two surcharges:

- The first method considers the G-SIB's size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity, consistent with a methodology developed by the BCBS.
- The second method uses similar inputs, but would replace substitutability with use of short-term wholesale funding and would generally result in significantly higher surcharges than the Basel III framework.

Under the proposal, estimated surcharges for US bank holding companies that would be identified as G-SIBs currently would range from 1.0% to 4.5% of a firm's total risk-weighted assets. Failure to maintain the capital surcharge would subject the G-SIB to restrictions on capital distributions and discretionary bonus payments. The proposal would be phased in beginning on 1 January 2016, becoming fully effective on 1 January 2019. The deadline for submitting comments to the proposal is 28 February 2015.

Europe

In the EU, the majority of the Basel III proposals have been implemented by the Capital Requirements Regulation (Regulation (EU) No 575/2013) (CRR) which, together with the Directive on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (Directive 2013/36/EU) recasting the previous Capital Requirements Directive, form the package of legislation known as "CRD4". CRR already has direct effect in all EU member states, whereas the new Directive was required to be separately implemented by each EU member state into its own laws by 31 December 2013.

Whereas the Basel III proposals apply only to internationally active bank groups, CRD4 applies to certain EU investment firms, as well as to EU banks and building societies.

CRR implements the Basel III recommendations very closely as to the minimum levels of capital that a financial institution must issue, although it provides a greater degree of detail as to regulatory adjustments and deductions. One departure from Basel III is that under CRR, instruments do not have to be common shares to be treated as common equity Tier 1 capital as long as they meet the detailed criteria set out in the Basel III rules. This is relevant in particular to non-joint stock companies, such as mutuals, co-operative banks and savings institutions.

In relation to instruments that previously qualified for regulatory capital treatment, but cease to be recognised as Tier 1 or Tier 2 capital under Basel III, the Basel III rules specify a cut-off date of 12 September 2010. Any instrument issued before that date can be de-recognised gradually over a ten-year phase-out period and any instrument issued on or after that date would be fully excluded from the relevant class of regulatory capital from 2013. CRR states that any instrument, issued before 31 December 2011, that previously qualified as regulatory capital shall continue to qualify as regulatory capital until 31 December 2021, but only as to a specified percentage of its amount, such percentage gradually decreasing each year until 31 December 2021. Some limited discretion is given to national regulators as to the exact percentage to apply for any particular period, so as to accelerate the rate of phase-out if considered appropriate.

In relation to the requirement under the Basel III rules that Tier 1 capital instruments must provide for a "going-concern" write-down

of principal or conversion into equity at a pre-specified trigger point, CRR provides that the trigger point will be the time when the institution's common equity Tier 1 capital as a proportion of its total risk-weighted assets falls below 5.125%, or any higher percentage specified in the terms governing the relevant instrument.

The European Banking Authority (EBA) was mandated to draft technical standards in respect of procedures and timing for the determination of trigger points. Since the write-down of principal on a going concern basis can be temporary, the EBA was also mandated to specify the nature of any subsequent write-up of principal and the procedures and timing of such write-up. The European Commission's delegated regulation (*Regulation (EU) No. 241/2014*) has now enacted these EBA technical standards in a binding form.

Under the Basel III rules, no Tier 1 capital instrument may contain any feature that would hinder the recapitalisation of the institution, and dividend pushers and alternative coupon satisfaction mechanisms are expressly prohibited. CRR went further and stated that dividend stoppers will also not be permitted in Tier 1 instruments.

Contingent capital instruments currently can qualify as additional Tier 1 or Tier 2 capital under CRD4. However, the CRD4 package did not contain the EU's proposed legislation for the BCBS's proposal for all Tier 1 and Tier 2 instruments to be able to absorb losses at the instigation of a competent authority, at the point of an entity's non-viability (*see above, International reform: Basel III*).

These provisions though are now included in the EU Bank Recovery and Resolution Directive, and were required to be implemented into the laws of each EU member state by 31 December 2014.

CONTINGENT CAPITAL

Broadly speaking, contingent capital is just another hybrid security. A contingent capital instrument is supposed to provide financial institutions leverage in good times, but provide a buffer in bad times. Academics have suggested various contingent capital arrangements. One version of contingent capital is for banks to issue debt that automatically converts to equity when two conditions are met (*Squam Lake Working Group on Financial Regulation*):

- The system is in crisis, either based on an assessment by regulators or based on objective indicators such as aggregate bank losses.
- The bank's regulatory capital ratio falls below a certain value.

There are a number of other permutations of contingent capital instruments, including some that have been used by insurance companies in the past. These approaches all attempt to address the fact that in difficult times, banks (which rely on investor confidence) find it difficult to raise capital. Contingent capital would act as equity and provide a cushion to convince depositors and other creditors that their money is safe.

This section considers:

- Why regulators are focusing on contingent capital instruments.
- Whether contingent capital instruments have the potential to replace hybrid securities like trust preferred securities.
- Some of the contingent capital products that have been issued to date.
- The tax treatment of contingent capital products.

Focus of regulators

Regulators are keenly focused on the need to bolster regulatory capital levels at financial institutions. In addition, regulators would like to avoid (to the extent possible) having taxpayers bear the brunt of a financial institution bailout. As a result, regulators have set higher regulatory capital requirements and established other

tools, such as "bail in" features for certain debt securities, "buffers" or extra capital cushions and contingent capital instruments with loss absorption features.

In January 2012, the US General Accounting Office completed a study on the use of hybrid capital instruments and made recommendations for legislative or regulatory actions regarding hybrids. In July 2012, the Financial Stability Oversight Council (FSOC) completed a study of a contingent capital requirement for certain non-bank financial companies and bank holding companies. Additional regulatory guidance will be required in the US regarding the types of hybrid securities (in addition to non-cumulative perpetual preferred securities) that will benefit from favourable regulatory capital treatment.

Potential of contingent capital instruments

The role of contingent capital instruments remains to be seen. In November 2011, the BCBS issued its final principles as to the methodology for determining which banks are to be considered by regulators as global systemically important banks (G-SIBs), as well as setting additional minimum capital requirements applicable to such banks, on top of the minimum capital requirements already intended to apply to all internationally active banks under Basel III.

Many global institutions had hoped that the BCBS would recommend that such additional capital requirements for G-SIBs could be met, at least partially, with contingent capital instruments, but their final recommendations proposed that only "core" Tier 1 capital instruments would be used for this purpose. Having said that, the BCBS stated that it would continue to review contingent capital and would support its use in meeting any higher national loss absorbency requirements than the global requirement, because the BCBS recognises that contingent capital instruments with a high trigger point can help absorb losses on a going concern basis.

However, it seems that contingent capital instruments will still have a role to play outside the Basel III requirements themselves. In November 2014, the Financial Stability Board (FSB) launched a consultation on the adequacy of the loss-absorbing capacity of G-SIBs in a resolution situation, which included a recommendation that G-SIBs should be required by regulators to hold total loss absorbing capacity (TLAC) (including Basel III minimum capital requirements (but not the capital buffers) and other instruments that can be "bailed-in" in a bank resolution) in the range of 16% to 20% of their risk-weighted assets. It also proposes that the TLAC requirements for a G-SIB should be at least twice its Basel III leverage ratio requirements. The Basel III leverage ratio measures a bank's Tier 1 capital as a percentage of its total (non-weighted) assets and off-balance sheet exposures, and as currently proposed by the BCBS would be at least equal to 3%. A bank required to maintain a 3% leverage ratio would therefore be required to hold TLAC of at least 6% of its total (non-weighted) assets and off-balance sheet exposures.

The FSB has stated that it expects at least one-third of a bank's minimum TLAC requirement to be met in the form of debt capital instruments and other TLAC-eligible liabilities that are not regulatory capital. If the FSB's final TLAC recommendations do not change from this position, then there will be a role for contingent capital instruments within this category of TLAC (as well as within the Additional Tier 1 and Tier 2 categories of Basel III regulatory capital, if they fulfil all the necessary criteria). It should be noted that the US federal banking agencies have not yet issued their proposal regarding TLAC requirements for a G-SIB. In the EU, each EU member state will be required from 1 January 2016, under the Bank Recovery and Resolution Directive, to set a minimum level of own funds and bail-inable liabilities (MREL) to be maintained by banks in its jurisdiction. The European Banking Authority has yet to publish its draft regulatory technical standards as to the assessment criteria for each EU member state's determination of MREL, but these are expected to be influenced by the FSB's TLAC proposals for G-SIBs.

Some contingent capital products

Many European banks have issued contingent capital products thus far, although no US banks have issued such products. Set out below are examples of such contingent capital products.

Lloyd's Enhanced Capital Notes. In November 2009, HM Treasury announced that RBS and Lloyds, both recipients of substantial capital injections from the UK government in the form of preference shares, would offer subordinated debt holders contingent or mandatorily convertible notes in order to increase regulatory capital and reduce their exposure to the UK Government's Asset Protection Scheme (under EU state aid rules the European Commission had granted approval to national support schemes on condition of the banks not paying dividends or coupons on core Tier 1 capital instruments). Lloyds completed an exchange offer in which it issued GBP7.5 billion of enhanced capital notes, which are fixed rate, subordinated debt securities with a ten-year term that convert into a fixed number of ordinary shares if Lloyd's core Tier 1 ratio falls below 5%. The interest rate on the enhanced capital notes is equal to the interest or dividend rate on the exchanged securities plus a fixed premium between 1.5% to 2.5%. The enhanced capital notes received lower Tier 2 capital treatment and will only receive core Tier 1 capital treatment if the notes are converted into ordinary shares. The enhanced capital notes were not offered in the US or to US persons as defined under Regulation S.

Rabobank's Senior Contingent Notes and Perpetual Non-Cumulative Capital Securities. In March 2010, Rabobank issued EUR1.25 billion of its 6.875% senior contingent notes, which are senior unsecured notes with a ten-year term, the principal of which is subject to a write-down if the equity capital ratio (equity capital divided by risk weighted assets of the Rabobank Group) falls below 7% (the occurrence of an event of default will temporarily delay the write-down). Rabobank also has an early redemption right (at par plus accrued and unpaid interest) following a withholding tax gross up event or loss of tax deductibility, in each case under Dutch tax law. The senior contingent notes though were not used as regulatory capital and were not offered in the US or to US persons as defined under Regulation S.

Rabobank subsequently issued fixed rate perpetual non-cumulative capital securities in two separate offerings in 2011 (each for US\$2 billion). One has an initial interest rate of 8.375% to (but excluding) the first reset date and thereafter reset every five years based on the US Treasury benchmark rate plus 6.425%, while the other has an initial interest rate of 8.40% to (but excluding) the first reset date and thereafter reset every five years based on the US Treasury benchmark rate plus 7.49%. In both cases though interest payments are at Rabobank's discretion (not cumulative). The principal of the capital securities is subject to a write-down if either:

- The equity capital ratio (equity capital divided by risk weighted assets) falls or remains below 8%.
- Either Rabobank or the Dutch Central Bank believes that there has been such a significant reduction in Rabobank's retained earnings or similar reserves causing a significant deterioration in Rabobank's financial and regulatory solvency position that the equity capital ratio will fall below 8% in the near term.

If the trigger is breached, Rabobank will cancel any accrued but unpaid interest and write-down the prevailing principal amount of the capital securities. The write-down amount is determined by multiplying the losses precipitating the trigger relative to the equity capital ratio prior to the loss incurrence by the ratio of the aggregate outstanding principal amount of capital securities relative to equity capital and all similar loss absorbing securities. In addition, Rabobank may redeem the capital securities, in whole but not in part, prior to a specified date upon the occurrence of a tax event or a capital event, and upon the occurrence of a capital event or Basel III capital event, Rabobank may substitute or vary the terms of the capital securities so that they remain regulatory

compliant securities. The capital securities received core Tier 1 capital treatment. The capital securities were not offered in the US or to US persons as defined under Regulation S.

Credit Suisse's Buffer Capital Notes. In February 2011, Credit Suisse issued approximately US\$6.17 billion of its Tier 1 buffer capital notes (issued through Credit Suisse Group AG) and US\$2 billion of its Tier 2 buffer capital notes (issued through Credit Suisse Group (Guernsey) Limited), which are subordinated notes that convert into ordinary shares if Credit Suisse's reported Basel III common equity Tier 1 ratio falls below 7% or if the regulator Swiss Financial Market Supervisory Authority (FINMA) determines that conversion is necessary to prevent a capital injection or restructuring. The conversion price will be the higher of a floor price of US\$20/CHF20 per share, subject to customary adjustments, or the daily weighted average sale price of Credit Suisse's ordinary shares over a trading period preceding the notice of conversion.

There are though some slight differences between the Tier 1 buffer capital notes and the Tier 2 buffer capital notes. The Tier 1 buffer capital notes:

- Have no maturity.
- Pay interest only at Credit Suisse's discretion (not cumulative).
- Provide for early redemption only at Credit Suisse's option five years from the purchase or exchange and in certain other circumstances with the approval of FINMA.
- Have an initial rate of US\$9.5% or CHF9.0%, as applicable, to (but excluding) the first call date and thereafter reset every five years.

The Tier 2 buffer capital notes:

- Have a 30-year term.
- Are guaranteed on a subordinated basis by Credit Suisse Group AG.
- Upon the occurrence of a capital event or a tax event allow Credit Suisse to substitute or vary the terms so that they remain regulatory compliant securities.
- Provide for early redemption only at Credit Suisse's option or either:
 - the first optional redemption date or on any interest payment date thereafter, in whole or in part; or
 - upon a change in tax or regulatory treatment or change in control, in whole, but not in part.
- Have an initial rate of US\$7.875% to (but excluding) a specified date and thereafter reset every five years based on the mid-market US dollar swap rate LIBOR basis having a five year maturity plus 5.22%.

The Tier 1 buffer capital notes received core Tier 1 capital treatment, while the Tier 2 buffer capital notes received lower Tier 2 capital treatment (and will only receive core Tier 1 capital treatment if the notes are converted into ordinary shares). The Tier 1 buffer capital notes and the Tier 2 buffer capital notes were not offered in the US or to US persons as defined under Regulation S.

UBS' Subordinated Notes. In August 2012, UBS issued (through its Stamford branch) US\$2 billion of its 7.625% Tier 2 subordinated notes, with a ten-year term, subject to a full write-down of the principal amount if either:

- UBS' ratio of core Tier 1 capital plus "high trigger" loss absorption contingent capital to risk-weighted assets falls below 5%.
- FINMA determines that a write-down is necessary in order to prevent UBS' insolvency, bankruptcy or failure or UBS has received public support in order to prevent UBS' insolvency, bankruptcy or failure.

The subordinated notes also may be redeemed prior to their maturity at UBS' option, in whole but not in part, either:

- At their aggregate principal amount, together with any accrued but unpaid interest thereon, upon the occurrence of a tax event, a regulatory event.
- At 101% of their aggregate principal amount, together with any accrued but unpaid interest thereon, upon the occurrence of certain changes in Swiss banking laws or regulations that lower certain capital requirements that UBS subsequently meets or treats as Tier 2 capital securities with terms that if included in the subordinated notes would have resulted in the subordinated notes not having received Tier 2 capital treatment.

The subordinated notes received lower Tier 2 capital treatment and were the first Basel III-compliant contingent capital securities to be offered in the US. The subordinated notes were exempt from registration with the US Securities and Exchange Commission (SEC) under section 3(a)(2) of the Securities Act.

Barclays' Contingent Capital Notes. In November 2012, Barclays issued (through Barclays Bank PLC) US\$3 billion of its 7.625% contingent capital notes, with a ten-year term, subject to the automatic transfer of the notes to the issuer's parent or other issuer group company if Barclays' 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 Financial Services Authority (FSA). In the event of an automatic transfer, holders will no longer have any rights against Barclays with respect to repayment of the principal amount of the contingent capital notes or the payment of interest on such notes for any period from (and including) the interest payment date falling immediately prior to the occurrence of such automatic transfer. As a result, holders will lose their entire investment in the notes. The contingent capital notes also may be redeemed prior to their maturity at Barclays' option, in whole but not in part, at their aggregate principal amount, together with any accrued but unpaid interest thereon, upon the occurrence of a tax event or a regulatory event, but only with the prior approval of the FSA and compliance with the FSA's main Pillar 1 rules (as well as provision of a notice to the FSA regarding Barclays' capital adequacy in the case of a redemption within five years of the issue date). The contingent capital notes are subordinated notes and received lower Tier 2 capital treatment. The contingent capital notes were registered with the SEC.

See Table, *Contingent capital securities: some examples*, for information on the features of certain contingent capital products that have been issued to date.

Tax treatment

The tax treatment of contingent capital products differs by jurisdiction as there is no uniformity across national tax laws in characterising such products for tax purposes. Set out below is a description of the tax treatment of the contingent capital products mentioned above.

In the case of Lloyds' Enhanced Capital Notes, the notes should fall within the UK's "quoted Eurobond" exemption and, therefore, there should be no withholding tax on interest. Some notes for UK tax purposes also may be deemed "deeply discounted securities" the disposal of which (including transfer, redemption or conversion) could be taxed as income. The notes would be treated as convertible equity and payments on the notes likely would be treated as non-deductible dividends for US tax purposes.

In the case of Rabobank's Senior Contingent Notes, the notes are treated as debt and interest on the notes is tax deductible for Dutch tax purposes and it is unclear if and/or what portion would be treated as debt or equity or another instrument for US tax purposes.

In the case of Credit Suisse's Buffer Capital Notes, it is unclear how the notes and interest on the notes would be treated for Swiss tax

purposes and the notes would be treated as convertible equity and payments on the notes likely would be treated as non-deductible dividends for US tax purposes.

In the case of UBS' Subordinated Notes, payments by the issuer of interest on, and repayment of principal of, the notes, will not be subject to Swiss federal withholding tax, provided that the proceeds from the offering and sale of the notes are used outside of Switzerland (unless use in Switzerland is permitted under the Swiss taxation laws in force from time to time without payments in respect of the notes becoming subject to withholding for Swiss withholding tax as a consequence of such use of proceeds in Switzerland). The notes would be treated as convertible equity and payments on the notes likely would be treated as non-deductible dividends for US tax purposes.

In the case of Barclays' Contingent Capital Notes, the notes should fall within the UK's "quoted Eurobond" exemption and, therefore, there should be no withholding tax on interest. The notes would be treated as convertible equity and payments on the notes likely would be treated as non-deductible dividends for US tax purposes.

Tax issues in the US

The principal tax consideration in connection with hybrid securities is whether payments made (or accrued) by the issuer are deductible for tax purposes (*see above, Main tax considerations*). Such a deduction is necessary for any hybrid security (including contingent capital) to provide a lower after-tax cost of capital for the issuer.

Whether payments are in fact deductible for US federal income tax purposes depends on the characterisation of the instrument for those purposes. Payments with respect to instruments characterised as indebtedness are generally deductible for US federal income tax purposes while payments with respect to instruments characterised as equity are generally not. Although many factors are included in the determination of an instrument's characterisation for US federal income tax purposes, it must under current law generally represent an unconditional obligation to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future. As a result, there may be a need for Congressional or US Treasury Department action before a US issuer has reasonable certainty that distributions on a contingent capital instrument are deductible for US federal income tax purposes.

Where the conversion generates cancellation of indebtedness income, under general US federal income tax principles such cancellation of indebtedness income is included in taxable income unless such income is specifically excluded (for example, if the taxpayer is insolvent or in a bankruptcy proceeding). To the extent indebtedness of a taxpayer is satisfied through an exchange for or conversion into equity, any cancellation of indebtedness income is calculated as the difference between the debt's adjusted issue price and the fair market value of the equity exchanged or converted into.

Therefore, to the extent any contingent capital product were treated as a debt instrument for US federal income tax purposes, the issuer would realise cancellation of indebtedness income to the extent of the difference between:

- The instrument's adjusted issue price.
- The fair market value of its equity exchanged or converted into.

(An issuer would also recognise cancellation of indebtedness income if the contingent capital instrument is permanently written down.)

To the extent any contingent capital product were not treated as a debt instrument but rather as an equity interest for US federal income tax purposes, the issuer would not realise cancellation of indebtedness income on the exchange or conversion into (a different class of) equity.

Tax issues in the UK

On 1 January 2014, the Taxation of Regulatory Capital Securities Regulations 2013 came into effect. The key effect of these regulations is that instruments that are, or were previously, additional Tier 1 or Tier 2 instruments will be taxed in the UK as loan relationships and that where a principal amount is written down, or the instrument is converted to a common equity Tier 1 instrument, no debit or credit will be brought into account for corporation tax purposes, by the issuer or by a connected holder, in respect of the conversion or the writing-up or writing-down. However, an unconnected holder of such an instrument can still bring into account for corporation tax purposes the debit incurred on the writing-down or conversion of the instrument. The regulations also have the effect that coupons will be deductible as interest and will not be viewed as distributions, and that no income tax will be withheld from payments on such instruments. For capital gains tax purposes, such instruments will be exempt as they will represent a "normal commercial loan". Transfers of the instruments also will be exempt from all stamp duties.

Rating agencies

Contingent capital instruments with conversion features present additional concerns for rating agencies. In such cases, the assessment of the "equity content" of the contingent capital instruments is difficult if the conversion triggers are not clearly defined or if the regulators have significant discretion to force a conversion, which makes it difficult to predict the likelihood of conversion. The rating agencies have issued statements and/or new methodologies regarding the treatment of contingent capital instruments.

Rating agencies will rate contingent capital instruments in certain instances. For example:

- Rabobank's perpetual non-cumulative capital securities were assigned a rating of "A" by Fitch Ratings (Fitch) (they were not assigned any rating by Moody's Investors Service (Moody's) or Standard & Poor's Rating Services (S&P)).
- Credit Suisse's Tier 2 buffer capital notes were assigned a rating of "BBB+" by Fitch (they were not assigned any rating by Moody's or S&P).
- UBS' subordinated notes were assigned a rating of "BBB-" by Fitch and S&P (they were not assigned any rating by Moody's).
- Barclays' contingent capital notes were assigned a rating of "BBB-" by Fitch and S&P (they were not assigned any rating by Moody's).

CONTINGENT CAPITAL SECURITIES: SOME EXAMPLES

See Table: Contingent capital securities: some examples.

Practical Law Contributor profiles



Ze'-ev D Eiger

Morrison & Foerster LLP
T +1 212 468 8222
E zeiger@mofo.com
W www.mofo.com

Qualified. New York, 2003

Areas of practice. Capital markets; securities; M&A; corporate.

Recent transactions. Mr Eiger works closely with financial institutions to create and structure innovative financing techniques, including new securities distribution methodologies and financial products.



Peter J Green

Morrison & Foerster LLP
T +44 20 7920 4013
E pgreen@mofo.com
W www.mofo.com

Qualified. England and Wales, 1991; New York, 1991

Areas of practice. Capital markets; securities; banking and finance.

Recent transactions. Mr Green works closely with investment banks and issuers on developing new financial products and new securities offering methodologies. He has worked on a range of complex financial instruments, including hybrid securities and other subordinated debt instruments. He has spoken at a number of conferences and written a number of articles relating to capital instruments under the new Basel III rules and contingent capital securities.



Thomas A Humphreys

Morrison & Foerster LLP
T +1 212 468 8006
E thumphreys@mofo.com
W www.mofo.com

Qualified. California, 1977; New York, 1980; England and Wales, 2013

Areas of practice. Federal tax; capital markets.

Recent transactions

Mr Humphreys works with investment banks and issuers on developing new financial products. He has advised investment banks and banks on most of the major capital markets developments in the last decade including trust preferreds, Tier One capital instruments, mandatorily remarketed debt instruments, mandatorily exchangeable debt instruments and contingent convertible bonds. He currently works with several banks and investment banks on developing new capital markets products involving equity, debt and preferred stock.



Jeremy C Jennings-Mares

Morrison & Foerster LLP
T +44 20 7920 4072
E jjenningsmares@mofo.com
W www.mofo.com

Qualified. England and Wales, 1993

Areas of practice. Capital markets; securities; banking and finance.

Recent transactions

Mr Jennings-Mares works closely with investment banks and issuers on developing new financial products and new securities offering methodologies.

CONTINGENT CAPITAL SECURITIES														
Issuer	Issue Date	Security	Amount	Coupon	Host Instrument	Regulatory Capital Treatment	Maturity/Term	Call/Redemption	Payment Deferral	Offering Format	Loss Absorption Feature	Trigger	Rating	Listing
Lloyds	11/3/09	Enhanced Capital Notes	Up to £6 bn	Fixed premium between 1.5% to 2.5% above the interest rate or dividend rate of the existing securities	Subordinated note	LT2 (CTI if converted into ordinary shares)	10, 12 or 15 years (depending on optional redemption terms of existing securities)	Early redemption at issuer's option upon a tax event or regulatory event	No	Regulation S	Conversion: Automatic conversion of the capital notes into ordinary shares	Low trigger: CTI capital falls below 5%	S&P: BB if guaranteed by Lloyds TSB Bank; BB- if guaranteed by Lloyds Banking Group Moody's: Ba2 if guaranteed by Lloyds TSB Bank; Ba3 if guaranteed by Lloyds Banking Group Fitch: N/A	yes
Rabobank	3/19/10	Senior Contingent Notes	€1.25 bn	6.875%	Senior note	Not used by issuer as regulatory capital	10 years	Early redemption at issuer's option upon a tax event	No	Regulation S	Write-down: Automatic and permanent write-down of original principal amount of the notes to 25% of par and automatic redemption of write-down; however, the occurrence of an event of default will temporarily delay the write-down	High trigger: Equity capital ratio (equity capital divided by risk weighted assets of the Rabobank Group) falls below 7%	N/A	yes
Rabobank	1/26/11	8.375% Perpetual Non-Cumulative Capital Securities	US\$2 bn	Initial rate of 8.375% for first 5.5 years; thereafter reset every five years based on the U.S. Treasury benchmark rate plus 6.425%	Subordinated note	CTI	Perpetual	Early redemption at issuer's option, in whole but not in part, (i) for first 5 years upon a tax event or regulatory event and (ii) on or after 5.5 years Mandatory redemption on or after 30 years (under certain conditions)	Yes	Regulation S	Write-down: Write-down of the prevailing principal amount of the capital securities The write-down amount is determined by multiplying the losses precipitating the trigger relative to the equity capital ratio prior to the loss incurrence by the ratio of the aggregate outstanding principal amount of capital securities relative to equity capital and all similar loss absorbing securities	High trigger: Loss absorption is triggered if (i) equity capital ratio (equity capital divided by risk weighted assets) falls or remains below 8% or (ii) either issuer or the Dutch Central Bank believes that there has been such a significant reduction in issuer's retained earnings or similar reserves causing a significant deterioration in issuer's financial and regulatory solvency position that the equity capital ratio will fall below 8% in the near term Other features: Upon the occurrence of a capital event or Basel III capital event, issuer may substitute or vary the terms of the capital securities so that they remain regulatory compliant securities	S&P: N/A Moody's: N/A Fitch: A	yes

CONTINGENT CAPITAL SECURITIES

Issuer	Issue Date	Security	Amount	Coupon	Host Instrument	Regulatory Capital Treatment	Maturity/Term	Call/Redemption	Payment Deferral	Offering Format	Loss Absorption Feature	Trigger	Rating	Listing
Rabobank	11/9/11	8.40% Perpetual Non-Cumulative Capital Securities	US\$2 bn	Initial rate of 8.40% for first 5.5 years; thereafter reset every five years based on the U.S. Treasury benchmark rate plus 7.49%	Subordinated note	CT1	Perpetual	Early redemption at issuer's option, in whole but not in part, (i) for first 5 years upon a tax event or regulatory event and (ii) on or after 5.5 years Mandatory redemption on or after 30 years (under certain conditions)	Yes	Regulation S	Write-down: Write-down of the prevailing principal amount of the capital securities The write-down amount is determined by multiplying the losses precipitating the trigger relative to the equity capital ratio prior to the loss incurrence by the ratio of the aggregate outstanding principal amount of capital securities relative to equity capital and all similar loss absorbing securities	High trigger: Loss absorption is triggered if (i) equity capital ratio (equity capital divided by risk weighted assets) falls or remains below 8% or (ii) either issuer or the Dutch Central Bank believes that there has been such a significant reduction in issuer's retained earnings or similar reserves causing a significant deterioration in issuer's financial and regulatory solvency position that the equity capital ratio will fall below 8% in the near term Other features: Upon the occurrence of a capital event or Basel III capital event, issuer may substitute or vary the terms of the capital securities so that they remain regulatory compliant securities	S&P: N/A Moody's: N/A Fitch: A-	Yes
Bank of Cyprus	5/18/11	Convertible Enhanced Capital Securities	€1.34 bn	Initial rate of 6.50% for first 5.5 years; thereafter reset every six months to 6 month LIBOR plus 3.00%	Subordinated note	CT1	Perpetual	Early redemption at issuer's option in whole but not in part, on or after 5.5 years (under certain conditions)	Yes (under certain conditions)	Regulation S	Conversion: Automatic conversion of the capital securities into ordinary shares Convertible at the option of the holder if a public offer for issuer's shares or any other change of control event occurs on any date from the issue date for a period of 60 calendar days at a certain specified change of control conversion price	Low trigger: Loss absorption is triggered upon (i) a contingency event or (ii) a viability event A "contingency event" occurs if issuer gives notice that either (i) prior to the Basel III adoption date, its CT1 ratio is below 5% or, on or after the Basel III adoption date, its CET1 ratio is below the minimum threshold as it will be determined, or (ii) on or after the Basel III adoption date, the Central Bank of Cyprus determines that issuer is in non-compliance with any required regulatory capital adequacy ratio thresholds specified in the applicable banking regulations	N/A	Yes

CONTINGENT CAPITAL SECURITIES														
Issuer	Issue Date	Security	Amount	Coupon	Host Instrument	Regulatory Capital Treatment	Maturity/Term	Call/Redemption	Payment Deferral	Offering Format	Loss Absorption Feature	Trigger	Rating	Listing
Credit Suisse	≥ 10/13	Tier 1 Buffer Capital Notes	CHF6 bn	Initial rate of US\$ 9.5% or CHF 9.0%, as applicable, to (but excluding) 10/13, which is the first call date of the Tier 1 capital notes; thereafter reset every five years	Subordinated note	CT1	Perpetual	Early redemption at issuer's option (i) on or after 5 years and (ii) in certain other circumstances with the approval of home-country regulator	Yes	Regulation S	Conversion: Automatic conversion of the capital notes into ordinary shares The conversion price will be the higher of a floor price of USD 20 / CHF 20 per share, subject to customary adjustments, or the daily weighted average sale price of issuer's ordinary shares over a trading period preceding the notice of conversion	High trigger: Loss absorption triggered if (i) issuer's reported CET1 ratio falls below 7% or (ii) the Swiss Financial Market Supervisory Authority (FINMA) determines that issuer 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	S&P: N/A Moody's: N/A Fitch: BB+	Not available
Credit Suisse	2/24/11	Tier 2 Buffer Capital Notes	US\$2 bn	Initial rate of US\$ 7.875% for first 5.5 years; 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%	Subordinated note	LT2 (CT1 if converted into ordinary shares)	30 years	Early redemption at issuer's option (i) in whole or in part, on the first optional redemption date or any interest payment date thereafter or (ii) in whole but not in part, upon a tax event, regulatory event or change in control	No	Regulation S	Conversion: Automatic conversion of the capital notes into ordinary shares The conversion price will be the higher of a floor price of USD 20 / CHF 20 per share, subject to customary adjustments, or the daily weighted average sale price of issuer's ordinary shares over a trading period preceding the notice of conversion In addition, upon the occurrence of a capital event or tax event, issuer may substitute or vary the terms of the capital notes so that they remain regulatory compliant securities	High trigger: Loss absorption triggered if (i) issuer's reported CET1 ratio falls below 7% or (ii) the Swiss Financial Market Supervisory Authority (FINMA) determines that issuer 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	S&P: N/A Moody's: N/A Fitch: BBB	Yes
UBS	12/17/12	Tier 2 Subordinated Notes	US\$2 bn	7.625%	Subordinated note	LT2	10 years	Early redemption at issuer's option, in whole but not in part, (i) at the aggregate principal amount of the subordinated notes upon the occurrence of a tax event or regulatory event, or (ii) at 101% of the aggregate principal amount of the subordinated notes upon the occurrence of certain changes in home-country banking laws or regulations that lower certain capital requirements that issuer subsequently meets	No	Section 3(a) (2)	Write-down: Automatic full write-down of the principal amount of the subordinated notes	Low trigger: Loss absorption triggered if (i) issuer's ratio of CT1 capital plus high trigger loss absorption contingent capital to risk-weighted assets falls below 5% or (ii) if the Swiss Financial Market Supervisory Authority (FINMA) determines that a write-down is necessary in order to prevent issuer's insolvency, bankruptcy or failure or issuer has received public support in order to prevent issuer's insolvency, bankruptcy or failure	S&P: BBB- Moody's: N/A Fitch: BBB-	Yes

CONTINGENT CAPITAL SECURITIES														
Issuer	Issue Date	Security	Amount	Coupon	Host Instrument	Regulatory Capital Treatment	Maturity/Term	Call/Redemption	Payment Deferral	Offering Format	Loss Absorption Feature	Trigger	Rating	Listing
Barclays	11/21/12	7.625% Contingent Capital Notes	US\$3 bn	7.625%	Subordinated note	LT2	10 years	Early redemption at issuer's option, in whole but not in part, upon the occurrence of a tax event or regulatory event, but only with the prior approval of the home-country regulator	No	SEC registered	Write-down: Automatic transfer of the capital notes to issuer's parent or other issuer group company	High trigger: Loss absorption triggered if issuer's equity capital ratio (CTI 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 Financial Services Authority (FSA)	S&P: BBB- Moody's: N/A Fitch: BBB-	Yes
Barclays	11/20/13	8.25% Fixed Rate Resetting Perpetual Subordinated Contingent Convertible Securities	US\$2 bn	Initial rate of 8.25% for first 5 years; thereafter reset every five years to the 5-year mid-market swap rate plus 6.705%	Subordinated note	CT1	Perpetual	Early redemption at issuer's option, in whole but not in part, (i) on any reset date or (ii) upon the occurrence of a tax event or regulatory event	Yes	SEC registered	Conversion: Automatic conversion of the securities into ordinary shares Conversion price fixed at US\$2.64 per conversion share	High trigger: Loss absorption triggered if the ratio of CET1 capital to risk weighted assets as of any quarterly financial period end date or a date when such ratio is calculated upon the instruction of the lead regulator, as the case may be, is less than 7% on such date Other features: Each holder of the securities acknowledges, agrees to be bound by, and consents to the exercise of, any UK bail-in power by the relevant UK resolution authority that may result in the cancellation of all, or a portion, of the principal amount of, or interest on, the securities and/or the conversion of all, or a portion, of the principal amount of, or interest on, the securities into shares or other securities or other obligations of issuer or another person, including by means of a variation to the terms of the securities to give effect to the exercise by the relevant UK resolution authority of such UK bail-in power	S&P: B+ Moody's: N/A Fitch: BB+	Yes
KBC Bank	1/25/13	8.00% Contingent Capital Securities	US\$1 bn	Initial rate of 8.00% for first 5 years; thereafter reset to a fixed rate per annum which will be based on the initial credit spread and the 5-year mid-market swap rate	Subordinated note	LT2	10 years	Early redemption at issuer's option, in whole but not in part, (i) on any reset date subject to regulatory approval (if required) and no trigger event having occurred or (ii) upon the occurrence of a regulatory event	No	Regulation S	Write-down: Automatic full write-down of the principal amount of the capital securities; provided that a regulatory event has not occurred and is not continuing	High trigger: Loss absorption triggered if the ratio of CET1 capital to risk weighted assets as of any quarterly financial period end date or a date when such ratio is calculated upon the instruction of the lead regulator, as the case may be, is less than 7%	S&P: BB+ Moody's: N/A Fitch: N/A	Yes

CONTINGENT CAPITAL SECURITIES														
Issuer	Issue Date	Security	Amount	Coupon	Host Instrument	Regulatory Capital Treatment	Maturity/Term	Call/Redemption	Payment Deferral	Offering Format	Loss Absorption Feature	Trigger	Rating	Listing
Credit Agricole	9/19/13	Contingent Capital Subordinated Fixed Rate Resettable Notes	US\$1 bn	Initial rate of 8.125% for first 5 years; thereafter reset every five years to the 5-year mid-market swap rate plus 6.283%; if a there is an S&P rating methodology change, the applicable interest rate will be reduced by 150 basis points	Subordinated note	LT2	20 years	Early redemption at issuer's option, in whole but not in part, (i) on the first reset date and on each interest payment date thereafter, (ii) upon a capital event or tax event or (iii) at any time on or after the first reset date upon an S&P rating methodology change	No	Rule 144A / Regulation S	Write-down: Automatic full write-down of the principal amount of the notes; provided that an S&P rating methodology change has not occurred	High trigger: Loss absorption triggered if the ratio of CET1 capital to risk weighted assets as of any quarterly financial period end date or a date when such ratio is calculated upon the instruction of the lead regulator, as the case may be, is less than 7 % Other features: Under French law, authorities are allowed to cancel, write-off or convert into equity failing banks' subordinated instruments (such as the notes), in accordance with their seniority	S&P: BBB- Moody's: N/A Fitch: BBB-	Yes
Credit Agricole	1/23/14	Undated Deeply Subordinated Additional Tier 1 Fixed Rate Resettable Notes	US\$1.75 bn	Initial rate of 7.875% for first 10 years; thereafter reset every five years to the 5-year mid-market swap rate plus 4.898%	Deeply subordinated note	AT1	Perpetual	Early redemption at issuer's option, in whole but not in part, (i) on the first reset date and on each interest payment date thereafter or (ii) upon a capital event or tax event	Yes	Rule 144A / Regulation S	Write-down: Automatic full write-down of the principal amount of the notes; provided that an S&P rating methodology change has not occurred	High trigger: Loss absorption triggered if the ratio of CET1 capital to risk weighted assets as of any quarterly financial period end date or a date when such ratio is calculated upon the instruction of the lead regulator, as the case may be, is less than 7% Other features: Under French law, authorities are allowed to cancel, write-off or convert into equity failing banks' subordinated instruments (such as the notes), in accordance with their seniority	S&P: BB+ Moody's: N/A Fitch: BB+	Yes.
Credit Suisse	8/8/13	6.500% Tier 2 Capital Notes	US\$2.5 bn	6.50%	Subordinated note	LT2	10 years	Early redemption at issuer's option, in whole but not in part, upon a capital event or tax event	No	Rule 144A / Regulation S	Write-down: Automatic full write-down of the principal amount of the capital notes	Low trigger: Loss absorption triggered if (i) the sum of (x) the ratio of CET1 capital to risk weighted assets contained in the relevant financial report and (y) the ratio of higher trigger capital to risk weighted assets is below 5%, or (ii) a viability event occurs	S&P: BBB- Moody's: N/A Fitch: BBB+	Yes

CONTINGENT CAPITAL SECURITIES														
Issuer	Issue Date	Security	Amount	Coupon	Host Instrument	Regulatory Capital Treatment	Maturity/Term	Call/Redemption	Payment Deferral	Offering Format	Loss Absorption Feature	Trigger	Rating	Listing
Swiss Reinsurance	10/7/13	7.50% Subordinated Contingent Write-off Securities	CHF175 mn	Initial rate of 7.50% for first 7 years; thereafter reset every five years to the 5-year mid-market swap rate plus 6.434%	Subordinated note	LT2	32 years	Early redemption at issuer's option, in whole but not in part, (i) on each reset date or (ii) upon a tax event, regulatory event, ratings methodology event or hurricane event calculation agent failure event, subject to regulatory approval (if required), no solvency event and no notice of a contingent write-off	Yes (under certain conditions)	Regulation S	Write-down: Automatic full write-down of the principal amount of the securities	Low trigger: Loss absorption triggered if there is (i) a SST Trigger Event or (ii) an Insurance Trigger Event An "SST Trigger Event" will be deemed to have occurred if SRZ does not have appropriate funds to cover 135% of the required minimum solvency margin (in accordance with the provisions of mandatorily applicable regulatory capital requirements) as shown in the most recent SRZ solvency report submitted to the Swiss Financial Market Supervisory Authority (FINMA) An "Insurance Trigger Event" is tied to the occurrence of a hurricane that causes insurance losses that equal or exceed a specified loss amount that is initially set at US\$134.3 bn Other features: FINMA could, in the future, issue rules that authorize it to commence restructuring, liquidation or bankruptcy proceedings in respect of, or impose protective measures on, reinsurance companies that it regulates, such as issuer, even if, at that time, an SST Trigger Event has not occurred These protective measures could include trading moratoriums or maturity postponements; and in a restructuring proceeding, a resolution plan could, among other things, provide for the transfer of the property of issuer and its consolidated subsidiaries (the "SRZ Group") or parts thereof with assets and debt as well as contracts to another entity, haircuts on obligations owed by issuer, including its obligations under the securities and/or the conversion of issuer's debt or other obligations, including its obligations under the securities, into equity of either issuer or its parent	N/A	Yes

European capital treatment: In the European Union ("EU"), the majority of the Basel III proposals have been implemented by the Capital Requirements Regulation (Regulation (EU) No. 575/2013) ("CRR") which, together with the directive (Directive 2013/36/EU) recasting the previous Capital Requirements Directive, form the package of legislation known as "CRD4". CRR already has direct effect in all EU member states, whereas the new directive was required to be separately implemented by each member state into its own laws by December 31, 2013. CRR implements the Basel III recommendations very closely as to the minimum levels of capital that a financial institution must issue, although it provides a greater degree of detail as to regulatory adjustments and deductions.

In relation to instruments that previously qualified for regulatory capital treatment, but cease to be recognized as Tier 1 or 2 capital under Basel III, the Basel III rules specify a cut-off date of September 12, 2010. Any instrument issued before that date can be de-recognized gradually over a ten-year phase-out period and any instrument issued on or after that date would be fully excluded from the relevant class of regulatory capital from 2013. Under CRR, any instrument issued before December 31, 2011 that previously qualified as regulatory capital shall be de-recognized gradually until December 31, 2021, with some discretion given to national regulators to accelerate the rate of phase-out if considered appropriate.

In relation to the requirement under the Basel III rules that Tier 1 capital instruments must provide for a "going-concern" write-down of principal or conversion into equity at a pre-specified trigger point, CRR provides that the trigger point will be the time when the institution's common equity Tier 1 capital as a proportion of its total risk-weighted assets falls below 5.125%, or any higher percentage specified in the terms governing the relevant instrument. The European Banking Authority ("EBA") drafted technical standards in respect of procedures and timings for the determination of trigger points, and also in relation to the nature of any subsequent write-up of principal (after a temporary write-down) and the procedures and timing of such write-up. The European Commission's delegated regulation (Regulation (EU) No. 241/2014), has now enacted these EBA technical standards in a binding form.