

KEY POINTS

- There are more questions than answers about contingent capital instruments.
- The trigger may provoke unintended behaviours.
- There are questions regarding disclosure of the trigger.
- Regulators should clarify these issues at the same time as they put forward guidance regarding regulatory capital.

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Is it a bird? A plane? Exploring contingent capital

Mythology is rich with creatures that had some characteristics of humans and some of animals, or, sometimes, some of different animals. Griffins and centaurs come to mind. They defied definition. Often, their incredible strength was awe-inspiring, but, just as easily, they could inspire terror. While less colourful, and certainly less fearsome, for quite some time now, many financial instruments that were engineered to provide financial institutions with high-quality regulatory capital also defied easy categorising. Financial institutions had come to rely on hybrid securities (securities that had some features of equity securities, and some features of debt securities) to raise capital and bolster their regulatory capital ratios. Now, after a year of unprecedented, almost epic dislocation and disarray, investors, regulators and rating agencies are questioning the adequacy and utility of various financial instruments as components of regulatory capital.

In the last year, many banks, even institutions that had previously been considered icons of stability, failed or had to be rescued or nationalised by their governments. The financial crisis has prompted US and European regulators to re-examine how much capital is enough capital for banks. Regulators generally agree that banks were too highly leveraged and that, going forward, banks should be required to have more capital. Policymakers also agree that there should be greater 'uniformity' across jurisdictions as to bank regulatory capital requirements and as to the treatment accorded to specific financial instruments. They reason that if regulatory capital standards and product definitions were harmonised, there would be fewer opportunities for 'arbitrage' by banks. But that's about as far as regulators have got in coming to a common understanding.

Regulators face many challenges as they formulate frameworks to implement these principles. Actually, the dialogue concerning

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regulatory capital long preceded the financial crisis. The financial crisis simply brought more attention to the occasionally arcane subject of regulatory capital requirements and has introduced many new participants, with their respective political agendas, to the debate. Regulators tend to react sharply following crises. Many have noted that the most valuable (from the perspective of withstanding stress scenarios) forms of capital are common stock and preferred stock. Of course, these also may be the most expensive. Investors, who faced unprecedented losses from investments in financial institutions, are sceptical about financial engineering. They have become mistrustful of Tier 1 regulatory capital calculations and have begun to rely instead on 'tangible common equity' calculations. Rating agencies, themselves facing more scrutiny than ever, have reviewed the performance of various financial products during the financial crisis and concluded that several did not perform as anticipated. In particular, rating agencies have noted that hybrids did not have sufficient loss absorbency features and, as a result, have adjusted their analysis of these securities. Banks, investors, and, even regulators, agree that it would be quite costly for banks to be constrained to common and preferred stock as the only elements of regulatory capital. An unlikely instrument has been advanced as a solution – contingent capital securities. Contingent capital securities are being hailed as an important regulatory capital component for financial institutions. As we discuss, if one were to put these securities into a 'generic' category, they would be just another hybrid.

In this article, we review the hybrid capital market, discuss regulatory and rating agency developments affecting hybrids, and consider contingent capital alternatives.

HYBRID SECURITIES

Hybrid securities are tax-efficient, regulatory and rating agency-qualifying capital that lower an issuer's cost of capital and that, in times of financial distress, are intended to conserve cash for the issuer. These securities are structured to obtain favourable equity treatment from ratings agencies, permit issuers to make tax-deductible coupon payments, and qualify as Tier 1 capital for US bank holding companies. (Under US law a bank holding company is an entity that directly or indirectly owns, controls or has the power to vote 25 per cent or more of a class of securities of a US bank. They are required to register with the Board of Governors of the Federal Reserve Bureau.) The benefits of a hybrid depend on its 'equity-like' or 'debt-like' characteristics. From a ratings agency perspective, the more equity-like the hybrid, generally, the more favourable the treatment for the issuer. From a tax perspective, the more debt-like the hybrid, generally, the more favourable the tax treatment for the issuer.

Since 2005, there was certainty, from a ratings agency perspective, about the elements of a hybrid. That year Moody's revamped its 'Tool Kit,' in which it identified a continuum of five baskets, from the A basket, which is 0 per cent equity treatment (or 100 per cent debt), at one extreme, to the E basket, which is 100 per cent equity (or 0 per cent debt), at the other extreme. Standard & Poor's followed suit with its pared down 'minimal equity content', 'intermediate equity content' and 'high equity content' categories. Recently, ratings agencies have re-evaluated their analysis of hybrids. On the tax side, there is less clear-cut guidance, but some widely shared views on the part of tax practitioners based, at least in part, on IRS

Spotlight

Notice 94-47 that identifies factors associated with debt versus equity.

Historically, ratings agencies have measured a hybrid against common equity and, in so doing, evaluate: the security's maturity date (if any), or permanence; the issuer's ongoing payment obligations in respect of the security; and the priority of payments relative to those associated with other securities and the corresponding rights to enforce payment obligations. The tax analysis focuses more sharply on the rights of the hybrid security holders: do hybrid security holders have rights akin to those of equity holders, or more like those of debt holders?

From the perspective of financial ratios, issuing a long-dated security that is treated like equity by ratings agencies, makes a hybrid less 'expensive' for the issuer. In order to replicate equity securities, hybrids have long maturities or are perpetual. A longer maturity makes a hybrid more akin to common equity than debt and provides the issuer with greater financial flexibility because it poses no refinancing risk, or at least the refinancing risk is far in the future. In order to obtain debt for tax treatment, a security must represent an 'unconditional obligation to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future.' Tier 1 capital, or core capital, for bank holding companies includes, among other things, common stock and non-cumulative perpetual preferred securities – or securities having no 'maturity.' Trust preferred securities are also treated as Tier 1 capital provided that they are subordinated to all subordinated debt, have a minimum five-year interest deferral, and the longest feasible maturity; however, US bank holding companies are limited in the amount of trust preferred securities that they may include within Tier 1 capital.

LOSS ABSORBENCY AND SUBORDINATION

Ratings agencies believed that in times of stress, hybrids would provide 'loss absorption' for financial institution issuers, since hybrids are deeply subordinated instruments with payment deferral provisions. A deferral feature (optional or mandatory) permits the issuer to defer interest or dividend payments. An issuer has no obligation to pay dividends on its

common stock; whereas, an issuer generally is contractually bound to make interest payments on debt securities. By including a deferral feature, a hybrid becomes more 'equity-like' from a ratings agency perspective. Theoretically, the longer an issuer can defer payments, the greater its financial flexibility.

Issuers were able to increase the equity content of hybrid securities by making payment deferrals mandatory, or automatic, upon reaching triggers that were considered meaningful given the issuers' financial positions. Using a formulaic approach to payment deferrals, rather than retaining issuer discretion, generated higher equity credit – assuming payments in respect of the hybrids are non-cumulative or may be settled in stock. As we note below, contingent capital instruments incorporate a formulaic approach of this sort. Rating agencies evaluated the issuer's payment obligations (cumulative versus non-cumulative payments) in conjunction with the other payment characteristics of the security, including the presence of a mandatory or optional deferral provision.

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 (at least for a very long time). In fact, a hybrid security holder has limited rights against the issuer for deferred interest payments. Some hybrids limit a security holder's right to proceed against the issuer to recoup deferred payments. In certain structures, deferred interest may be permanently cancelled if certain conditions are satisfied and, as a result, the holder of the 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. In bankruptcy, however, the security holder's claim is limited to a maximum deferred interest amount.

PRODUCT INNOVATION AND LACK OF CONSISTENCY

From 2006 to early 2008, there was a fair bit of product innovation as financial engineers introduced new features for hybrid securities, like longer maturities, bifurcated maturities,

and interest deferral triggers. These features were intended to ensure that the hybrid securities received equity credit, while preserving debt for tax treatment. During this period, financial institutions relied heavily for funding on hybrid issuances that incorporated these elements. While these innovations or enhancements provided value for issuers, they also resulted in a lack of transparency in the hybrid capital market. Issuers and investors found it difficult to distinguish between the 'new and improved' structures, especially with their additional bells and whistles. Complexity made comparisons and valuations of different securities difficult. The opaqueness of some structural enhancements also caused consternation for the ratings agencies, which reacted by refining their guidelines in order to cut through some of this clutter.

From a bank regulatory perspective, there has not been a standardised approach to the treatment of hybrid capital instruments. The Basel framework did not address the features of hybrid instruments. The only available guidelines were contained in the Sydney Press Release issued by the Basel Committee on Banking Supervision ('BCBS') on 27 October 1998. Of course, a lot has changed since then, leaving regulators essentially on their own with respect to formulating assessments of hybrid capital instruments. Many regulators and policymakers have argued that, at least in part, the lack of consistent standards for the various elements that may comprise regulatory capital led to financial institutions attempting to 'game' the system.

HYBRIDS DURING THE FINANCIAL CRISIS

It is beyond the scope of this article to analyse the performance of hybrid capital instruments during the financial crisis. It is safe to say that there is a consensus that hybrids did not perform as expected, but then again, nothing performed as expected.

However, commentary regarding the performance of hybrids has been somewhat inconsistent. 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 not to exercise their option to redeem outstanding hybrids because replacement capital would have been more expensive or 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. Rating agencies downgraded a number of hybrids – noting increased risk of coupon deferral and the possibility that hybrid investors would bear losses. In certain instances, hybrids also suffered from principal writedowns. At least on the surface, in this context, it would seem that hybrid securities absorbed losses (as intended) and provided some ‘equity-like’ cushion for their financial institution issuers during a time of stress.

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 upon an agreement that the bank issuers would not pay hybrid coupons. This was unexpected. In its announcement regarding its new rating methodology for hybrid securities, Moody’s noted that given these developments, hybrid ratings should eliminate any assumption of systemic support and should instead focus on the intrinsic creditworthiness of the issuer. Moody’s also noted that its ratings would take into account the special features of the particular hybrid security. Moody’s has announced that it will be reviewing the ‘equity’ credit assigned to hybrids, including its basket approach.

Concern regarding the behaviour of hybrids, whether or not warranted, has focused attention on potential replacements for these securities within the regulatory capital structure.

HARMONISATION EFFORTS AND POST-CRISIS REGULATORY INITIATIVES

The dialogue regarding the classification and features of hybrid securities had commenced long before the financial crisis. In April 2007, the European Commission invited the Committee of European Banking Supervisors

(‘CEBS’) to consider harmonisation in the treatment of hybrid capital instruments in the EU. The CEBS issued a draft proposal for a common EU definition of Tier 1 hybrids in December 2007 (referred to as the CEBS Proposal). Also in December 2007, the UK’s Financial Services Authority (‘FSA’) issued a consultation paper on the definition of capital, which included a discussion on the criteria for hybrid capital instruments. The final CEBS Proposal was released in March 2008. The European Commission began a public consultation in 2008 and published a proposal to amend the Capital Requirements Directive (which sets out regulatory capital requirements for financial institutions in the EU) (‘CRD’) in October 2008. The European Parliament and Council adopted changes to the CRD in May 2009¹ in order, among other things, to agree common definitions and descriptions of hybrid capital instruments that could be regarded as ‘innovative’ Tier 1 capital. The CEBS is now focused on providing more detailed guidelines for national bank supervisors in Europe to follow in connection with their supervision of banks’ use of hybrid instruments for regulatory capital purposes. The CEBS launched a consultation in June 2009 which closed to comments in September 2009. Implementation does not take effect until the latter half of 2010.

Nonetheless, the CEBS provides useful guidance relating to permanence of the securities, redemption of the securities, payment flexibility, including the inclusion of alternative coupon settlement mechanisms, and loss absorbency features.

In their regular meetings, G20 leaders have committed to work 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 BCBS should raise ‘the quality, consistency and transparency of Tier 1 capital.’ The Financial Stability Board (‘FSB’) of the G20 supports the revision of the Basel II framework undertaken by the BCBS. The FSB will specifically examine ‘the use of “contingent capital” and comparable instruments as a potentially cost-efficient tool to constitute a portion of the capital buffer in a form that acts as debt during normal times but

converts to loss-absorbing capital, ie, equity during financial stress, thus acting as a shock absorber for the capital position.’ This was not the first time that the notion of ‘contingent capital’ instruments had been raised.

CONTINGENT CAPITAL

What is 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 from the Squam Lake Group have suggested various ‘contingent capital’ arrangements.² Professor Raghuram G Rajan has compared contingent capital to ‘installing sprinklers ... when the fire threatens, the sprinklers will turn on’. One version of contingent capital is for banks to issue debt that automatically converts to equity when two conditions are met: first, the system is in crisis, either based on an assessment by regulators or based on objective indicators such as aggregate bank losses....and second, the bank’s capital ratio falls below a certain value.³ Another version of contingent capital is to require systemically important leveraged financial institutions to buy fully collateralised insurance policies (from unleveraged institutions, foreigners, or the government) that will infuse capital into these institutions when the system is in trouble.⁴ There are a number of other permutations of contingent capital instruments, including some which 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.

Policymakers, including, in the US, Federal Reserve Chairman Bernanke, Treasury Secretary Geithner, and Federal Reserve Governor Tarullo, have stepped forward to express their support for contingent capital. In December 2009, the US House of Representatives passed the ‘Wall Street Reform and Consumer Protection Act of 2009’ (HR 4173), which contains a section on ‘contingent capital’. That section authorises the

Federal Reserve Board of Governors to issue regulations 'that require a financial holding company to maintain a minimum amount of long-term hybrid debt that is convertible into equity when (1) a specified financial company fails to meet prudential standards ... and (2) the [agency] has determined that threats to US financial system stability make such conversion necessary.' However, there are no details regarding the types of instruments that would be considered acceptable.

In the UK, regulators noted that hybrids must be 'capable of supporting Core Tier 1 capital by means of a conversion or write-down mechanism at an appropriate trigger' and that such instruments might be regarded as a form of 'contingent Core Tier 1 capital'. In November 2009, as part of the HM Treasury's announcement of the implementation of financial stability measures for Lloyds Banking Group and Royal Bank of Scotland, the HM Treasury announced that the recapitalisations would incorporate issuances of contingent convertibles (called 'CoCos') or mandatory convertible notes ('MCNs'). A Lloyds Banking Group affiliate recently issued £9bn in a form of contingent capital called 'enhanced capital notes' to existing Tier 1 and Upper Tier 2 security holders. The offering was intended to allow Lloyds to avoid the need for further UK government support. The enhanced capital notes have a ten-year term and pay fixed, non-deferrable interest. They are convertible into a fixed number of Lloyds' ordinary shares if Lloyds' consolidated core Tier 1 ratio falls below 5 per cent. Although the Lloyds transaction provides one indication of a potential structure for contingent capital, it leaves many unanswered questions.

CONSIDERATIONS

In the US, the exact form a contingent capital security will take, if any, is not clear. At first blush, it appears that, although many blamed financial engineering for contributing to the crisis, a financially engineered product is presented as part of the solution to avoiding future crises. The financial instrument is a hybrid security. In any of its suggested incarnations, it will have elements of a debt security and elements of an equity security.

From a regulatory capital perspective, the treatment accorded to 'innovative' hybrid

securities is still under discussion. It remains to be seen whether a contingent capital instrument would be slotted in as an innovative Tier 1 instrument. Ratings agencies may remain cautious regarding these securities. Standard & Poor's has noted that 'contingent capital is not a panacea' for banks. It is true that it is not clear whether a contingent capital instrument would convert into capital early enough to help a bank undergoing stress and whether, even if it did, it would provide sufficient capital to mitigate the need for other capital raising. A limit on the percentage of 'innovative' hybrid instruments that would count toward Tier 1 capital would obviously impact the latter issue.

From a federal income tax standpoint, however, a mandatory convertible type security, such as the Lloyds' CoCos raises serious federal income tax issues if the issuer intends to claim a deduction for interest on the security. The first issue is whether the instrument is debt or equity under general federal income tax concepts. The test is a 'facts and circumstances' test that is difficult to apply to instruments with both debt and equity features. Focusing on the Lloyds transaction, the instrument is in the form of debt with a relatively short maturity and fixed interest payments. However, creditors' rights are an important, if not essential, element of debt treatment for US federal income tax purposes. In the Lloyds transaction, the instrument converts into equity when Lloyds fails the 5 per cent core capital test. The holder has no creditors' rights when that happens. That may be why, for US federal income tax purposes, Lloyds is treating the instrument as equity (in the UK, on the other hand, the securities are treated as debt for UK tax purposes). For instruments not following the Lloyds structure, whether a holder of a mandatory convertible has creditors' rights depends on the 'trigger' built into the instrument. Thus, under the formulation in HR 4173 a holder would have creditors' rights so long as the issuer's distress does not coincide with 'threats to United States financial system stability'. It is unclear whether this is sufficient to give the holder creditors' rights. Also, depending on the circumstances, the actual conversion of a contingent capital security into equity may be unlikely to occur so that

the expectation is that a holder will be paid in full on its debt claim. It is unclear whether this should be taken into account, and if so, what is the standard – for example, is a reasonable expectation of repayment sufficient?

Even if the contingent capital instrument is debt for federal income tax purposes, a second set of tax issues arises under Internal Revenue Code s 163(l), which disallows an interest deduction for corporate debt payable in the issuer's equity. It is unclear whether that section applies to a contingent capital instrument and again will depend on the exact features of the security.

A third issue arises if the instrument is converted into equity. For federal income tax purposes, an issuer recognises cancellation of indebtedness income if it issues equity in exchange for debt and the equity's fair market value is less than the debt's face amount. One would expect that the equity issued under a Lloyds-type contingent capital instrument would be worth less than the debt's face amount if conversion occurs. Accordingly, the issuer would recognise income at that time. Since one would expect the issuer to be in a tax loss position, the income would likely serve to reduce the issuer's tax loss carrybacks and carryovers. This would be an undesirable side effect occurring at exactly the wrong time.

CONCLUSION

From a structuring perspective, designing an instrument that will achieve the intended objectives and be attractive to investors remains a challenge. As ever with hybrid securities, the issuer will want the most 'efficient' structure. With a contingently convertible instrument, there are some important considerations. The most obvious is setting the right trigger. A contingent capital instrument is intended to convert with a modicum of disruption; however, the trigger itself may provoke unintended behaviours. In the Squam Lake version, there is a 'double' trigger proposed for contingent capital instruments. One prong of the trigger is focused on overall conditions, not on the particular bank's condition. This is important. If a trigger were set that related to the bank's stock price, which is reminiscent of the contingently convertible bonds that were

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TABLE: CRD REQUIREMENTS AS TO PROPERTIES OF INNOVATIVE TIER ONE INSTRUMENTS ('ITOS')

Redemption/Maturity	Perpetual, or with maturity of at least 30 years. May be redeemed only with consent of relevant regulator. Competent authority may permit earlier redemption in case of an unforeseen change of regulatory classification
Call Option permitted	Yes, but may not be exercised earlier than five years after issuance (or if the terms provide for a step-up or other incentive to redeem, incentive may not become effective before ten years after issuance). Call can only be exercised with consent of relevant regulator
Coupons	Non-cumulative only and able to be cancelled, on a non-cumulative basis, by issuer at any time
Alternative coupon settlement	Coupon may be satisfied by distribution of common stock in lieu (question whether or not the in-kind distribution can be monetised prior to distribution to holder of ITOs)
Incentives to redeem permitted	Incentives such as interest rate step-up are permitted for perpetual securities if they are 'moderate' (which according to the CEBS means they do not exceed 100 basis points* or 50% of the initial credit spread* and only one step-up is permitted during the life of the ITOs), and may not become effective earlier than ten years after the ITO issuance. A principal stock settlement mechanism is also permitted if the conversion ratio does not exceed 150% of the conversion ratio at the issue date of the ITOs
Ranking on bankruptcy or liquidation	Subordinate to all non-subordinated creditors
Other material features	The terms of the ITOs must provide for principal, interest and dividends to be such as to absorb losses and not hinder recapitalisation of the ITO issuer

first referred to in the US in 2000 as 'co-cos', then, it is conceivable that market participants might be encouraged to short the issuer's stock. Such a trigger also raises the prospect of substantial dilution if, in fact, there were no conversion 'floor'. The security might then have an unintended 'death spiral' effect, which could result in significant dilution for existing equity holders and may provoke a 'race to the bottom' for short sellers. Academics have raised the possibility of setting a trigger based on market capitalisation instead. A market capitalisation-based trigger mitigates shorting dangers, but it still may have a death spiral effect. Then, there are questions regarding

disclosure of the trigger. In the US, the trigger would unquestionably have to be disclosed by the issuer to investors. Standard & Poor's has asked about ongoing disclosure of trigger levels or ratios. In its commentary on contingent capital instruments, Standard & Poor's asked a number of questions, including the following: how frequently the trigger ratio will be monitored, who will do the monitoring, and whether the status of the ratio will always be disclosed.

It is difficult to gauge whether investors will have an appetite for these newest hybrids. Certain categories of investors cannot purchase debt securities that may

morph into equity securities (in legal form), or securities that expose them to equity type risks. Hybrid investors may still be reeling from the losses that they suffered during the financial crisis. If investors were surprised that their hybrid payments were deferred or suspended altogether, they may not be too pleased with instruments that are even more equity-like under stress scenarios. It is not clear how an investor would price a security so that the investor is compensated for the risk of conversion at par. Unless structures are modified, it is the investor who bears the risk that the security will convert into a fixed number of shares of equity at a time when the bank's stock price is likely dropping. It is also not clear that investors will be comfortable without a more detailed procedure or enforcement mechanism that requires prompt conversion when a trigger is breached.

Thus, there are more questions than answers about contingent capital instruments. In a perfect world, regulators would clarify these issues at the same time as they put forward guidance regarding regulatory capital. Whether 2010 will see that perfect world is unclear. ■

* Less the swap spread between the initial index basis and the stepped-up index basis.

- 1 Proposal for a Directive amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management (1 October 2008), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2008:0602:FIN:EN:PDF>
- 2 See Written Statement by Raghuram G Rajan to the Senate Banking Committee Hearings on 6 May 2009, as well as the Squam Lake Group's proposal at www.cfr.org/publication/19001/reforming_capital_requirements_for_financial_institutions.html.
- 3 Squam Lake Group paper at www.cfr.org/publication/19002.
- 4 See Kashyap, Anik K; Rajan, Raghuram G and Stein, Jeremy C, 'Rethinking Capital Regulation', in Federal Reserve Bank of Kansas City Symposium, Maintaining Stability in a Changing Financial System, February 2009, pp 431-71; www.kc.frb.org/publicat/sympos/2008/KashyapRajanStein.03.12.09.pdf.