Developments in BANK HYBRID CAPITAL - *the regulatory perspective*

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Bank hybrid capital, i.e., instruments that are capital for regulatory purposes but debt for tax purposes, has been around in any number of guises since the United States adopted bank capital rules in the early 1980s.[1] The adoption of the Basel Accord ('Basel I')[2] paved the way for more sophisticated hybrid capital instruments. Today's markets are seeing a new interest in bank hybrid capital instruments as the regulator draws even clearer lines between Tier 1 capital and other instruments.

BACKGROUND

Basel I sets out rules for measuring capital adequacy for banks. It divides capital into two categories: (i) core capital ('Tier 1') and supplementary capital ('Tier 2'). Tier 1 capital includes common stock, non-cumulative perpetual preferred stock, disclosed reserves and minority interests in the equity accounts of consolidated subsidiaries. Tier 2 capital includes undisclosed reserves, asset revalutation reserves, general provisions/loan loss reserves, hybrid (debt/equity) capital instruments (e.g., mandatory convertible debt, cumulative perpetual preferred stock), term subordinated debt and intermediate term preferred stock.

Basel I then compares regulatory capital to assets by looking at two ratios (i) Tier 1 capital to total consolidated assets, and (ii) total capital to total risk-weighted assets. A bank is required to maintain a minimum ratio of (i) 4% Tier 1 capital to total consolidated assets, and (ii) 8% total capital to total risk-weighted assets.

In the US, the bank regulatory agencies, (the Federal Reserve Board ('FRB' or 'Federal Reserve'), the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Office of Thrift Supervision) adopted the principles of Basel I in 1989. In particular, even though Basel I was designed to apply to internationally active banks, the US bank regulators extended it to all commercial banks in the US and to bank holding companies ('BHCs'), including financial holding companies.

DEVELOPMENT OF BANK HYBRID SECURITIES

The earliest hybrids were US mandatory exchangeables designed to qualify as primary capital under the pre-Basel I capital adequacy rules. These rules included in primary capital, among other items, common stock, perpetual preferred stock, and mandatory convertible instruments. In 1985, the US Internal Revenue Service ('IRS') blessed one such instrument: a 10-year deeply subordinated debt instrument payable in the bank holding company's preferred stock.[3] At maturity the holder had the right to receive common or perpetual preferred stock with a value equal to the instrument's face amount. If the holder elected, the issuer would sell the preferred on the holder's behalf (and at the BHC's expense) with the holder having the right to recover any shortfall against the BHC. Presumably the instrument's short term and the contractual right to receive the instrument's face amount convinced the IRS that the instrument was debt for federal income tax purposes. This ruling marks the only published ruling by the IRS addressing a bank hybrid security in the last 20 years.

Outside the US, bank hybrid securities have been relatively easier to create for one key reason: a number of jurisdictions permit interest deductions on perpetual debt instruments. For example, Belgium and France each permit interest deductions for interest paid on perpetual debt instruments. The US, on the other hand, does not permit interest deductions on perpetual debt.

In the mid-1990s, US investment bankers began exploring alternative avenues to create hybrid securities in light of this tax obstacle. In 1996, Chase Manhattan Bank sponsored the first real estate investment trust ('REIT') designed to create Tier 1 capital for a bank. Chase formed a REIT by contributing cash and assets in exchange for common stock. The REIT sold non-cumulative perpetual preferred stock to the public. The REIT used the proceeds from the offering to buy additional mortgages from Chase. Income on the mortgages was collected by the REIT and distributed by the REIT to the preferred shareholders. Under the special US tax rules applicable to REITs, the REIT could deduct the dividends paid on the preferred (and the common). The net effect was to "carve out" the income stream on the mortgages from the corporate level tax.

The next key development was the Federal Reserve Board's decision in 1996 to treat 'trust preferred' securities as Tier 1 capital, subject to a limit equal to 25% of a bank holding company's Tier 1 capital. A trust preferred represents beneficial ownership interest in a trust, normally a Delaware statutory trust. The trust invests the proceeds of the trust preferred offering in a subordinated, long-dated (e.g., 49-year) debt issued by the bank holding company. Interest on the debt instrument can be deferred, usually for up to five years, without default. The benefit of a trust preferred from a federal income tax standpoint is that interest on the loan is deductible. The trust is a flow-through entity for federal income tax purposes and its income does not attract a separate tax. The net effect for the issuer is a tax deduction for distributions on the trust preferred. The FRB guidance treated such instruments as Tier 1 so long as (i) they were subordinated to all subordinated debt, (ii) they had a minimum five-year option to defer interest, and (iii) they had the longest feasible maturity. The guidance permitted redemption only with the FRB's permission. It appears that the most important feature to the FRB was the five-year interest deferral, the thought being that a financial institution would either be bankrupt or have recovered in five years.

After the FRB's 1996 announcement a number of large bank holding companies issued a substantial amount of trust preferred securities. More recently, small issuers have pooled their trust preferreds in large offerings organised by investment banks. The idea is to bring the trust preferred concept to a small bank that otherwise would be shut out of the trust preferred market.

On the tax side, during the 1990s the Clinton Administration proposed limiting such securities either by imposing a maximum maturity date (40 years) or by restricting interest deductions for instruments that were not shown on the balance sheet as debt. The IRS, on the other hand, issued a non-binding 'technical advice memorandum' that held that a trust preferred-like security was debt for federal income tax purposes.

That remains the only IRS guidance on such instruments.

Today, the attractiveness of trust preferreds has been reduced for the largest bank holding companies. In 2005, the Federal Reserve tightened up the treatment of trust preferreds for internationally active bank holding companies that are subject to Basel I. In the case of internationally active bank holding companies, trust preferreds were limited to 15% of Tier 1 capital. A combined limit of 25% applies to trust preferreds and certain mandatory convertible securities which were described by the Federal Reserve as "securities that consist of the joint issuance by a bank holding company to investors of trust preferred securities and a forward purchase contract, which the investors fully collateralise with the securities, that obligates the investors to purchase a fixed amount of the bank holding company's common stock, generally in three years."

Since the 2005 announcement, investment bankers in the US have been working to create securities that are treated as Tier 1 capital, create interest deductions for the issuer, and are outside of the 15% basket and instead subject to the 25% limit applicable to 'mandatory convertible' securities. The first offering of this type was accomplished by Wachovia Corporation, a BHC, in January 2006.

In the Wachovia structure, Wachovia issued an investment unit ('Wachovia Income Trust Securities' or 'WITS') consisting of (i) a 37-year subordinated debt instrument, and (ii) a five-year forward contract on perpetual preferred stock. Both the WITS and perpetual preferred carried a 5.8% coupon until March 15, 2011. The offering is structured so that after five years the subordinated note is remarketed. Proceeds from the remarketing are used to exercise the forward contract. If the note is not remarketed then the note is used to settle the holder's obligations under the forward contract.

The Federal Reserve Board on January 23, 2006 issued a letter to Wachovia that considered this structure. The letter concluded that the security would count outside of the 15% basket as Tier 1 capital. The Federal Reserve took this position despite the fact that at least some market participants viewed the structure as having a 'step-up' in rate after five years. Thus, the FRB has historically not permitted Tier 1 instruments to contain stepped-up interest rates coupled with a call option. The thinking apparently is that the step-up will induce the issuer to exercise the call, creating a *de facto* maturity date for what the FRB requires be a perpetual instrument. In the WITS transaction when the perpetual preferred stock is issued, the issuer will be paying a non-deductible coupon as compared to a deductible coupon on the subordinated note. The issue is whether the issuer will be induced to call the perpetual preferred because its after-tax cost of keeping the security outstanding has increased dramatically. We understand that the FRB is considering further guidance on this issue after the Wachovia letter.

More recently, Washington Mutual ('WaMu') used a partnership structure to accomplish a similar result. The WaMu offering was 'fixed-to-floating rate perpetual non-cumulative trust securities' ('trust securities'). The trust securities are issued by a Delaware statutory trust ('Trust'). They represented interests in a like amount of fixed-to-floating rate perpetual non-cumulative preferred securities ('preferred securities') issued by Washington Mutual Preferred Funding LLC ('Preferred Funding'). Preferred Funding, in turn, purchased a regular interest in a real estate mortgage investment conduit ('REMIC') for federal income tax purposes. The REMIC owns home equity loans ('HELs') transferred by Washington Mutual Bank ('WMB'). Preferred Funding is designed to be treated as a partnership for federal income tax purposes.

The preferred securities are designed to be treated as core capital of Washington Mutual Bank for regulatory purposes. In this regard, it is important to note that WMB is a federal savings bank regulated by the Office of Thrift Supervision, or OTS, which is the primary regulator. Unlike the Federal Reserve Board, the OTS does not treat trust preferred as 'Tier 1' capital. The preferred securities are non-cumulative in that Preferred Funding will pay dividends on the preferred securities only if, as and when declared by Preferred

Funding's Board of Managers. If, however, Preferred Funding does not pay dividends on the Preferred Securities then Washington Mutual Inc., the parent of WMB, agrees not to pay dividends on its publicly held common stock. The preferred securities are also subject to conversion into perpetual non-cumulative preferred stock issued by WMI. The conversion will occur if the OTS so directs following certain events, including WMB becoming 'undercapitalised' under the OTS 'prompt corrective action' regulations, or the OTS anticipates WMB becoming undercapitalised.

From a federal income tax standpoint, the REMIC is a flow-through entity. Income on the HELs passes through to Preferred Funding which is a partnership for federal income tax purposes. As a partnership, Preferred Funding is not subject to US federal income tax. Instead, its income is allocated to its partners, including the Trust. The net effect of the structure, as with the Chase REIT structure described earlier, is to "carve out" from corporate income tax the income stream on the HELs. The structure bears some resemblance to a transaction done by Lehman Brothers in August, 2005, so-called ECAPs. However, in the ECAPs structure the offering proceeds are loaned directly back to Lehman and its affiliates rather than being invested in mortgages.

The current wave of hybrid security development is being driven, as usual, by the desire to lower the cost of raising capital. In the case of US banks, unlike foreign banks, this is not easy to do because the US does not recognise perpetual debt as debt for federal income tax purposes. Instead, US BHCs and banks are being forced to come up with creative structural solutions that bridge the gap between US bank regulators and US tax authorities. We expect there will be continued innovation in the months to come.

Notes:

1. Joint News Release of the Federal Reserve Bank's Board of Governors and the Office of the Comptroller of the Currency (December 17, 1981).
2. Basel Committee, "International Convergence of Capital Measurement and Capital Standards" (July, 1988).
3. Rev. Rul. 85-119, 1985-2 C.B. 60.

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