

Basel III Numerator

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Overview

- Evolution of new capital requirements
- Major capital reforms
 - Composition of capital
 - Increased risk-based ratios
 - Leverage ratio
 - Countercyclicality
 - Liquidity
 - Contingent capital
- Recent market experience
 - Replacement of non-qualifying hybrid securities
 - Contingent capital instruments

Evolution: Sources of Basel III

- Insufficient capital to weather the financial crisis.
- Over-reliance on what proved to be inadequate credit risk analysis of assets.
- Under-reliance on loss-absorbing Tier 1 capital and leverage measurements.
- Certain hybrid instruments insufficient “loss absorbent”.
- Opacity of certain complex financial instruments.

Evolution – Basel II

- Basel II was almost exclusively focused on a more sophisticated analysis of the credit risk of different assets—i.e., the denominator of the capital adequacy ratios.
- Based on changes to the denominator, Basel II revised slightly the minimum ratios for Tier 1 and total risk-based capital. As with Basel I, there was no leverage ratio.
- The requirements for the components of capital have remained conceptually the same since Basel I in 1988, with some adjustments for new securities, such as trust preferreds.
- The Basel II requirements relating to the credit and other risks of particular assets remain largely in place.

Evolution – A Brief Chronology

- July 2006: Basel II finalized for internationally active banking organizations.
- June 2008: US regulators propose simpler standardized approach for institutions that do not use Basel II.
- August 2007: Banc Paribas defaults on bonds backed by US mortgages, formally triggering the financial crisis.
- March 2008: Collapse of Bear Stearns.

Chronology – cont'd

- July 2009: BCBS publishes enhancements to Basel II, relating primarily but not exclusively to securitizations.
- September 2009: BCBS announces other initial measures to address financial crisis.
- December 2009: BCBS releases consultative document on Basel III
- December 2009 – July 2010: Dodd-Frank debated and enacted.
- December 2010 – July 2011: Basel III largely completed.

Evolution – Dodd-Frank Act

- The Dodd-Frank Act confirms and elaborates on the Basel III reforms.
 - Enhanced capital ratios generally
 - Composition of capital – the Collins Amendment
 - Leverage ratio
 - Countercyclicality requirement
 - Liquidity
 - Contingent capital
- Dodd-Frank also includes qualitative reforms, such as risk committees and stress test requirements.

Capital Components – Common Equity

- Definition of Tier 1 capital moves toward the definition of “tangible common equity.”
- Explicit minimum ratio of common equity to risk weighted assets.
- Specific eligibility criteria for common equity, including full subordination and absence of any repurchase or redemption obligation.

Capital Components – Other Tier 1 Instruments

- Several innovative Tier 1 instruments will be phased out, including, for example, step-up instruments, cumulative preferred stock, and trust preferred stock.
- Other instruments may qualify on Tier 1 capital, if they are:
 - Subordinated to depositor claims;
 - Perpetual, with no maturity date or incentive to redeem;
 - Redeemable at the issuer's option only after five years and then subject to certain conditions
 - Subject to discretion on the issuer's part to cancel payments
 - Recapitalization – neutral.

Capital Components – Hybrids Instruments

- Several “innovative” Tier 1 instruments would be phased out, including, for example, step up instruments; cumulative preferred stock; and trust preferred stock.
- Rules promulgated pursuant to the Collins amendment will exclude trust preferreds and other hybrids from the numerator of Tier 1, subject to limited exceptions
 - The exclusion applies to all hybrid securities issued on or after May 19, 2010.
 - For mutual holding companies and thrift and bank holding companies with less than \$15 billion in total consolidated assets, hybrids issued before May 19, 2010, are included in Tier 1 until they mature.
 - For bank holding companies with assets of \$50 billion or more and systemically important nonbank financial companies, hybrids issued before May 19, 2010, will be phased out of Tier 1 from January 2013 to January 2016
 - Intermediate U.S. holding companies of foreign banks have a five-year transition period to phase-out pre-May 19, 2010, hybrid securities from Tier 1 capital.

Capital Components – Hybrid Instruments

- Within 18 months of enactment, GAO must conduct a study of the use of hybrid capital instruments as a component of Tier 1, which shall consider, among other things:
 - the benefits and risks of allowing instruments to be used to comply with Tier 1 requirements,
 - the economic impact of prohibiting the use of hybrids, and
 - possible specific recommendations for legislative or regulatory actions regarding the treatment of hybrids

Capital Components – Deductions

- Basel III introduces a series of new deductions from Tier 1 capital:
 - Minority interests in consolidated subsidiaries of banks;
 - Banks' own non-controlling, minority investments in financial institutions;
 - Deferred tax assets up to a limit;
 - Shortfall in reserves;
 - Mortgage serving rights;
 - Goodwill and other intangibles;
 - Gains on sale in securitization transactions;
 - Gains and losses due to changes in banks' own credit risk; and
 - Defined benefit pension fund assets and liabilities.
- New markets for instruments to mitigate these deductions will arise.

Capital Components –Tiers 2 and 3

- Basel III simplifies Tier 2 capital by establishing a single set of eligibility criteria and eliminating Upper and Lower Tier 2.
- In order to qualify as Tier 2 capital, any instrument must be subordinated to depositors and general creditors; not secured; not guaranteed; must have an original maturity of at least five years; and must be callable by the issuer only after a minimum of five years.
- Tier 3 (market risk) will be eliminated completely.

Dodd-Frank

- Collins amendment (Sec. 171) is an overlay on the Basel III requirements.
 - Requires the establishment of new minimum leverage and risk-based capital requirements for bank and thrift holding companies.
 - The floor for the new standards is the current set of rules applicable to banks and thrifts.
 - Unclear how the U.S. regulators will treat new holding company instruments that are modeled on earlier capital instruments.
- Limits discretion in establishing Basel III requirements: U.S. can adopt more onerous standards, but cannot adopt laxer standards.

Increased Risk-Based Ratios

- Minimum common equity
 - Current Basel requirement is 2%.
 - New requirement of 3.5% will take effect Jan. 1, 2013, rising to 4.5% by Jan. 1, 2015.
- Minimum Tier 1 capital
 - Current requirement is 4%.
 - Requirement of 4.5% will take effect Jan. 1, 2013, rising to 6% by Jan. 1, 2015.
- Minimum total capital requirement
 - Remains at 8%.
- Note new ratios are based on more stringent definition of capital.

Capital Conservation Buffer

- Requires banks to build up capital outside periods of stress which can be drawn down as losses are incurred.
- Ratio of Tier 1 common equity to risk-weighted assets.
- Buffer is phased in in equal increments over three year period, beginning with 0.625% on Jan. 1, 2016.
- On January 1, 2019 permanent buffer of 2.5% takes effect.

Countercyclical Buffer

- Buffer to be employed when “excess credit growth is judged to be associated with a build-up of system-wide risk.”
- Buffer is an extension of the capital conservation buffer.
- Buffer is set on a national basis; buffers will not be internationally uniform.
- Buffer requirement should be announced 12 months in advance of effective date.
- Phase-in along the same time frame and in the same amounts as conservation buffer.
- Ceiling will be 2.5% as of Jan. 1, 2019.
- Requirements higher than the phase-in amounts presumably could not be imposed.

Leverage Ratio

- A leverage ratio will be used as a supplementary measure to the risk-based capital framework.
- Ratio requires a minimum level of capital relative to total assets.
 - Minimum ratio of Tier 1 capital to total assets of 3% will be monitored in 2011 and 2012.
 - Ratio will be used on a parallel run through 2016. (Ratio must be disclosed beginning in 2015.)
 - Adjustments may be made in 2017, and the presumptive rate of 3% takes effect on Jan. 1, 2018.
- Capital Measure: **numerator** of the leverage ratio (capital) would consist of only high quality capital that is generally consistent with the revised definition of Tier 1 capital.
- Total Exposure Measure: generally, the proposal indicates that the **denominator** of the leverage ratio (the total exposures) would be determined in accordance with applicable accounting rules.

Leverage Ratio (cont'd)

- High quality liquid assets include cash and cash-like instruments in the measure of exposure.
- Securitization exposures would be counted in a manner generally consistent with accounting treatment.
- Derivatives exposures would either follow the applicable accounting treatment or use the current exposure method.
- Other off-balance sheet items included: commitments, unconditionally cancellable commitments, direct credit substitutes.
- Note that Dodd-Frank addresses leverage in other ways:
 - Possible limits on short term debt.
 - Specific debt-to-equity limit of 15% for bank holding companies with consolidated assets of \$50 billion or more and systemically important nonbank financial companies.

Phase-ins

Phase-in arrangements (all dates are of January 1 of each year)

(%)	2011	2012	2013	2014	2015	2016	2017	2018	2019
Minimum Common Equity Capital Ratio			3.50	4.00	4.50	4.50	4.50	4.50	4.50
Capital Conservation Buffer						0.625	1.25	1.875	2.50
Minimum Common Equity plus Capital Conservation Buffer			3.50	4.00	4.50	5.125	5.75	6.375	7.00
Minimum Tier 1 Capital			4.50	5.50	6.00	6.00	6.00	6.00	6.00
Minimum Tier 1 Capital plus Capital Conservation Buffer ¹						6.625	7.25	7.875	8.50
Minimum Total Capital			8.00	8.00	8.00	8.00	8.00	8.00	8.00
Minimum Total Capital plus Capital Conservation Buffer			8.00	8.00	8.00	8.625	9.25	9.875	10.50
Phase-in of deductions from Tier 1 (including amounts exceeding limit for DTAs, MSRs and certain investments)				20	40	60	80	100	100
Phase-out capital instruments no longer qualifying as Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon (10 per year beginning 2013)						

Public Sector Capital Injections	Included in Capital						Not included in capital (as of Jan. 1 2018)		
Leverage Ratio	Supervisory monitoring		Parallel run Jan. 1 2013 – Jan. 1 2017 Disclosure starts Jan. 1 2015			Final Adjustments		3.0 (Unless Adjusted)	
Liquidity Coverage Ratio (LCR)	Observation period begins				Introduce minimum standard				
Net Stable Funding Ratio (NSFR)		Observation period begins						Introduce minimum standard	

Source: Annex 2, BCBS Press release, Group of Governors and Heads of Supervision announces higher global minimum capital standards, 12 September 2010

Contingent Capital

- Final piece of Basel III
 - Principles outlined on January 13, 2011.
 - BCBS held further discussions yesterday, which are continuing today.
- Contractual terms of instruments should allow for either the permanent writedown of principal or conversion to common equity when a bank is viewed as non-viable
- Non-viability is when:
 - a public sector injection or the equivalent is needed, without which the bank would become non-viable, or
 - a write-off is required, without which the firm would become non-viable
- Local regulators would have discretion to specify a conversion rate and also whether to implement either a write-off or a conversion
- EU regulators considering more onerous “bail-in” measures.

Contingent Capital - Dodd-Frank Requirement

- Within two years of enactment, the FSOC must conduct a study on contingent capital that evaluates, among other things:
 - the effect on safety and soundness of a contingent capital requirement,
 - the characteristics and amounts of contingent capital that should be required, and
 - the standards for a triggering requirement
- The Council may make recommendations to the Fed on contingent capital requirements for bank holding companies with consolidated assets more than \$50 billion and systemically important non-bank financial companies.
 - Federal Reserve authorized but not required to set a contingent capital requirement.

Contingent Capital - Swiss regulators

- In October 2010, a council appointed by the Swiss government proposed a set of measures to Swiss regulators
 - Includes an option to issue contingent capital to satisfy a portion of the new regulatory minimum capital requirements
 - The host instrument must qualify as Tier 2 capital or better
 - The instrument must convert to equity capital, rather than having principal written down
- Contingent capital may be utilized within two components: the capital buffer and progressive component
 - Within the proposed capital buffer, a maximum of 3% can be contingent capital whose conversion trigger is set at 7% common equity ratio
 - The proposal establishes a 6% progressive component, which may be composed entirely of contingent capital whose conversion trigger is set at 5% common equity ratio
- More details are forthcoming as regulators must still conduct rulemaking

Canadian regulators - OSFI guidance

- Following release of Basel bail-in release, OSFI provided guidance on national implementation of Basel III framework
- OSFI will revise capital adequacy guidelines, which are expected to be in place by end of 2012

Canadian regulators – Capital products

- Capital instruments issued prior to September 10, 2012 that previously qualified for regulatory capital but do not meet Basel III criteria will be phased out starting in January 2013 (on scaled basis)
- Banks should prioritize redemptions of capital instruments taking into account the Basel III transition period and the objective of minimizing the amount of capital that will be subject to a capital treatment event redemption

Canadian regulators – Contingent capital

- Starting in January 2013, all non-common Tier 1 and Tier 2 capital instruments must have provisions that require full and permanent conversion into common stock on the occurrence of a trigger event
- Trigger events would include: (1) regulatory notice that the institution has ceased, or is about to cease, to be viable, and that after conversion of contingent capital instruments is reasonably likely to be restored to viability; or (2) a regulator publicly announces that the institution has accepted or agreed to accept a capital injection from the government
- Contingent capital instruments must meet all other applicable Basel III requirements. Holders of such instruments cannot after conversion upon a trigger event have any residual claims senior to common equity

Canadian regulators – Contingent capital (cont'd)

- There cannot be any impediments to conversion. Conversion should be automatic and immediate (cannot require a shareholder vote or the receipt of other approvals)
- The terms of any contingent capital instrument must include that a conversion does not constitute an event of default
- The entity must ensure that conversion of the contingent capital instrument is not an event of default, or a credit event, under any other agreement

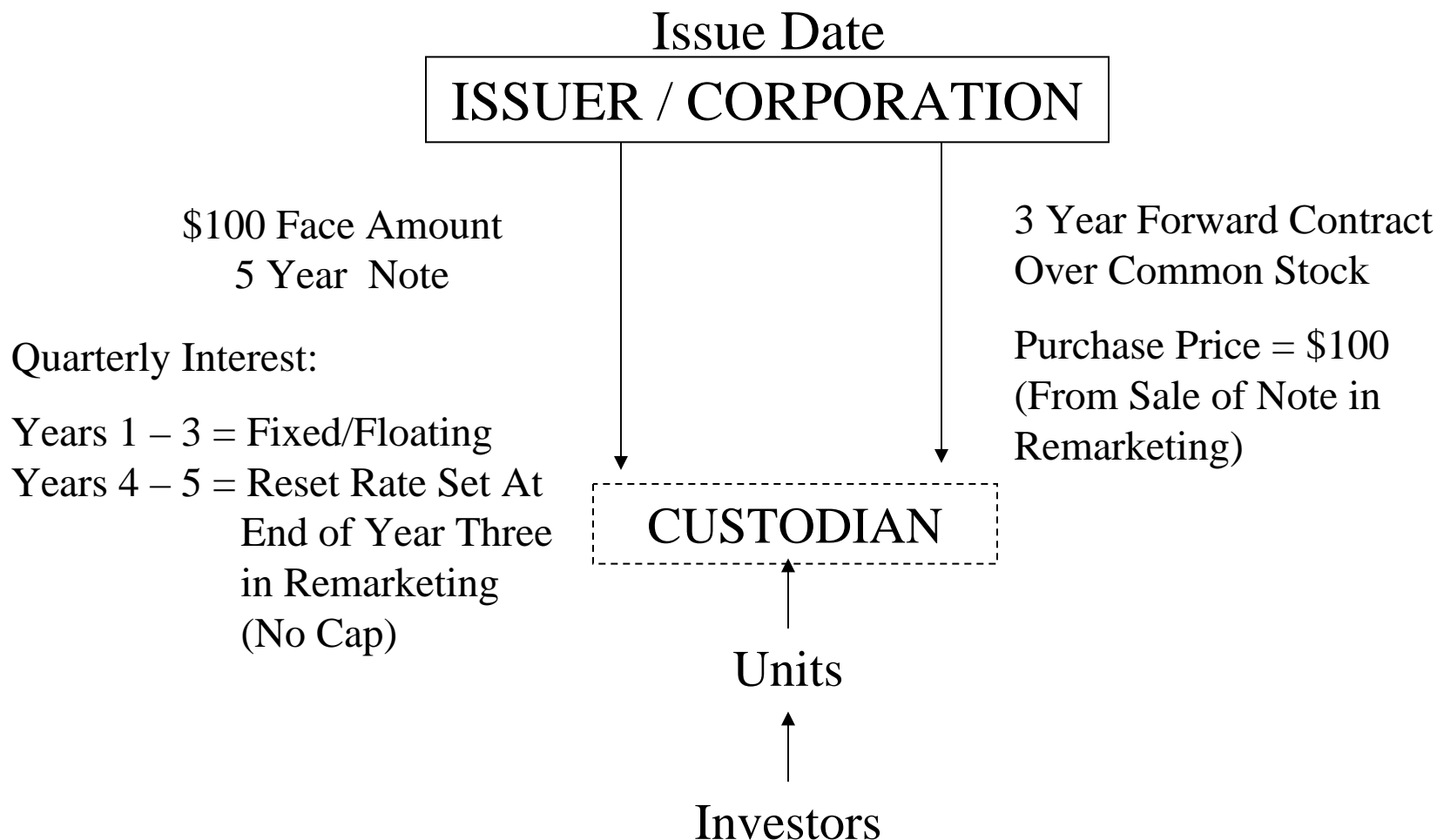
Canadian regulators – Assessing viability

- In considering whether an entity has reached the point of non-viability it should consider:
 - Whether its assets are sufficient to provide adequate protection to depositors and creditors;
 - Whether the entity's regulatory capital has reached a level that may adversely affect the entity's depositors and creditors;
 - Whether the entity has failed to pay any liability that has become due and payable or the entity will not be able to pay its liabilities as they become due and payable; and
 - Whether the entity is able to recapitalize on its own

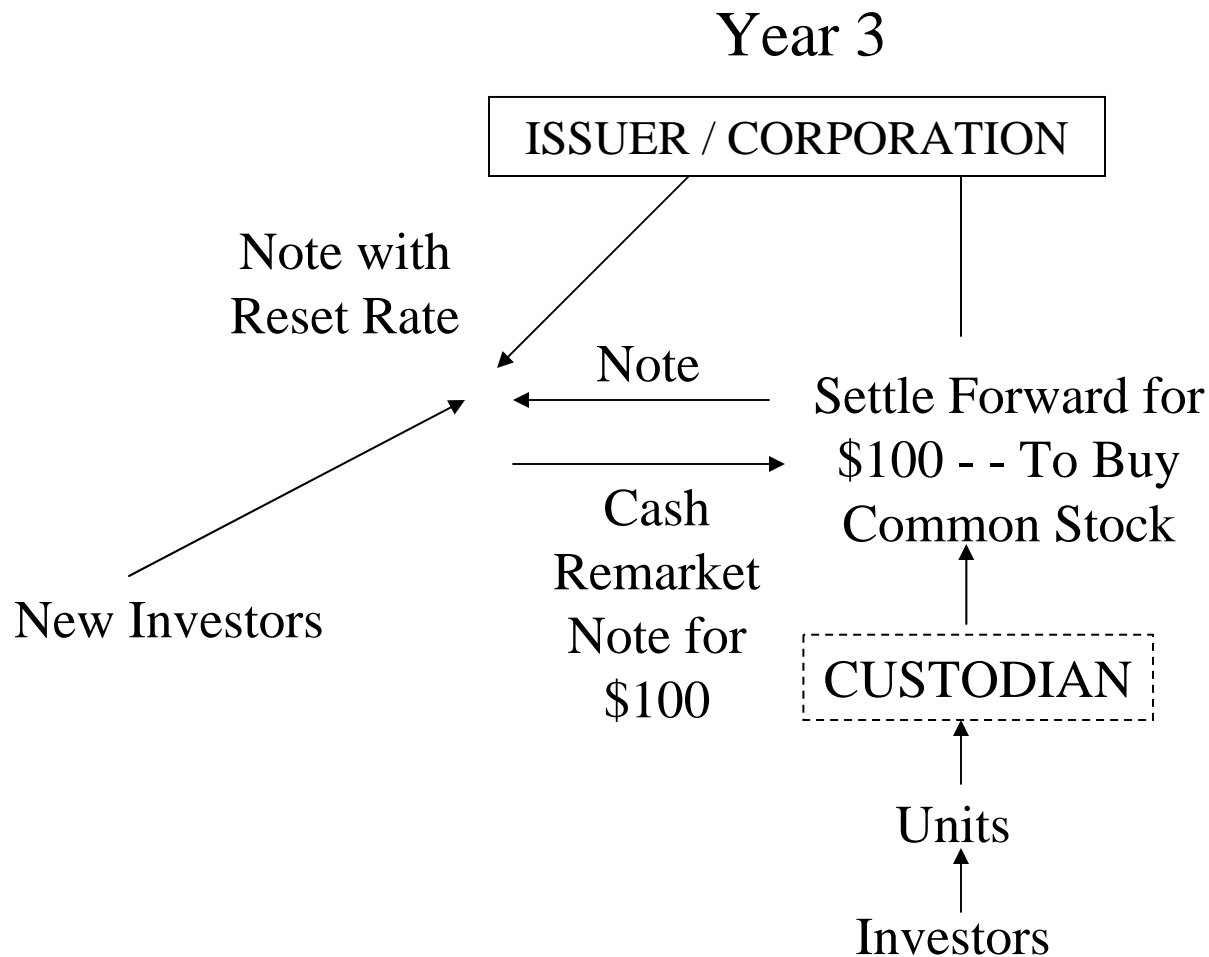
Market Activity

Tier 1 Instrument Proposals

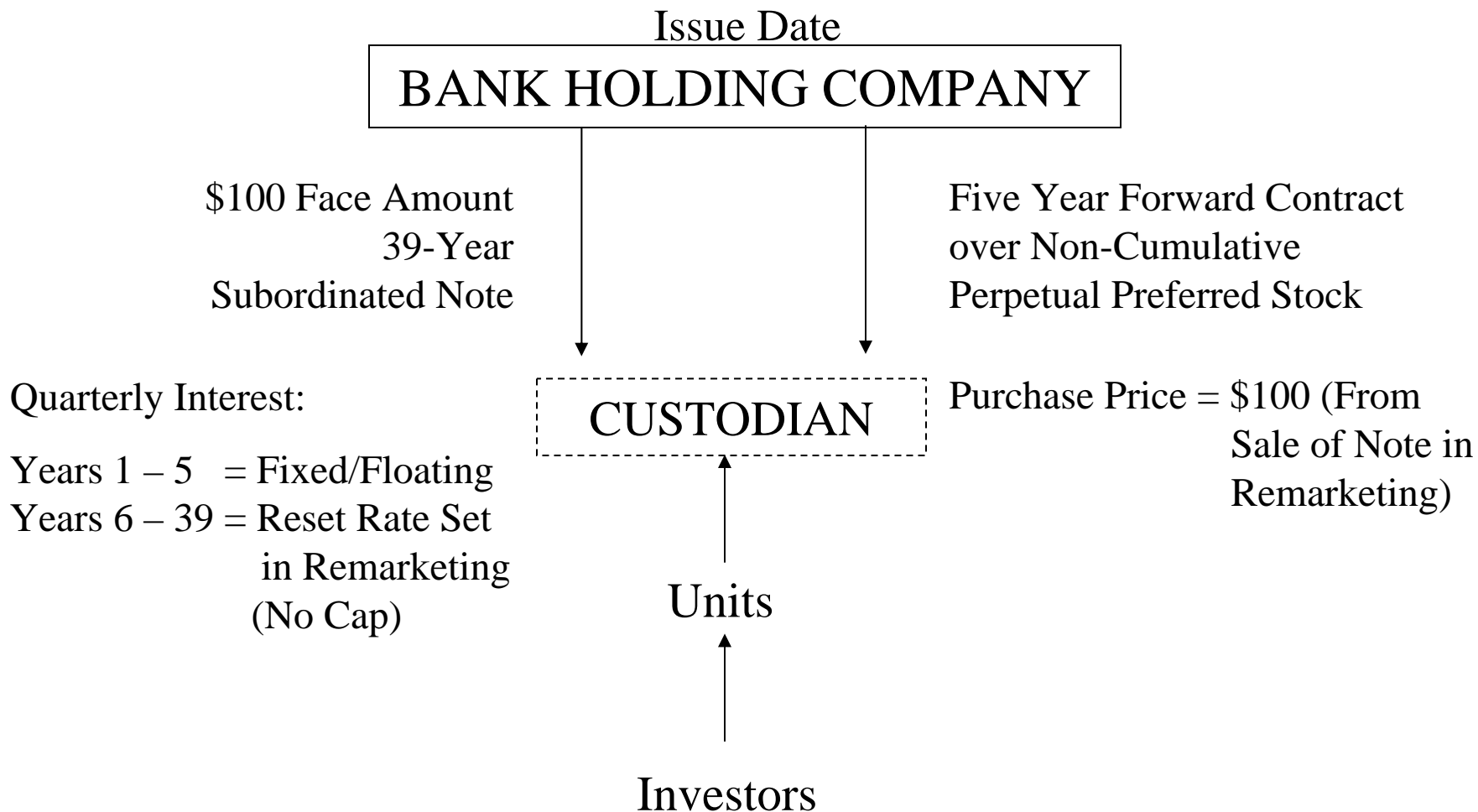
Mandatory Convertible Instruments — Common Stock Equivalents



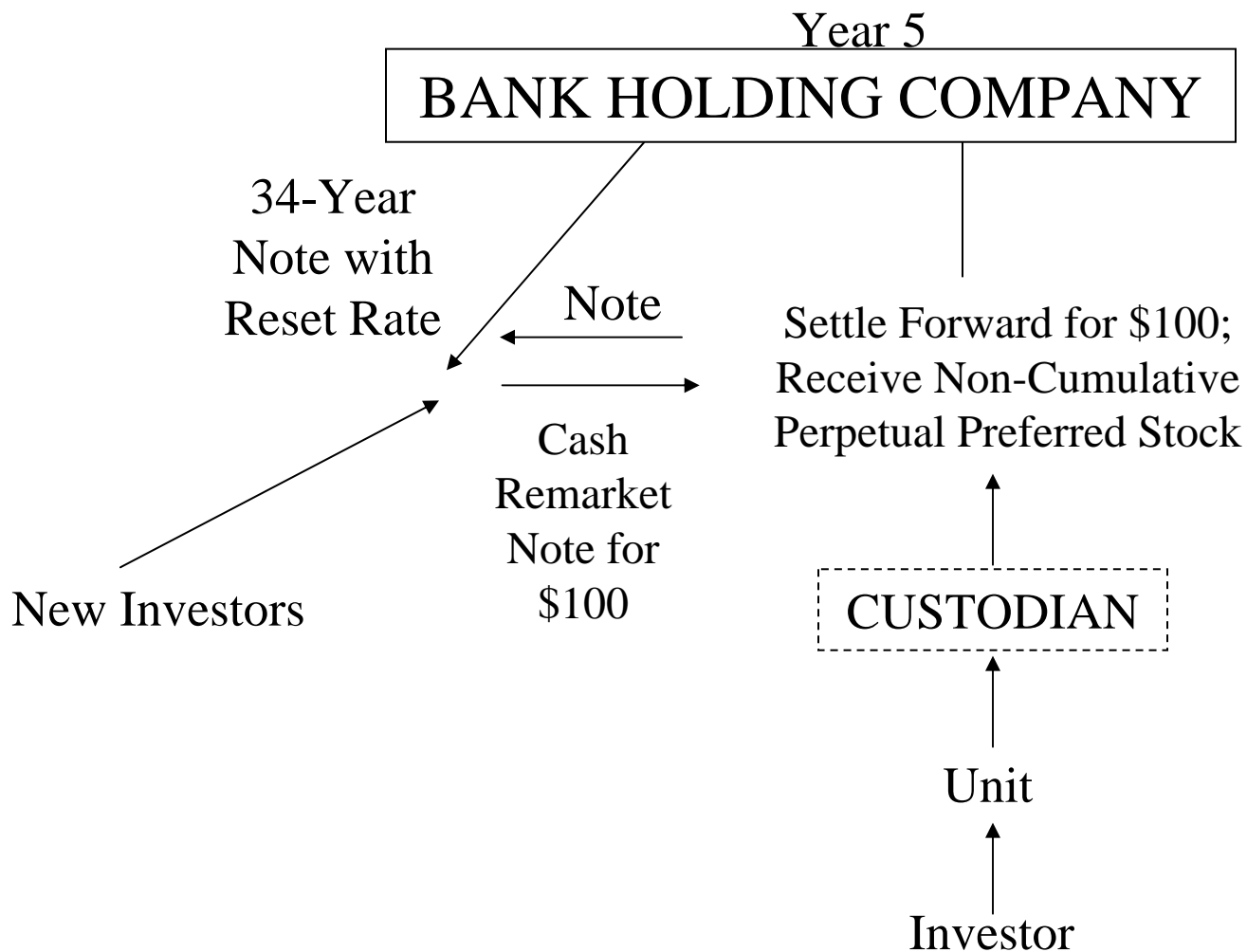
Mandatory Convertible Instruments — Common Stock Equivalents (cont'd)



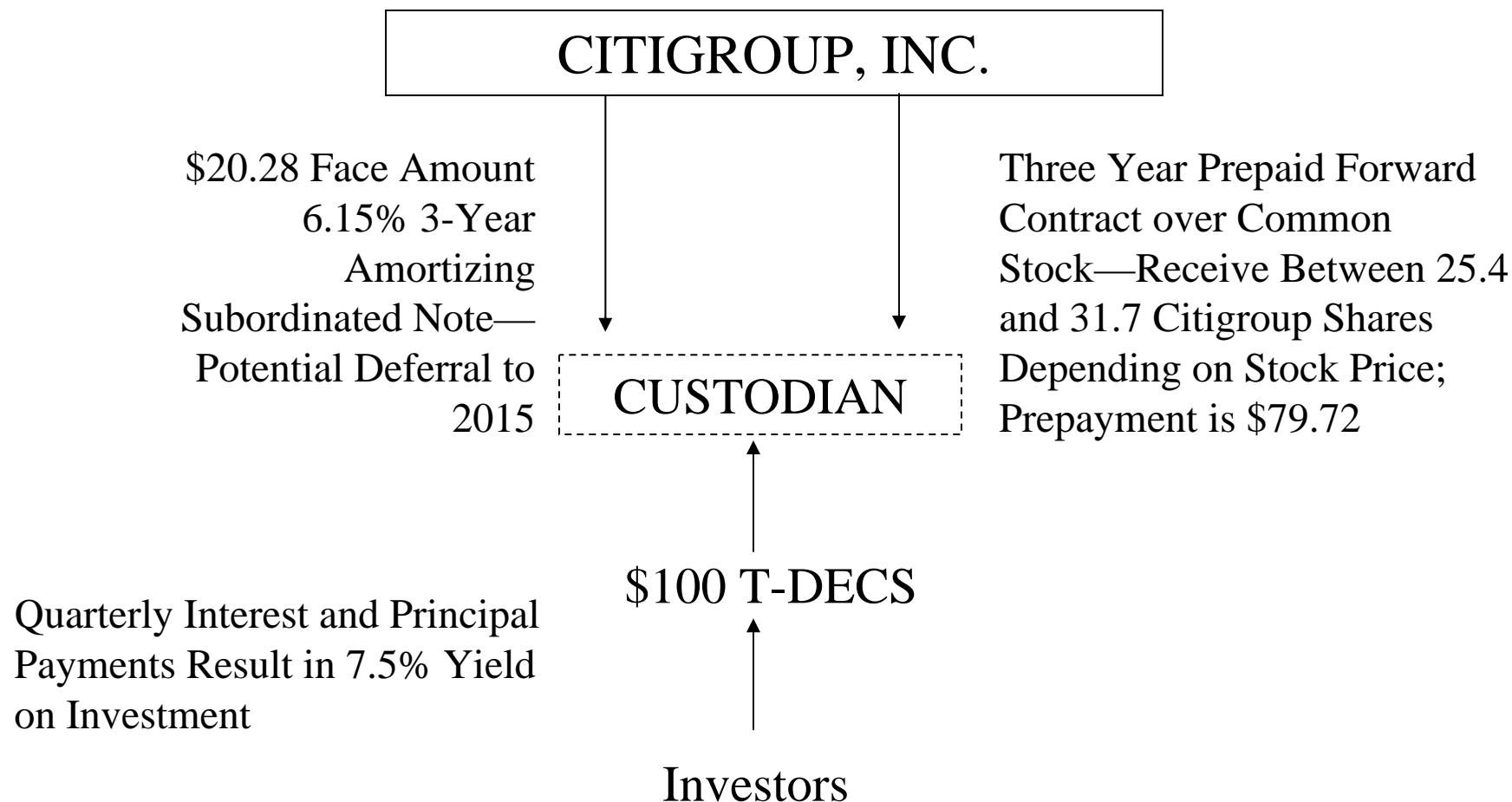
Mandatory Convertible Instruments — Preferred Stock Equivalents



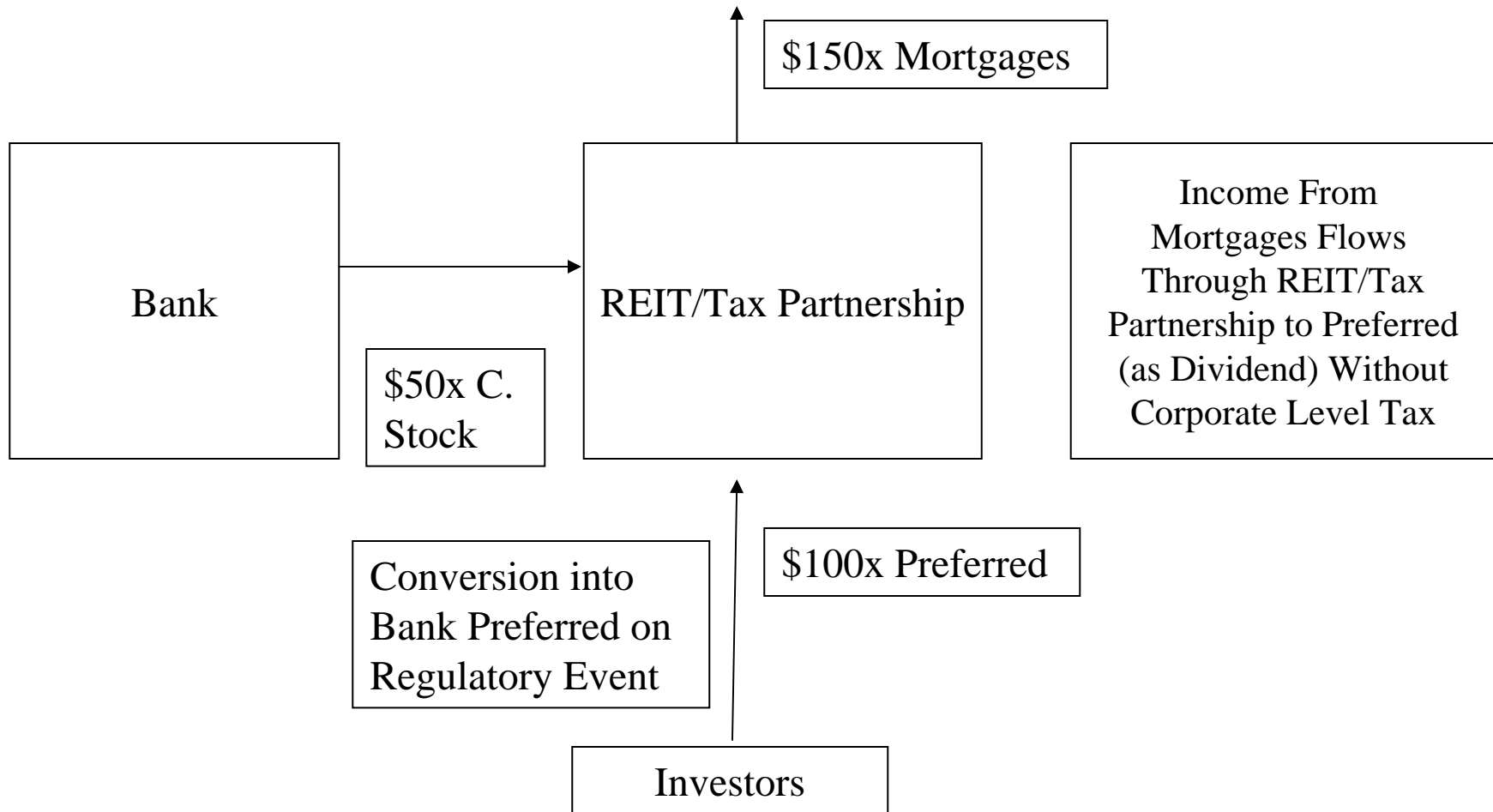
Mandatory Convertible Instruments — Preferred Stock Equivalents (cont'd)



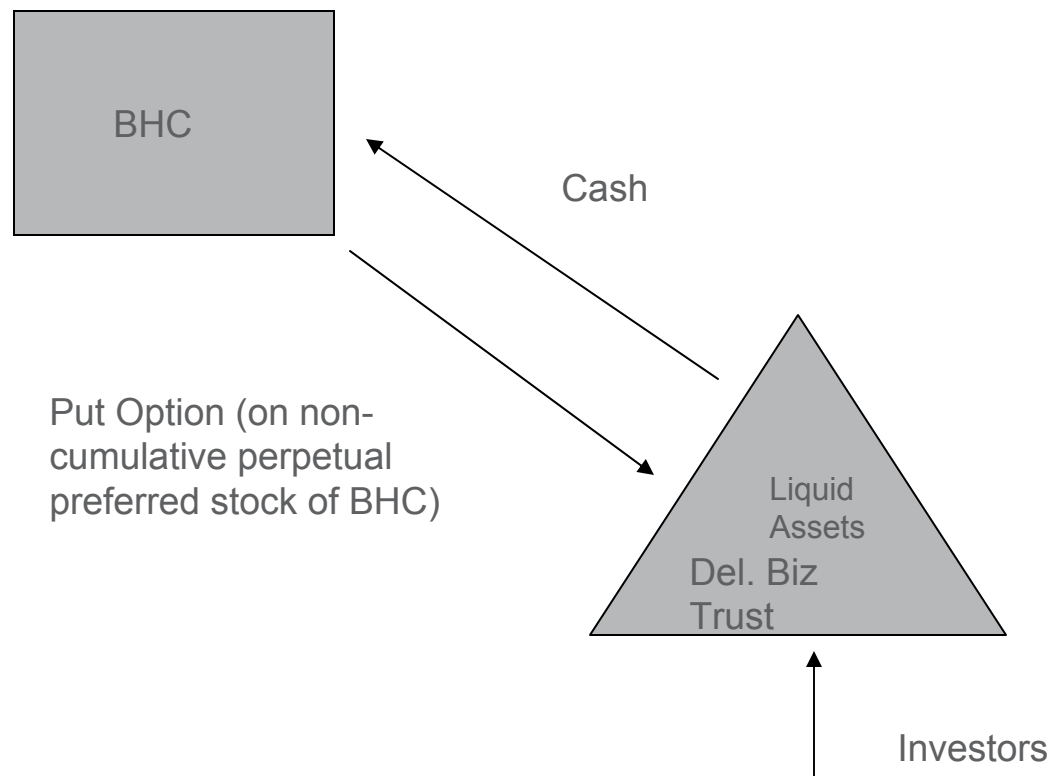
T-DECS



“REIT” Preferred



Standby Stock Facilities

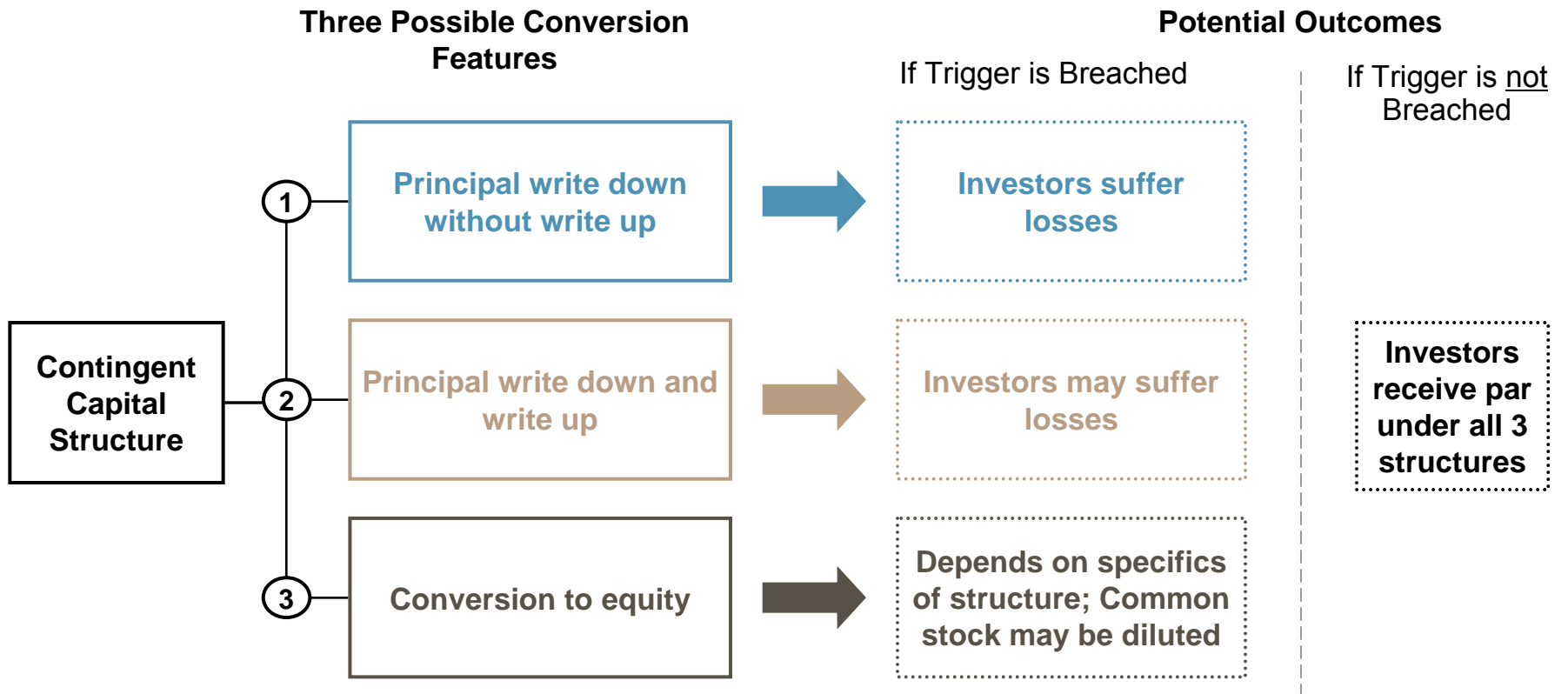


Market Activity Contingent Capital

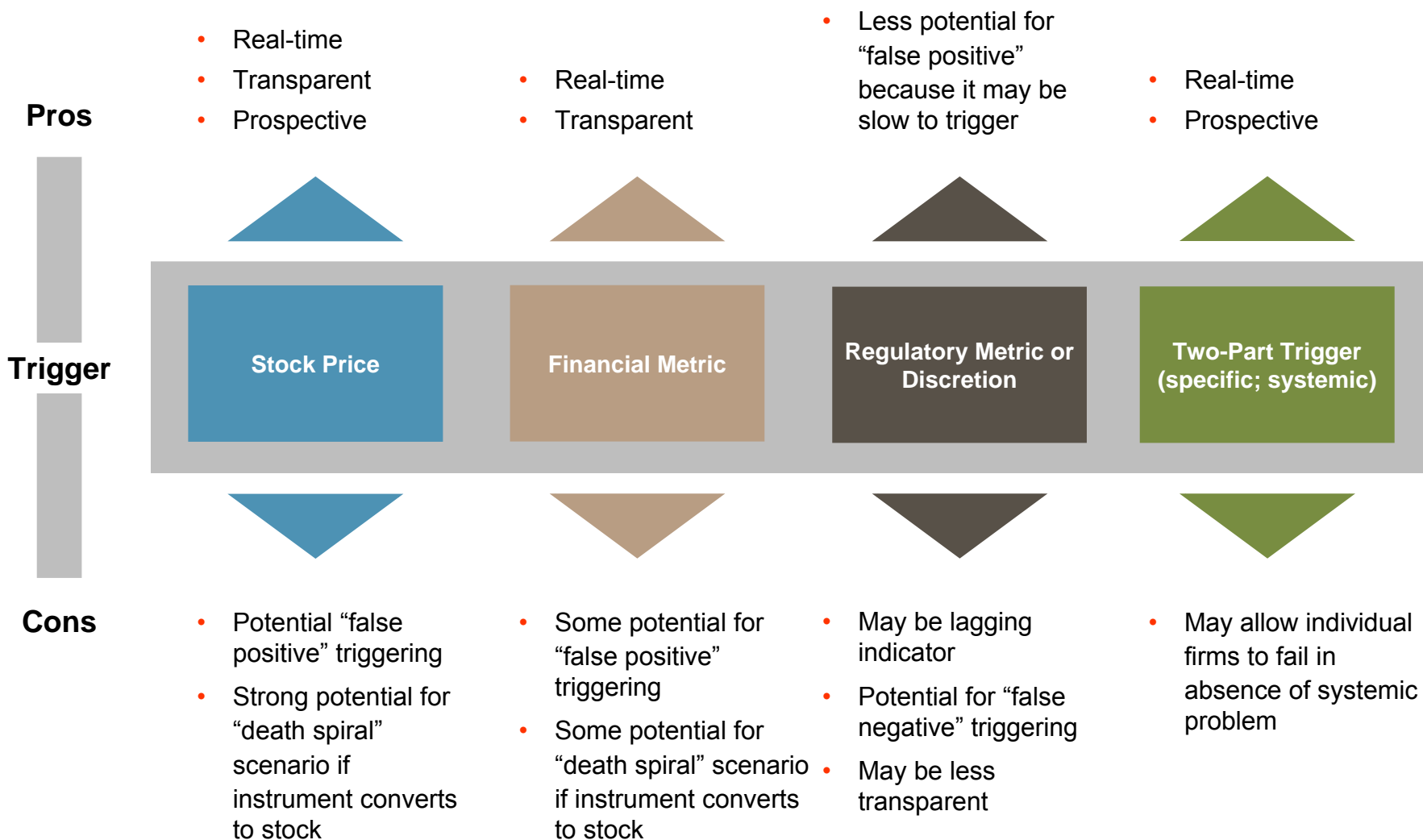
Contingent capital

- Contingent capital could be viewed as the latest incarnation of hybrids; forms of contingent capital may include:
 - Contingent debt instruments, including mandatorily convertible debt
 - Contingent funding vehicles/contingent “facilities”
 - Securities with permanent or temporary write-down features
 - Collateralized insurance policies

Possible Conversion Features



Possible Conversion Triggers – Pros & Cons



Lloyds Bank — November 2009

- £7.5 Billion Issue (Exchange Offer)
- Styled as “Enhanced Capital Notes”
- Ten year term
- Fixed interest rate, non-deferrable
- Converts to a fixed number of common shares if Lloyd’s core Tier One ratio falls below 5%
- Intended to be lower Tier 2 bonds for regulatory purposes
- Lloyds and holders agree to treat as equity for U.S. federal income tax purposes

Rabobank Senior Contingent Notes — March 2010

- Sale of €1.25b of 6.875% Senior Contingent Notes due 2020
- Notes are senior unsecured notes, with a ten-year term
- Subject to a Write Down of principal if a Trigger Event occurs
- Write Down is not a “default”
- Trigger Event: if Equity Capital Ratio falls below 7%
(Equity Capital Ratio = Equity Capital/RWA)
- Sold to institutions

Rabobank Perpetual Non-Cumulative Capital Securities — January 2011

- The capital securities are perpetual and have no scheduled maturity date
- Bear interest at the initial interest rate of 8.375% to (but excluding) July 26, 2016, payable semi-annually, and thereafter at a rate reset every five years based on the U.S. Treasury benchmark rate plus 6.425%
- Coupons are not cumulative and can be deferred in the following circumstances:
 - Payments on the capital securities and other parity or junior securities are greater than distributable profits
 - Regulatory solvency rules prohibit coupon payments
 - Equity capital ratio (equity capital divided by risk weighted assets) is less than 8%
 - The Dutch Central Bank believes that there will be a coupon deferral

Rabobank Perpetual Non-Cumulative Capital Securities — January 2011 (cont'd)

- Constitute direct, unsecured and subordinated obligations of the issuer and rank *pari passu* and without any preference among themselves
- Optional and mandatory redemptions
 - Issuer may redeem the capital securities, in whole but not in part, on or after July 26, 2016, but must redeem the capital securities on the first interest payment date on or after January 26, 2041 if certain conditions are met
 - Issuer may redeem the capital securities, in whole but not in part, prior to July 26, 2016 upon the occurrence of a tax event or a capital event
- Upon the occurrence of a capital event, the issuer may substitute or vary the terms of the capital securities so that they remain regulatory compliant securities

Rabobank Perpetual Non-Cumulative Capital Securities — January 2011 (cont'd)

- Loss absorption is triggered if:
 - Equity capital ratio falls or remains below 8%
 - Either the issuer or the Dutch Central Bank believes that there has been such a significant reduction in the issuer's retained earnings or similar reserves causing a significant deterioration in the issuer's financial and regulatory solvency position that the equity capital ratio will fall below 8% in the near term
- If loss absorption is triggered, the issuer will cancel any accrued but unpaid interest and write-down the prevailing principal amount of the capital securities
 - 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

Credit Suisse Tier 1 Buffer Capital Notes – February 2011

- Credit Suisse entered into an agreement with Qatar Holding LLC and The Olayan Group to issue USD 3.5 billion and CHF 2.5 billion of Tier 1 buffer capital notes (“Tier 1 BCNs”) with a coupon of USD 9.5% and CHF 9.0%, respectively, for cash or in exchange for USD 3.5 billion of 11% and CHF 2.5 billion of 10% Tier 1 capital notes issued in 2008
- The purchase or exchange of the Tier 1 BCNs will occur no earlier than October 2013, which is the first call date of the Tier 1 capital notes
- Subject to the implementation of Swiss regulations requiring Credit Suisse to maintain buffer capital and receipt of all required consents and approvals from shareholders, including approval for additional conditional capital or conversion capital

Credit Suisse Tier 1 Buffer Capital Notes – February 2011 (cont'd)

- The Tier 1 BCNs will be converted into ordinary shares if Credit Suisse's reported Basel III common equity Tier 1 ratio falls below 7%
 - 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 Credit Suisse's ordinary shares over a trading period preceding the notice of conversion
- The Tier 1 BCNs will also be converted if the Swiss Financial Market Supervisory Authority ("FINMA") determines that Credit Suisse requires public sector support to prevent it from becoming insolvent, bankrupt or unable to pay a material amount of its debts, or other similar circumstances
- The Tier 1 BCNs will help Credit Suisse satisfy an estimated 50% of its high trigger contingent capital requirement set by FINMA

Credit Suisse Tier 2 Buffer Capital Notes – February 2011

- Regulation S private issuance of USD 2 billion 7.875% Tier 2 Buffer Capital Notes due 2041 (“Tier 2 BCNs”)
- Supplementing offering of the Tier 1 BCNs to Qatar Holding LLC and The Olayan Group that was announced on February 14, 2011
- The Tier 2 BCNs will help Credit Suisse satisfy an estimated 70% of its high trigger contingent capital requirement set by FINMA
- The Tier 2 BCNs are expected to carry a rating of ‘BBB+’ from Fitch Ratings and to be listed on the Euro-MTF exchange

Credit Suisse Tier 2 Buffer Capital Notes – February 2011 (cont'd)

- The Tier 2 BCNs are subordinated notes with a 30-year maturity and may be redeemed by the issuer at any time from August 2016
- Guaranteed on a subordinated basis by Credit Suisse Group
- The initial coupon is reset every five years from August 2016
- Interest payments will not be discretionary or deferrable
- Same conversion feature as the Tier 1 BCNs

Selected Tax Issues

Debt Versus Equity

Debt Characteristics:

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

Issue:

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

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

Selected Tax Issues

Section 163(I)

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

Selected Tax Issues (cont'd)

Cancellation of Indebtedness

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

Selected Tax Issues (cont'd)

Foreign Investor Concerns

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

Recent Contingent Capital Transactions

Rabobank's Senior Contingent Notes

- 10-year senior notes, where if Rabobank's Equity Capital Ratio falls below 7%, principal is written down by 75% and the remaining 25% is redeemed for cash

Potential U.S. tax issues: Debt vs. Equity, COD income

Lloyd's Banking Group's Enhanced Capital Notes

- 10-year senior notes that convert to a fixed number of common shares if Lloyd's Tier 1 common capital ratio falls below 5%

Potential U.S. tax issues: Debt vs. Equity, 163(l), COD income

Neither instrument would likely be treated as indebtedness giving rise to tax deductible interest under current U.S. tax law

Recent Contingent Capital Transactions (cont'd)

Rabobank's Perpetual Non-Cumulative Securities

- Perpetual subordinated securities, where if (1) Rabobank's equity capital ratio falls or remains below 8% or (2) either Rabobank or the Dutch Central Bank believes that the equity capital ratio will fall below 8% in the near term, principal is written down by an amount 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

Credit Suisse's Tier 1 Buffer Capital Notes

- Perpetual subordinated notes that convert to a fixed number of common shares if (1) Credit Suisse's Basel III common equity Tier 1 ratio falls below 7% or (2) the Swiss Financial Market Supervisory Authority determines that Credit Suisse requires public sector support to prevent it from becoming insolvent

Neither instrument would likely be treated as indebtedness giving rise to tax deductible interest under current U.S. tax law

Recent Contingent Capital Transactions (cont'd)

Credit Suisse's Tier 2 Buffer Capital Notes

- 30-year subordinated notes that convert to a fixed number of common shares if (1) Credit Suisse's Basel III common equity Tier 1 ratio falls below 7% or (2) the Swiss Financial Market Supervisory Authority determines that Credit Suisse requires public sector support to prevent it from becoming insolvent

Potential U.S. tax issues: Debt vs. Equity, 163(l), COD income

Would likely not be treated as indebtedness giving rise to tax deductible interest under current U.S. tax law

Ratings considerations

- During financial crisis, rating agencies had downgraded quite a number of hybrids and certain agencies adjusted their “notching” and “equity credit” criteria. Are the rating agency concerns relating to hybrids applicable to contingent capital instruments?
- Will rating agencies rate contingent capital instruments?

Rating Agency Treatment

Moody's

Ratability

- Will consider rating contingent capital securities that convert into common equity only if it can reasonably assess when conversion would likely occur and if the triggers are objective and measurable.
 - Moody's **may not** rate securities whose triggers are linked to the breach of **regulatory capital triggers** or are subject to **regulatory discretion**
 - Moody's **will not** rate securities whose equity conversion is linked to a non-credit related event, is at the bank's discretion, and/or tied to credit rating movement

Equity Credit

- In order to determine the amount of equity credit to be awarded, Moody's will still focus on all of the structural features of the instrument

S&P

Ratability

- Will rate contingent capital securities as hybrid equity depending on their specific features, such as the trigger and transparency of the conversion element

Equity Credit

- Level of trigger and details of the conversion mechanism are critical
 - The conversion needs to occur early during the issuer's credit deterioration in order to help the bank
 - A trigger level set at, or close to, the regulatory capital threshold would generally not warrant equity-like treatment
 - S&P would not view a security as equity-like if there is a lag between the trigger breach and conversion (e.g., stipulated delays or infrequent trigger measurement dates)

Fitch

- Currently, no published criteria on contingent capital, but the agency recently released a statement that it expects to be able to rate "new-generation" bank hybrid securities, including contingent capital

Investor Considerations

- Convertible instruments
 - certain investors may not be able to hold instruments that convert into equity, or may be required to dispose of instruments once they convert into equity, which is precisely when there may be limited liquidity
 - will convertible instruments with a trigger encourage shorting?
 - is there a preference for write-down vs. conversion? depends if write-down allows for write-up? and if conversion is for fixed vs. variable number of shares?
 - will there be enough transparency to enable investors to analyze the risk?
 - how will investors analyze and price these securities? it will be a challenging balancing act: how can an issuer achieve a low probability of conversion, and provide clarity about when conversion would occur
- Will these securities be included in bond indices? if not, will that limit even further the potential investor base?

Contingent Capital Considerations

Benefits

- Provides a cushion (“loss absorbency”)
- High quality
- Argument that it would result in stronger risk management and may reduce moral hazard
- Contingency can be set to be triggered early on, when stress scenario emerges

Concerns

- Not “new” capital; just reshuffles the deck
- Not clear how investors will price; not clear whether there is an investor base
- If “equity” then certain investors may not be able to purchase
- Rating agencies may not rate
- May not be tax efficient
- For convertible instruments, it may be difficult to set right trigger and avoid “death spiral”
- Basel treatment still unclear
- U.S. regulatory treatment still unclear

Addressing Outstanding Hybrid Securities

Transactions to consider

- Exchange offers
 - Many banks will want to consider exchange offers for their outstanding Tier 1 instruments that may not be qualifying Tier 1 going forward
- Consent solicitations
 - Many banks had entered into replacement capital covenants in connection with their hybrid issuances
 - These banks may wish to consider consent solicitations to do away with replacement capital covenants in order to gain additional flexibility for the future
 - Banks with outstanding remarketable securities may wish to consider consent solicitations to modify the terms of these securities prior to their remarketing date

Transactions to consider (cont'd)

- Remarketings
 - Modifying the terms of the remarketings
 - Many banks issued securities that must be remarketed in 2011 and 2012
 - Banks may want to evaluate alternatives to and/or modifications of remarketings, including liability management options (to address remarketing itself), or may want to participate in the remarketing, or may want to have the remarketing agent act as principal, or may want to change the terms of the instrument

Recent Remarketings (Financial Institutions)

- On December 15, 2010, Citigroup completed a remarketing of \$1,875,000,000 4.587% junior subordinated deferrable interest debentures (representing the third of four series of debt securities required to be remarketed under the terms of Citigroup's Upper DECS Equity Units)
- On February 1, 2011, U.S. Bancorp completed a remarketing of \$676,378,000 3.442% Remarketed Junior Subordinated Notes due 2016 (in connection with Normal ITS)
- On February 11, 2011, State Street completed a remarketing of \$500,100,000 4.956% Junior Subordinated Debentures due 2018 (in connection with Normal APEX)
- On February 15, 2011, Wells Fargo completed a remarketing of \$2,501,000,000 in principal amount of remarketable junior subordinated notes (in connection with Wachovia WITS)

Wells Fargo Remarketing

- The remarketing was structured as a sale by selling securityholders of newly issued notes obtained in exchange for remarketable junior subordinated notes
- The selling securityholders purchased the remarketable junior subordinated notes from Wachovia Capital Trust III
- The selling securityholders were Morgan Stanley and Credit Suisse
- The difference between the amount received by the selling securityholders for the newly issued notes, inclusive of accrued interest, and the price paid by the selling securityholders for the junior subordinated notes in the remarketing was approximately \$6.25 per \$1,000 principal amount of notes and \$15,631,733.14 in the aggregate

Tax

- Tax considerations need to be taken into account for any remarketing, especially:
 - Rev. Rul. 2003-97
 - PLR 201105030

Executive compensation

- Given that the banking agencies will impose restrictions on incentive-based compensation, many banks are re-evaluating their compensation policies and the types of instruments available to them for employee compensation.
- Some banks are considering using contingent capital instruments for employee compensation because:
 - Achieves desired “risk” alignment
 - Obtains capital relief