

## A Return to Simplicity Paved with Complexity

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Regulatory reform in the United States and internationally seems directed at preventing market participants from making the same mistakes that contributed to the financial crisis. This may sound simple and straightforward; however, avoiding making the same mistakes is, in practice, harder than it sounds. Underlying the regulatory reforms that we discuss below are certain important prevailing views shaped by recent experience: that our financial institutions must maintain higher regulatory capital levels, that financial institutions should limit the use of leverage, that “simpler” financial products with a higher equity content will be more loss absorbent during financial downturns, and that certain activities (*i.e.*, proprietary trading, securities lending, derivatives and securitization) are inherently “risky”. If these are your starting points, it is clear that future financing needs and financing alternatives for banks will change. Financial institutions will be limited in their ability to use leverage, they will face higher regulatory capital requirements, and they will not be able to use many of the funding tools that they relied upon in the past. In this article we review the regulatory capital requirements set forth in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. 111-203 as well as those included in the Basel III framework and consider how banks are likely to finance their activities going forward.

The Dodd-Frank Act requires that bank regulators establish heightened prudential standards for risk-based capital, leverage, liquidity, and contingent

capital. Systemically important institutions, which include the largest bank holding companies, will be subject to more onerous regulatory capital, leverage and other requirements, including a maximum debt-to-equity ratio of 15-to-1. The Collins Amendment provisions included in the Dodd-Frank Act require 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-to-total assets standard applicable currently to insured depository institutions under the prompt corrective action provisions of the Federal Deposit Insurance Act although final regulatory capital ratios will not be set for some time. The legislation also limits regulatory discretion in adopting Basel III requirements in the United States and raises the possibility that additional capital requirements will be imposed for activities determined to be “risky,” including, but not limited to, derivatives, securitization, and securities lending.

Consistent with the Basel III framework, the Dodd-Frank Act no longer permits bank holding companies to include certain hybrids, like trust preferred securities, within the numerator of Tier 1 capital. The legislation applies retroactively to trust preferred securities issued after May 19, 2010. Bank holding companies and systemically important nonbank financial companies will be required to phase-in these requirements from January 2013 to 2016. Mutual holding companies and thrift and bank holding companies with less than \$15 billion in

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total consolidated assets are not subject to this prohibition. Within 18 months of the enactment of the Dodd-Frank Act, the Government Accountability Office, pursuant to Section 174, must conduct a study on the use of hybrid capital instruments and make recommendations for legislative or regulatory actions regarding hybrids. For U.S. financial institutions that have long depended on hybrid capital issuances for funding, not having this funding tool at their disposal is a significant change.

Pre-financial crisis, banks relied on a combination of financing tools, including, but not limited to, issuances of senior and subordinated debt and hybrid securities, short-term borrowings, Federal Home Loan Bank advances, securitizations, and, to a much lesser extent, the issuance of equity securities. Hybrids were particularly attractive because these securities, which had equity-like and debt-like characteristics, were structured to obtain favorable equity treatment from ratings agencies, permit issuers to make tax-deductible payments, and qualified as Tier 1 capital for bank holding companies. Moreover, there was no dilution for existing equity holders as a result of hybrid issuances. Over time there was significant hybrid product innovation as issuers became interested in securities with longer or bifurcated maturities and modified interest triggers. These enhanced hybrid features improved the “efficiency” of the securities, from the perspective of issuers. Investors who sought attractive yields were active buyers. However, during the financial crisis, many noted that hybrids did not perform as expected. Each group of market participants, or “interest group,” had their own differing expectations. Rating agencies noted that the securities did not provide sufficient loss absorbency for their financial institution issuers. The rating agencies proceeded to revisit their ratings methodology for hybrids, resulting in significant numbers of securities being downgraded. Hybrid investors had become accustomed to purchasing these securities and thinking of them, or treating them, as bonds. Investors 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 alternative (or replacement) capital would have been more expensive or unavailable. Other issuers exercised their deferral rights and did not make payments on outstanding hybrids, although they continued to make payments on outstanding debt securities. In some cases, issuers “wrote down” the principal amount on hybrids. One might argue that, in such cases, issuers were availing themselves of the “flexibility” provided by hybrids. Nonetheless, the hybrids we all had become accustomed to are a thing of the past; this view was echoed by international banking regulators putting the final touches on the Basel III framework.

The Basel III framework requires that banks hold additional regulatory capital, after required deductions (*e.g.*, for unrealized losses, goodwill and other intangibles, deferred tax assets above specified minimums, etc.), and narrows the types of instruments that are qualifying instruments. Basel III emphasizes the quality, consistency and transparency of the capital base. Tier 1 capital must consist predominantly of “common equity,” which includes common shares and retained earnings. This new definition of Tier 1 capital is closer to the definition of “tangible common equity.” There are a number of criteria that must be satisfied in order for non-common equity to be classified as Tier 1. These criteria indicate that a Tier 1 security must be subordinated to depositor and general 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, and cannot hinder recapitalization. Several “innovative” Tier 1 instruments will be phased out, including, for example, step up instruments, cumulative preferred stock and trust preferred stock. The implementation period will begin in 2013.

Basel III sets the minimum common equity requirement at 4.5 percent of risk-weighted asset, the minimum Tier 1 capital requirement at 6

percent and the minimum total capital requirement at 8 percent. For each category, there will be a 2.5 percent capital conservation buffer. The capital conservation buffer must be met with equity. If an institution “uses up” the capital conservation buffer and approaches any of the previously specified capital requirements, it will become subject to progressively more stringent constraints on dividend declarations and on executive compensation. Likely, this means that most institutions will calculate the minimums with the conservation buffer as they will not want to become subject to operating restrictions associated with “eating into” the buffer. These basic requirements will be phased in between 2013 and 2015 and the buffer will be phased in from 2016 to 2018.

The requirements set out in the Dodd-Frank Act, taken together with the Basel III requirements, has many banks and their advisers working to understand which types of instruments, other than common stock and preferred stock (the issuance of which would result in dilution and would be expensive from a funding perspective), might be useful funding tools going forward. Many speculate that mandatory or exchangeable instruments, mandatory equity units and REIT preferred securities may work, though additional analysis is needed.

The Dodd-Frank Act raises the possibility that “contingent capital” instruments may be a partial solution to the funding dilemma. Regulators usually have referred to contingent capital instruments as hybrid debt that is “convertible into equity when (1) a specified financial company fails to meet prudential standards. . . and (2) the [regulatory agency] has determined that threats to. . . financial stability make such conversion necessary.” There are a variety of different types of contingent capital—for example, contingent capital may include mandatorily convertible debt securities with a regulatory trigger, a market value trigger, or a double trigger; a security with a principal write-down feature; funded or collateralized “insurance” policies; or committed funding arrangements using

forward purchase contracts. As part of the Basel III framework, the Basel Committee on Banking Supervision (BCBS) released a consultative document for comment that contained a proposal to require that the contractual terms of capital instruments issued by banks provide for write-off or conversion to common equity at the discretion of regulators in the event that the bank issuer is unable to support itself in the private markets (referred to as a “gone-concern proposal”). The BCBS is expected to finalize its views regarding this loss absorbent gone-concern capital, as well as its views regarding going-concern contingent capital before year-end. Given that there has been limited market experience with contingent capital instruments, there are many questions that remain to be answered before these instruments become useful. In the United States, there are a number of adverse tax consequences associated with contingent capital instruments that convert into equity. In addition, rating agencies, which have only just begun to consider these instruments, have expressed concerns about whether they would provide ratings for those that convert into equity. Most important, perhaps, is that it is not clear whether there would be willing investors for securities that morph during their term from debt to equity and that require that holders bear the risk of moving down in the issuer’s capital structure during stress scenarios. The quest for simplicity may take a big detour when it comes to structuring attractive contingent capital instruments. Bank issuers and their advisers will have to work diligently to structure instruments that are at once “qualifying” and loss-absorbent, high quality, capable of being rated by rating agencies, and appealing to investors.

Thus far, we have focused only on one “side” of the funding dilemma. Another essential lesson of the financial crisis is that banks should de-lever and minimize their reliance on short-term funding. Both the Dodd-Frank Act and the Basel III framework address these concerns. The Dodd-Frank Act sets forth the prospect of leverage limits and for larger systemically important institutions raises the

possibility of limitations on short-term funding. In the United States, the SEC has been focused on enhanced disclosures by financial institutions of their short-term funding levels, fearing that financial institutions engaged in “window dressing” control their debt levels around quarter end and earnings reports. Basel III addresses leverage and liquidity through a number of different measures, some of which are still to be finalized. BCBS has agreed to test a global minimum Tier 1 leverage ratio (Tier 1 capital to average consolidated assets) of 3 percent beginning in 2011. In addition, the Basel III framework introduces a liquidity coverage ratio and a net stable funding ratio, both of which are intended to address shorter term borrowings and leverage. These are still to be finalized.

To the extent that financial institutions have relied on securitization as a financing tool, both the Dodd-Frank Act and other regulations will result in significant changes. The Dodd-Frank Act includes a number of provisions that affect the securitization market. These focus on “credit risk retention” and require originators and securitizers of financial assets to retain a portion of the credit risk of securitized financial assets or, in more popular terms, to have “skin in the game.” The Dodd-Frank Act generally requires credit risk retention of 5 percent of any asset included in a securitization, or less than 5 percent if the assets meet underwriting standards established by regulation. Risk retention requirements also will be required for collateralized debt obligations, securities collateralized by collateralized debt obligations, and similar instruments collateralized by other asset-backed securities. The Dodd-Frank Act prohibits a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset unless regulations to be adopted specify otherwise. The “costs” of securitization also, of course, have been affected by accounting changes and other regulatory developments and will be affected as well by Basel. Many observers noted that in large measure the popularity of securitization could be attributed to the fact that

securitization permitted the “recycling” of capital as banks were able to sell loans to securitization trusts and free up their balance sheets to originate new loans. That will no longer be the case.

Financial institutions will have to look to supplement their securitization activities with other funding alternatives in order to fund their loan originations. Many have suggested that covered bonds might provide a partial answer. Covered bonds are debt instruments that have recourse either to the issuing entity or to an affiliated group to which the issuing entity belongs or both. If an issuer defaults, there is then recourse to a pool of collateral (the cover pool) separate from the issuer’s other assets. The cover pool usually consists of residential mortgage loans, but may consist of commercial mortgage loans. The assets in the cover pool are subject to strict criteria and must be replaced if they no longer satisfy that criteria. Typically, the cover pool provides for overcollateralization to preserve the value of the covered bond holders’ claim in the event of the issuer’s insolvency.

In some format, covered bonds have been used in Europe, beginning with the *pfandbrief* in Germany, since the 18<sup>th</sup> century. The market for these securities has been well-established and generally stable. Covered bonds have significant benefits. Covered bond holders have dual recourse, with a claim against the issuer, and also a privileged or preferential claim (embodied in statute) against the cover pool in the event of the issuer’s insolvency. Covered bonds are secured by high quality, historically low risk assets. Covered bonds usually are issued by depository institutions that are regulated entities subject to supervision by domestic banking authorities, which ensures regulators would step in if a safety and soundness issue were to arise.

The covered bond market has grown rapidly in recent years to an estimated \$3 trillion in outstanding notes. In Europe, depository institutions seeking to diversify their funding

sources find that the covered bond market provides a relatively cheap (compared to securitization) and accessible funding alternative. Covered bond investors include central banks, pension funds, insurance companies, asset managers and bank treasuries that are attracted by covered bonds' liquidity, credit ratings and covenants. Covered bonds appeal to investors seeking low risk yield-bearing products having long maturities. This means that bank issuers of covered bonds are able to attract new investors that are not the same investors that usually purchase RMBS or CMBS. From a funding perspective, the long maturities of covered bonds allow bank issuers to match assets and liabilities over the long term. However, there are a number of obstacles for covered bonds in the United States. Until legislation (which is currently pending) is passed in the United States that provides a statutory framework for the issuance of covered bonds and creates a first-priority interest in the cover pool for covered bond holders, the market for covered bonds issued by U.S. institutions will remain limited.

For at least three years, U.S. banks have been forced to deal with challenges and uncertainties of historic proportion. The Dodd-Frank Act and Basel III represent a domestic and global effort to address some of these challenges. Though much of the detail will be forthcoming, we already know that, as a general matter, balance sheet risk will be discouraged and financing simplicity will be the order of the day (at least for some time). While the ability to refrain from making the same mistakes twice is a virtue of the wise, it is not wise to assume that risk avoidance and financing simplicity will not give rise to a whole new set of challenges for financial institutions.

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