

# Bail-In Capital and Contingent Capital

**Peter Green**  
**Tom Humphreys**  
**Anna Pinedo**  
**April 12, 2011**

LN2-8551 v1

# Overview

---

- New capital requirements and resolution/recovery plans:
  - Basel III
  - BCBS rules on loss absorbency
  - FSB/BCBS work re systemically important financial institutions
  - EU Commission Consultation
  - Dodd-Frank rules
  - National guidance.
- Recent market experience:
  - Tier 1 instruments
  - Contingent capital instruments.
- Relevant issues:
  - Tax
  - Ratings.
- Issuer and investor considerations.

# Basel III

# 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 developed 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: Basel III

---

- On December 17, 2009, the BCBS announced far-reaching proposals for comment. From December 2009 to November 2010, there were a number of revisions to these proposals.
- Most of the significant elements of the framework have now been finalized. The G-20 at its November 2010 meetings endorsed the agreements that had been reached and the final rules were published on December 16, 2010.
- The new Basel framework (referred to as Basel III) responds to the comments and statements of the G-20, as well as of policymakers and commentators, and their collective assessments regarding loopholes or weaknesses that may have contributed to the financial crisis.

# Basel III - Four major components

---

- Quality, consistency and transparency of the capital base:
  - Greater emphasis placed on the common equity component of Tier 1 capital
  - Simplification of Tier 2
  - Elimination of Tier 3
  - Detailed regulatory capital disclosure requirements.
- Enhancement of risk coverage through enhanced capital requirements for counterparty credit risk.
- Introduction of non-risk adjusted leverage ratio.
- Measures to improve the countercyclical capital framework.

# Quality, Consistency & Transparency

---

- The definition of Tier 1 capital will move toward the definition of “tangible common equity.”
- Tier 1 capital (referred to as going concern capital) must consist primarily of common equity + retained earnings – regulatory adjustments (including deductions of tangible assets).
- Non-equity Tier 1 must be subordinated and have discretionary dividends/coupons with no incentive to redeem in times of stress.
- There will be an explicit minimum ratio of common equity to risk weighted assets.
- There will be specific eligibility criteria for common equity.

# Eligibility Criteria for Common Equity

---

- 14 criteria are identified, which must be satisfied in order for common shares to be included as common equity.
- Common shares must be fully subordinated to all other claims in liquidation, with no fixed or capped claim on liquidation, except at the discretion of the issuing bank. There cannot be any obligation on the issuer's part to repurchase or redeem the securities.
- Several "innovative" Tier 1 instruments would be phased out, including, for example, step up instruments; cumulative preferred stock; and trust preferred stock.

# Tier 1 Additional Going Concern Capital

---

- Tier 1 Additional Going Concern Capital also is defined by reference to specific criteria, including that:
  - The instrument is subordinated to depositor claims
  - The instrument is perpetual, with no maturity date or incentive to redeem
  - The instrument may be redeemable at the issuer's option only after five years and then subject to certain conditions
  - The instrument must permit discretion on the issuer's part to cancel payments
  - The instrument cannot impede recapitalization
  - It is capable of principal loss absorption on a going concern basis.

# Tier 2 and Tier 3 Capital

---

- The framework simplifies Tier 2 capital by establishing a single set of eligibility criteria for Tier 2 capital and eliminating Upper and Lower Tier 2.
- In order to qualify as Tier 2 capital, an instrument must be:
  - subordinated to depositors and general creditors
  - unsecured
  - not guaranteed
  - original maturity of at least 5 years
  - callable by issuer only after 5 years and with prior supervisory approval
  - dividends/ coupons not to have credit sensitive dividend feature.
- Tier 3 will be eliminated completely.

# Highlights

---

- Minimum common equity requirement will be set at 4.5% (up from 2%) of risk weighted assets.
- Minimum Tier 1 capital requirement will be set at 6% (up from 4%).
- Minimum total capital requirement will be set at 8%.
- Capital conservation buffer: for each category, there will be a 2.5% conservation buffer that must be met with equity. If an institution “uses up” the conservation buffer and approaches the minimums it will become subject to restrictions on dividends, restrictions on compensation, etc.

# Basel III Capital Threshold 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 <sup>1</sup>						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

## Other features of Basel III

---

- Harmonization and tightening up of regulatory adjustments.
- Amendments to counterparty credit risk framework.
- Introduction of countercyclical buffer.
- Introduction of leverage ratio.
- Introduction of two new liquidity ratios:
  - Liquidity Coverage Ratio
  - Net Stable Funding Ratio.

# Basel, FSB and G-20 discussions

---

- Although in large measure, the Basel III framework has been finalized, there are still a few open issues:
  - additional requirements, including contingent capital requirements, that may be applicable to institutions that are deemed systematically important or globally systematically important
  - non-common going-concern and gone-concern capital
  - “bail-in” debt.

# BCBS Paper on Loss Absorbency at Point of Non-viability

# BCBS Paper on Loss Absorbency at Point of Non-viability

---

- On January 13, 2011 the Basel Committee published its minimum requirements to ensure all regulatory capital instruments are capable of fully absorbing losses at the point a bank becomes non-viable:
  - Goal is to address the loss absorption of regulatory capital by making Tier 1 and Tier 2 instruments capable of bearing losses if the bank is unable to support itself in the private market.
- Applies to all tier 1 and tier 2 instruments that are not common stock.
- Additional rules for banking groups.
- BCBS requirements are minimum requirements.

## BCBS Paper on Loss Absorbency at Point of Non-viability (cont.)

---

- The contractual terms of instruments must provide for either the permanent write-down of principal or conversion to common equity when a bank is viewed as non-viable
- Trigger event is the earlier of:
  - The decision to make a public sector injection of capital without which the bank would have become non-viable.
  - The decision that a write-off/conversion is necessary without which the bank would have become non-viable.
- Exception where governing jurisdiction of bank automatically applies a write-down or conversion upon the occurrence of the trigger events.
- Applies to all instruments issued on or after January 1, 2013.

# Systemically important institutions – Bail-in requirements and recovery/resolution planning

## G-20 – Systemically Important Financial Institutions

---

- G-20 meeting in Seoul endorsed FSB’s proposals to reduce “moral hazard risks” posed by SIFIs and address the “too big to fail” issue.
- SIFIs should have loss absorbency capital commensurate with system-wide losses that would be occasioned by their failure.
- Initial focus on global SIFIs (GSIFIs):
  - FSB and national authorities to draw up list of GSIFIs by mid 2011.
- GSIFIs to be required to have greater capacity to absorb losses than under proposed Basel III minimum standards.
- More intensive and effective supervisory oversight.
- BCBS to produce report on additional loss absorption capacity of GSIFIs by mid 2011.

## G-20 – Systemically Important Financial Institutions (cont.)

---

- Resolution Frameworks:
  - All jurisdictions should have a resolution framework in place to facilitate rapid resolution of a failing institution.
  - Depositors should be able to continue to access their deposits.
  - Authorities must have power to transfer and sell viable parts of the entity.
- Internationally active institutions:
  - Sharing and co-operation agreements.
  - Elimination of laws protecting domestic creditors at expense of foreign creditors.
  - For GSIFIs, co-operation agreement between home and host authorities.
- FSB to draw up criteria for assessing resolvability of SIFIs by March 2011

# EU Commission Consultation on Crisis Management in the Financial Sector and Recovery and Resolution Planning

# EU Commission Consultation

---

- EU Commission Communication re EU framework for crisis management in the financial sector – October 2010.
- EU Commission technical details of a possible framework for bank resolution and recovery – January 2011 consultation paper containing:
  - Supervision, preparation and prevention
  - Early intervention
  - Resolution tools
  - Framework for co-operation between national authorities.

# EU Commission Consultation (cont.)

---

- Scope
  - All credit institutions
  - Certain investment firms
  - EU holding companies of credit institutions/other financial companies
- Each member state to identify “resolution authority” to exercise resolution powers
- European Banking Agency (**EBA**) to have role in supervision of proposed framework and development and co-ordination of recovery and resolution plans

## EU Commission Consultation (cont.)

---

- Enhanced supervision of credit institutions.
- Firms must develop recovery plans aimed at restoring the long term viability of the entity in times of financial difficulty.
- A resolution plan should also be developed for when an entity fails and there is no realistic prospect of recovery.

# EU Commission Consultation (cont.)

---

- The consultation paper sets out various resolution tools and powers to be used by resolution authorities when there is no realistic prospect of recovery of an entity and all other measures exhausted.
- 3 alternative trigger options:
  - Solvency test
  - Regulatory authorization test
  - Regulatory capital test.
- In exercising resolution powers, authorities should have regard to specified resolution objectives:
  - Ensuring continuity of essential financial services
  - Avoiding adverse effects on financial stability
  - Protecting public funds
  - Protecting insured depositors.

# EU Commission Consultation (cont.)

---

- Principles underlying the use of resolution tools and powers should include:
  - Shareholders should first bear losses and unsecured creditors bear residual losses
  - Creditors of same class treated in fair and equitable manner
  - No creditor should incur greater losses than under a liquidation.
- Resolution tools include:
  - Sale of business tool – no need for shareholder consent
  - Bridge bank tool – temporary measure
  - Asset separation tool – moral hazard concerns
  - Debt write down / conversion tool (bail-in provisions).
- Protection for partial property transfers.

# EU Commission Consultation - Bail-in provisions

---

- Aim is to avoid failing institutions being bailed-out or recapitalized by public funds and allow institution to continue as a going concern.
- Two approaches:
  - Authorities to have broad powers to write off or convert into equity all senior debt, subject to certain exemptions
  - Requirement on banks to issue a fixed volume of “bail-in” debt.

# EU Commission Consultation – National Co-operation

---

- Consultation and co-operation between authorities in absence of harmonized insolvency regime and single EU supervisory authority.
- “Resolution colleges” for cross-border banks.
- Member states required to establish bank resolution fund.

# The Dodd-Frank Act

# Dodd-Frank

---

- Generally, imposes more stringent regulatory capital requirements on financial institutions
  - Requires the Council to make recommendations to the Fed regarding the establishment of heightened prudential standards for risk-based capital, leverage, liquidity and contingent capital
- Requires that the Fed, on its own, or with recommendations from the Council, establish prudential standards for supervised nonbanks and for bank holding companies with total consolidated assets equal to or greater than \$50 billion, that include:
  - Risk-based capital requirements
  - Leverage limits
  - Liquidity requirements
  - Overall risk management requirements
  - Requirements for a resolution plan
  - Concentration limits.

# Dodd-Frank (cont.)

---

- The standards to be set by the Fed will include:
  - A contingent capital requirement
  - Enhanced public disclosures
  - Short-term debt limits.
- Includes other requirements, including:
  - A risk committee requirement
  - A stress test requirement
  - For bank holding companies or a supervised nonbank with total consolidated assets equal to or greater than \$50b a maximum debt-to-equity ratio of 15-to-1.

## Dodd-Frank (cont.)

---

- Incorporates a revised Collins amendment (Sec 171):
  - Requires the establishment of minimum leverage and risk-based capital requirements
  - Sets as a floor at the risk-based capital requirements and the Tier 1 to total assets standard applicable to insured depository institutions under the prompt corrective action provisions of the FDIA
    - No deduction for investment in bank subsidiaries
    - Effect on accounting issues and risk weights is unclear.
- Limits discretion in establishing Basel III requirements (U.S. can adopt more onerous standards, but cannot adopt laxer standards).

## Dodd-Frank (cont.)

---

- Raises the specter of additional capital requirements for activities that are determined to be risky:
  - Derivatives, securitized products, financial guarantees, securities borrowing and lending and repos
  - Assets valued based on models
  - Concentrations of market share.
- These requirements become effective upon implementing regulations, which are required within 18 months of enactment.

## Dodd-Frank hybrid timeline

---

- Rules promulgated pursuant to the Collins amendment are expected to exclude trust preferreds and other hybrids from the numerator of Tier 1, subject to limited exceptions:
  - Mutual holding companies and thrift and bank holding companies with less than \$15 billion in total consolidated assets are not subject to this
  - Intermediate U.S. holding companies of foreign banks have a five-year phase-in period
  - For newly issued securities (hybrids issued after May 19, 2010), the requirement is retroactively effective
  - For bank holding companies and systemically important nonbank financial companies, phase-in for hybrids issued prior to May 19, 2010 will be phased in from January 2013 to January 2016.

## Dodd-Frank hybrid timeline (cont.)

---

- Within 18 months of enactment, the Comptroller 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
  - Possible specific recommendations for legislative or regulatory actions regarding the treatment of hybrids.

# Dodd-Frank - Council Study

---

- Within two years of enactment, the Council must present the results of a study on contingent capital that considers, among other things, an evaluation of:
  - The effect on safety and soundness of a contingent capital requirement
  - The characteristics and amounts of contingent capital that should be required
  - The standards for a triggering requirement.
- Following the study, the Council may make recommendations to the Fed to require a minimum amount of contingent capital.

# 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 (cont.)

---

- 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
  - Possible specific recommendations for legislative or regulatory actions regarding the treatment of hybrids.

# Other National Guidance

# 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

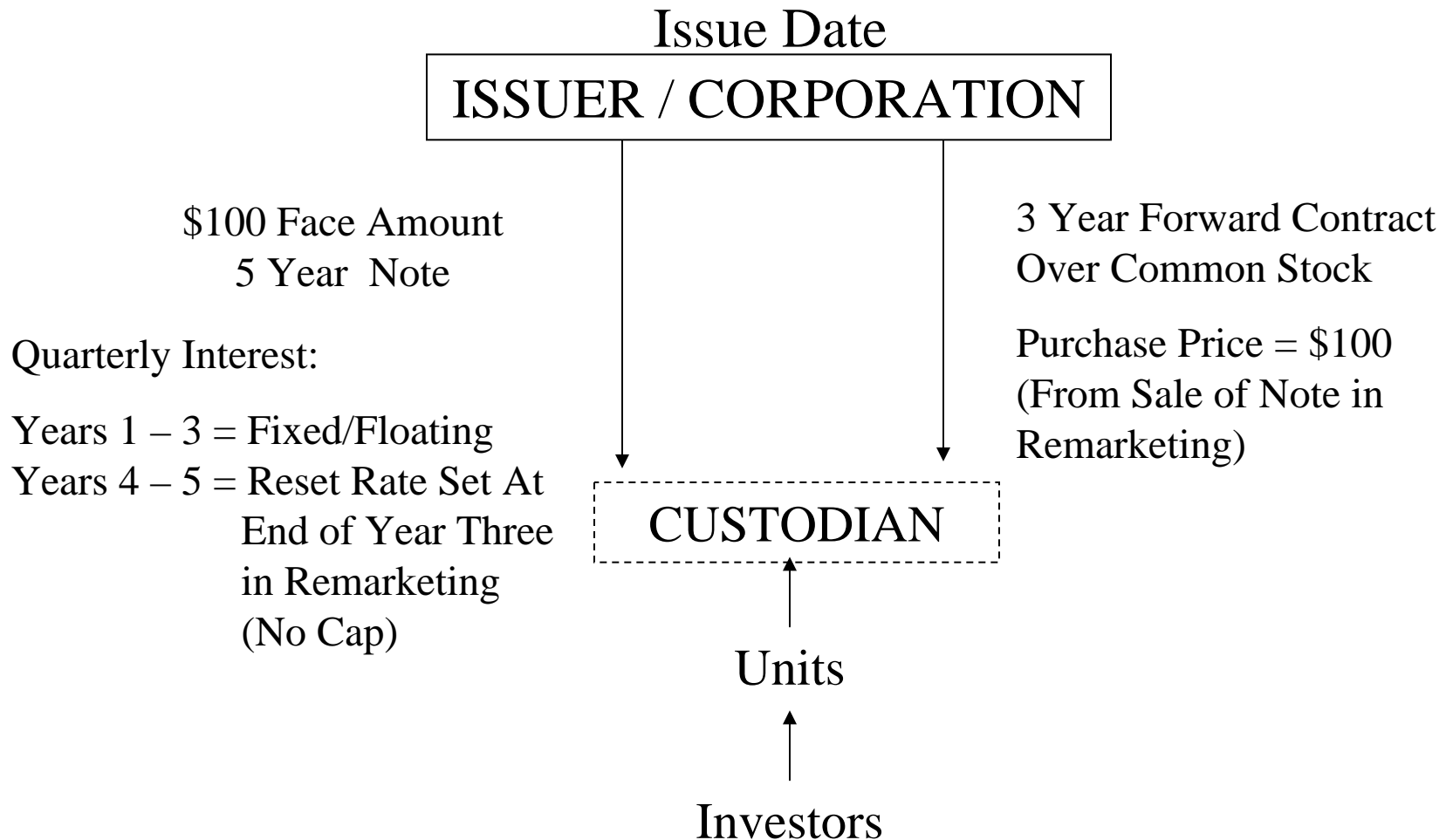
---

- 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
  - Whether the entity is able to recapitalize on its own.

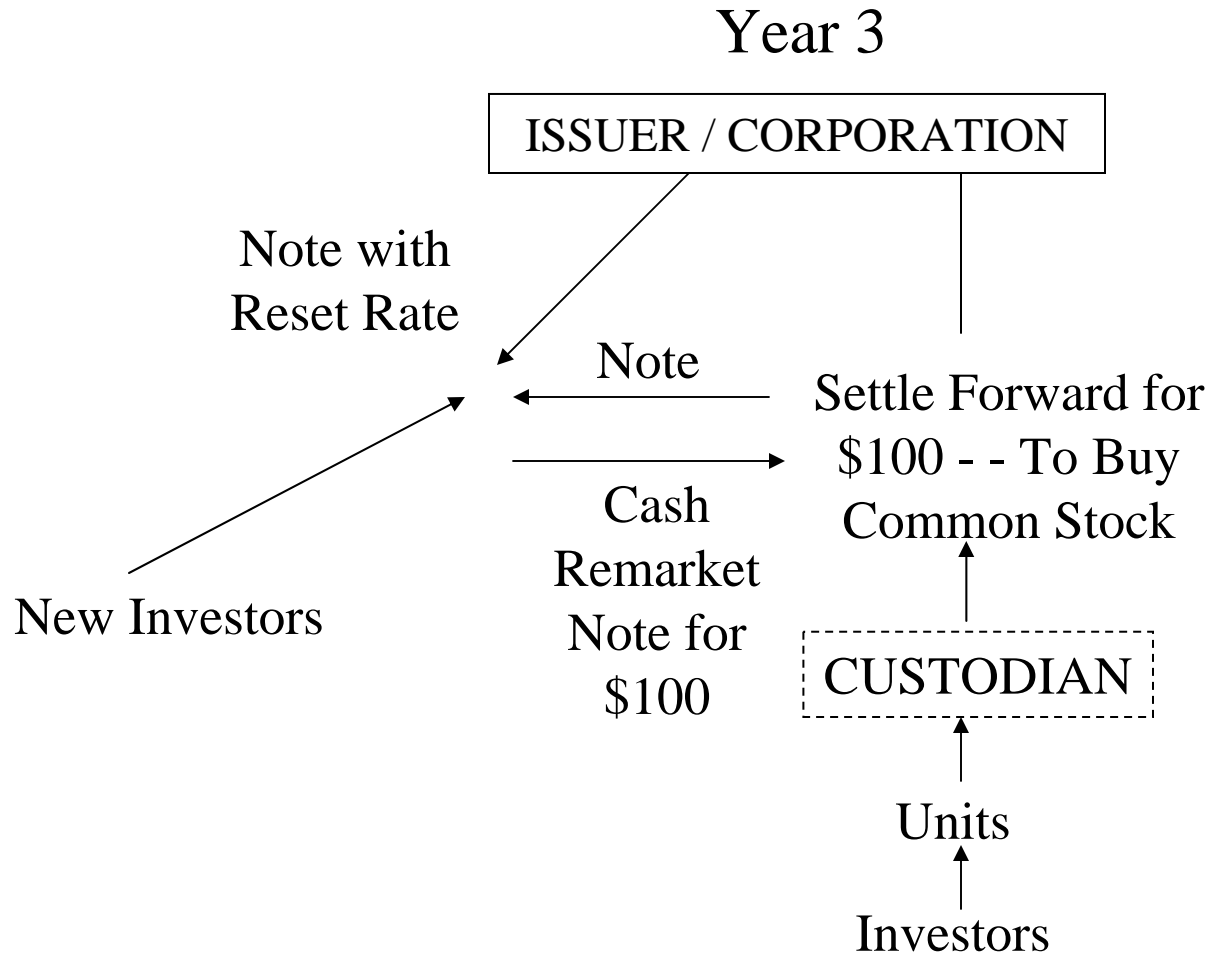
# Market Activity

## Tier 1 Instrument Proposals

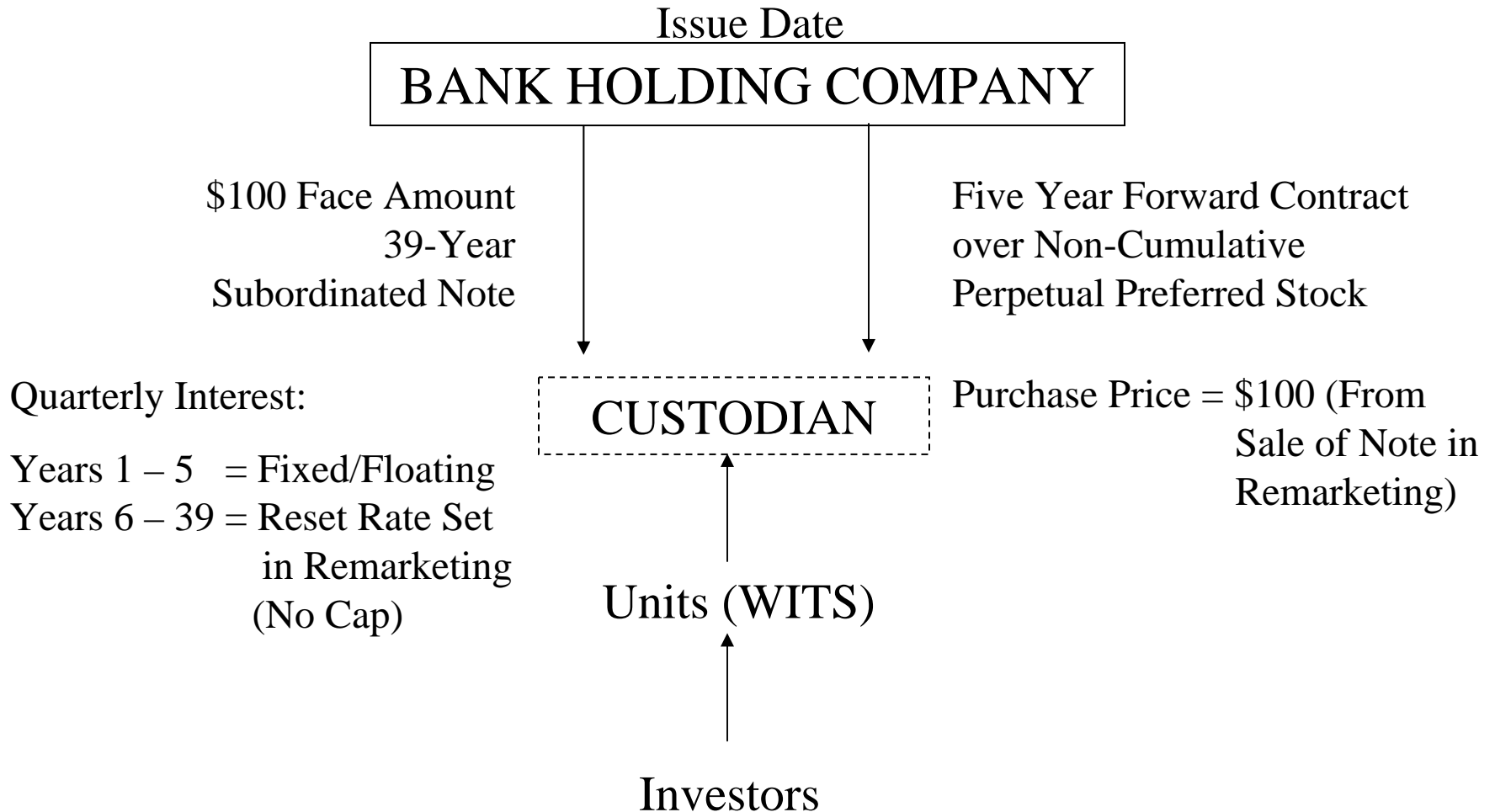
# Mandatory Convertible Instruments — Common Stock Equivalents



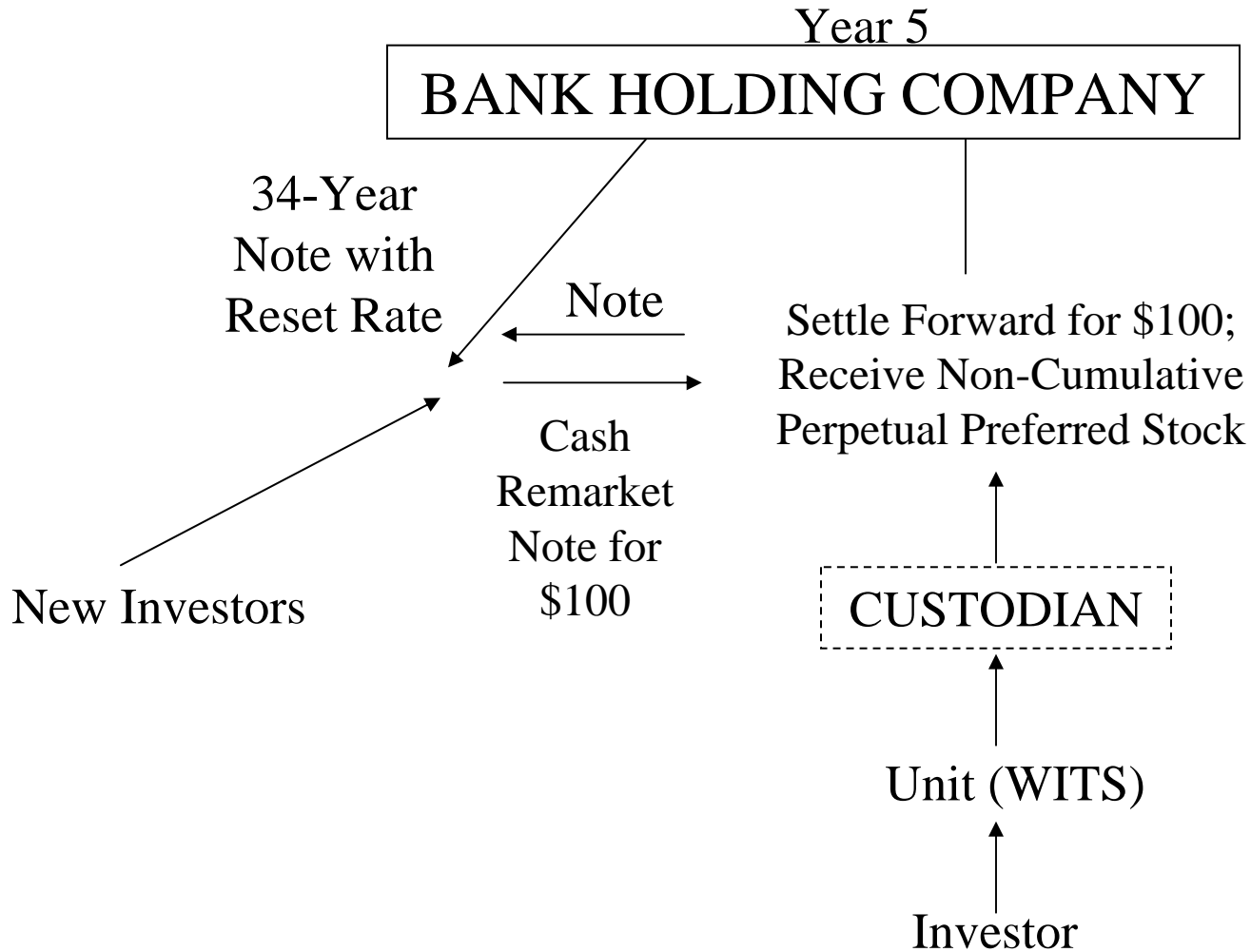
# Mandatory Convertible Instruments — Common Stock Equivalents (cont'd)



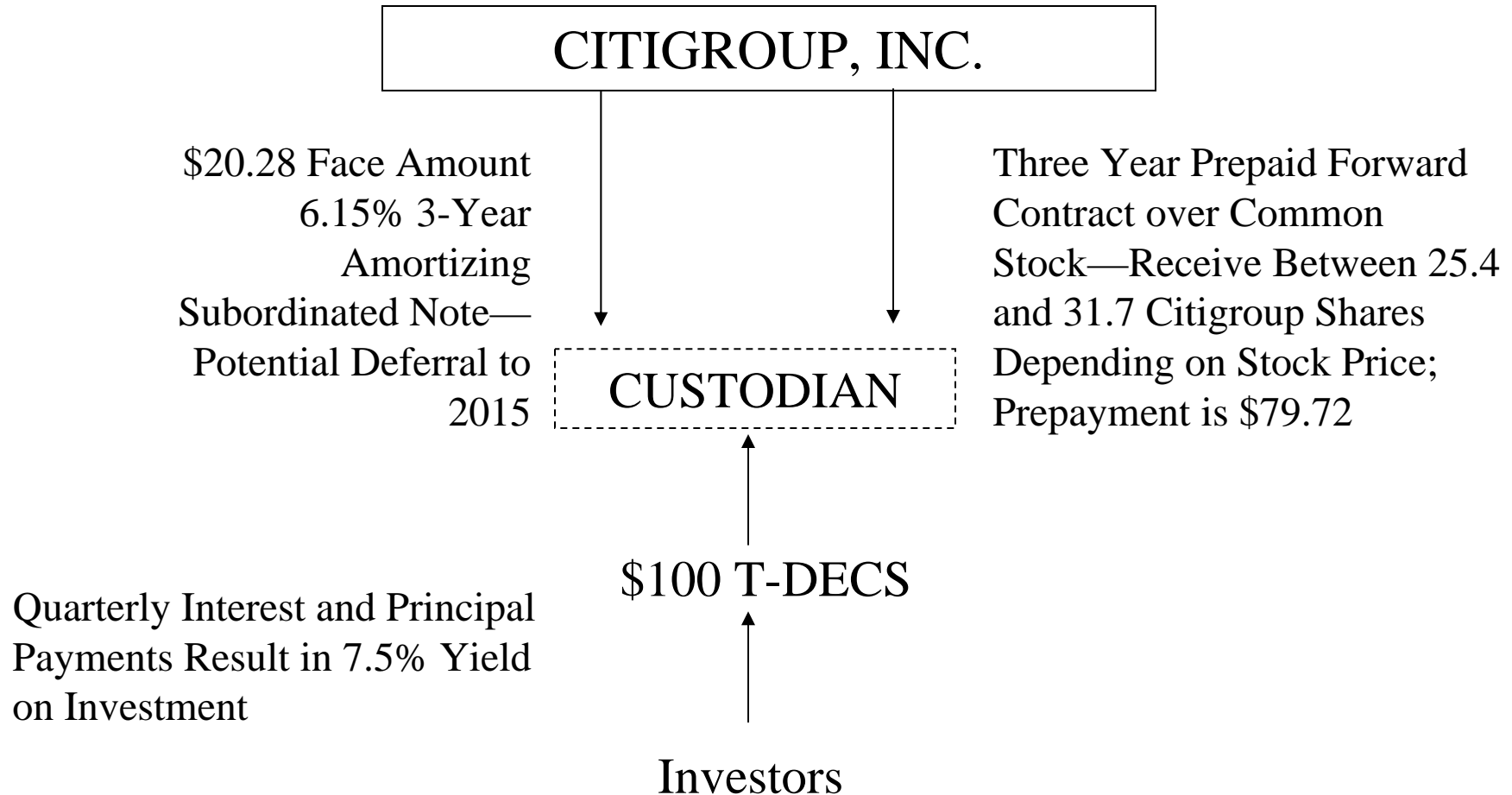
# Mandatory Convertible Instruments — Preferred Stock Equivalents



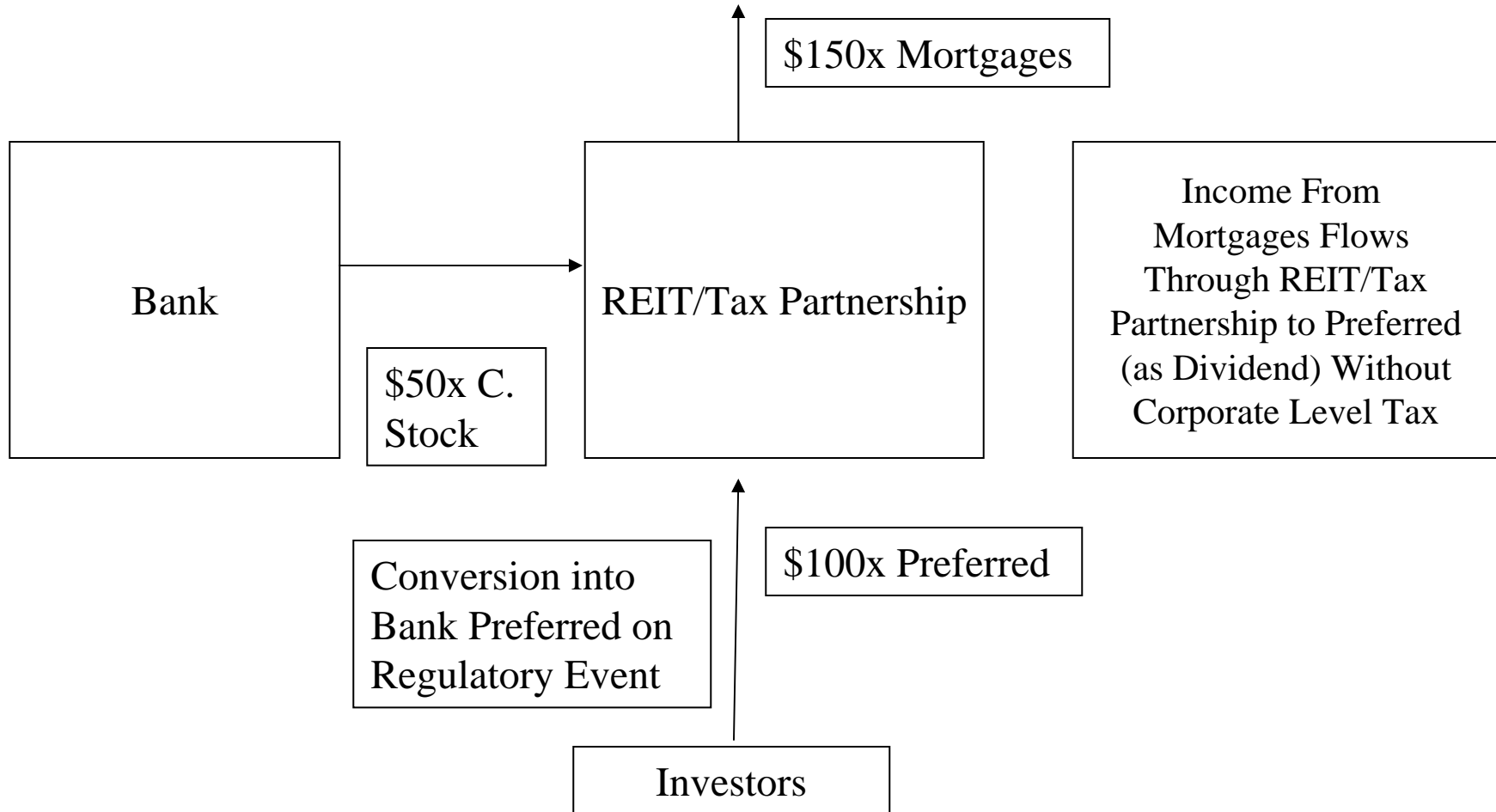
# Mandatory Convertible Instruments — Preferred Stock Equivalents (cont'd)



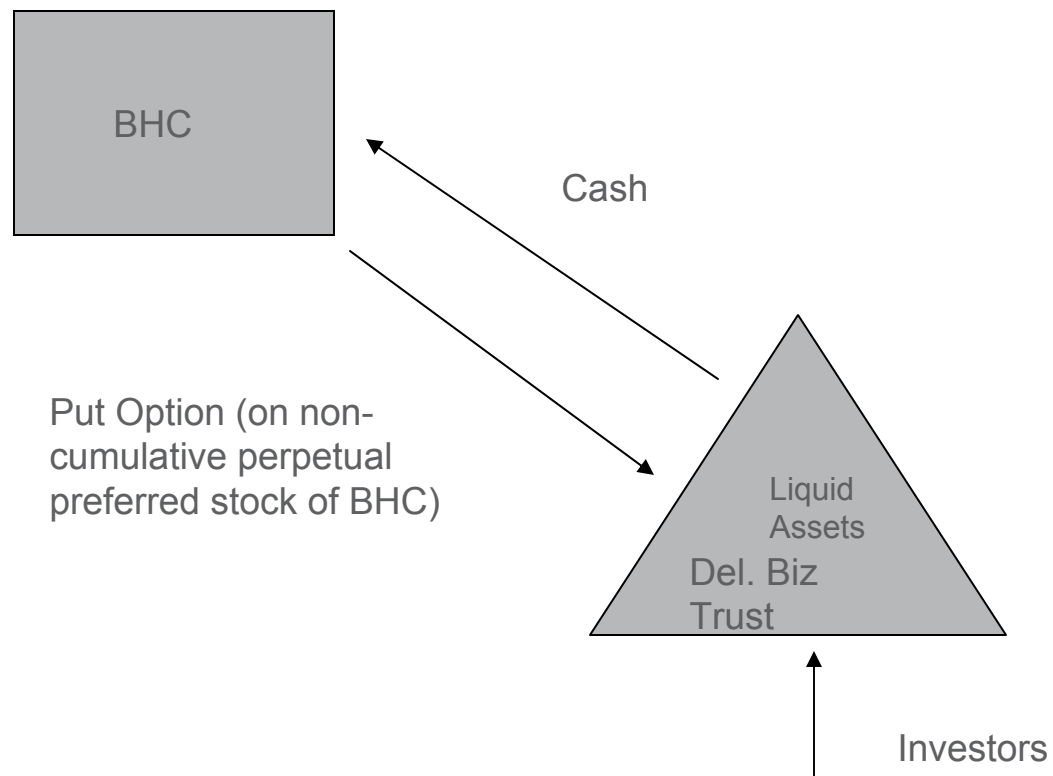
# T-DECS



# “REIT” Preferred



# Standby Stock Facilities



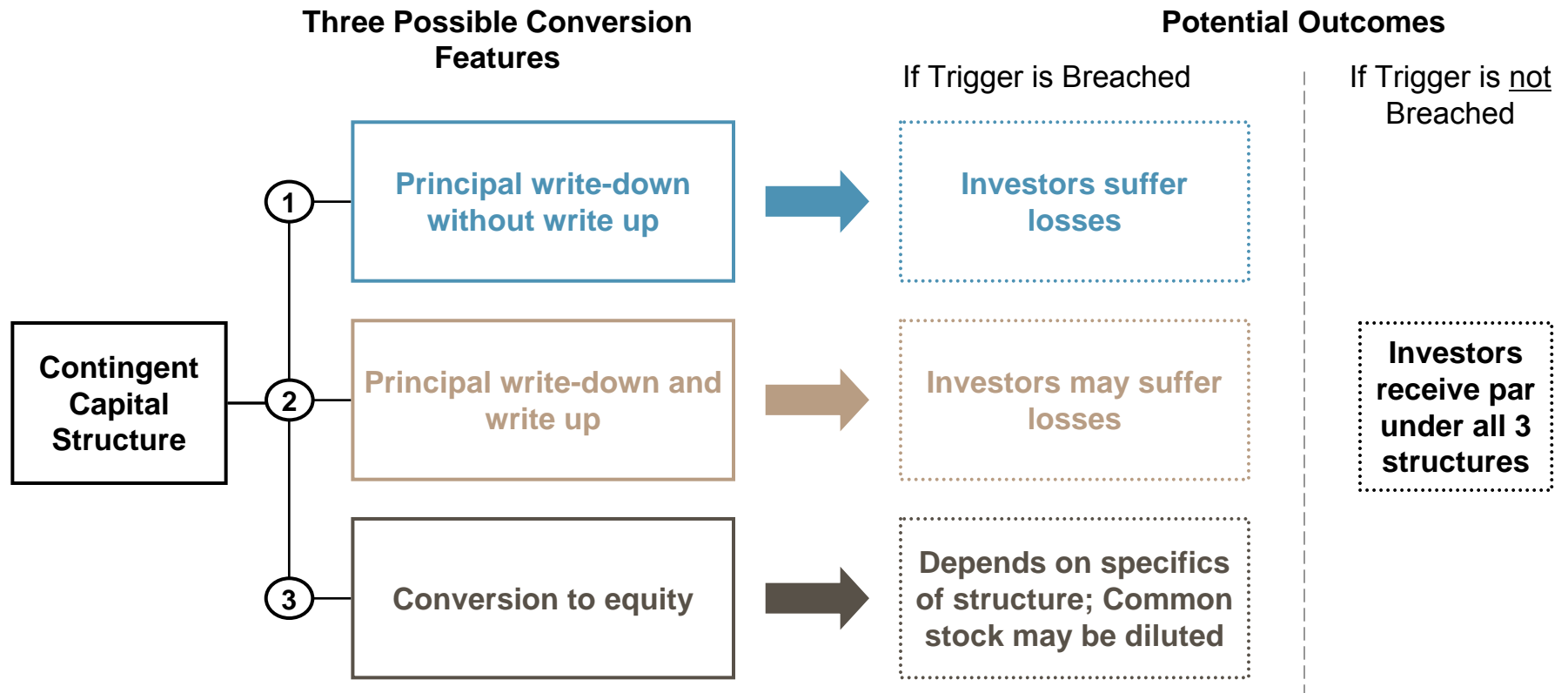
# Market Activity Contingent Capital

# Contingent capital

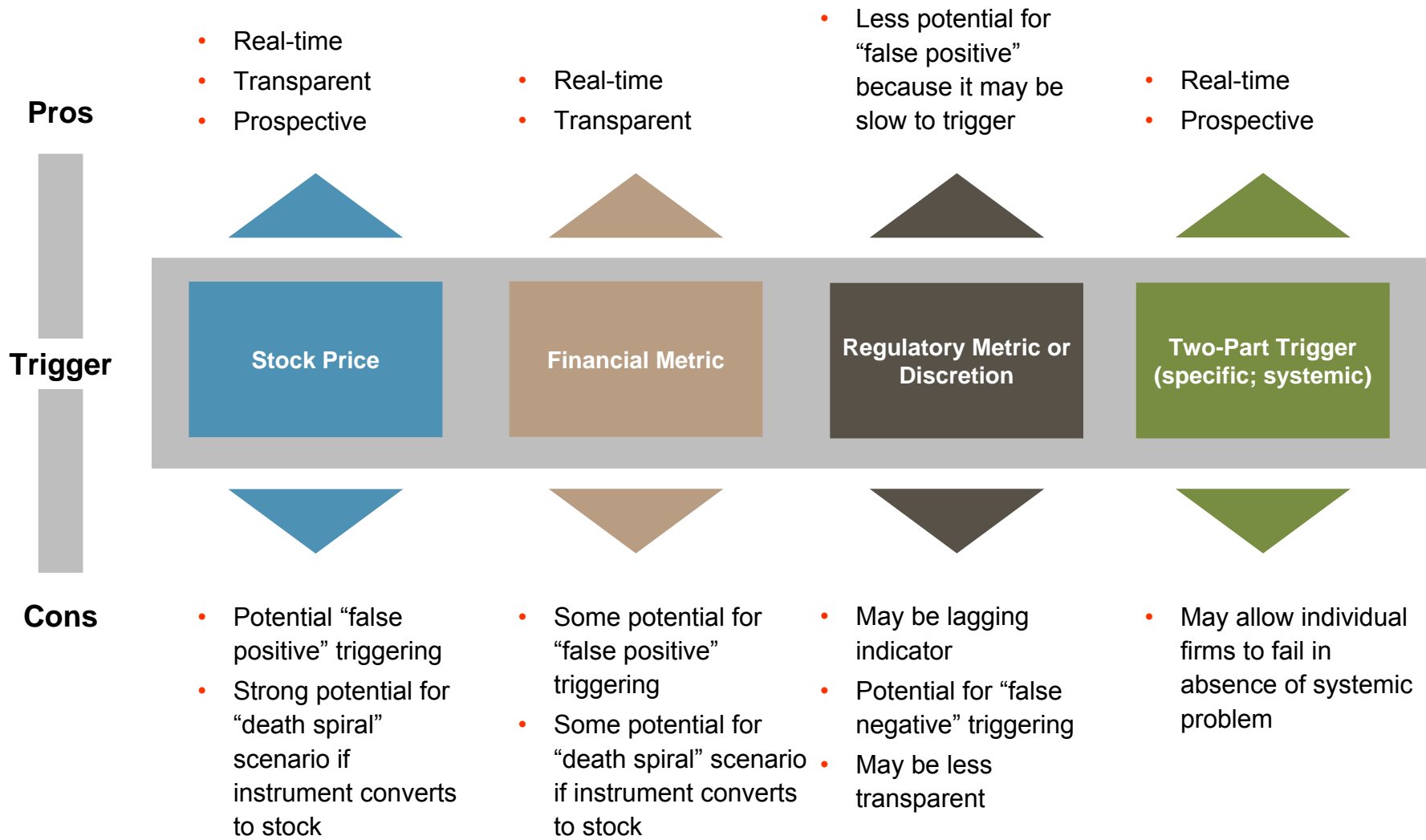
---

- Contingent capital could be viewed as the latest incarnation of hybrids and 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 Enhanced Capital Notes — November 2009

---

- £7.5 billion issue (in exchange for existing securities, including capital securities, notes and preference shares).
- Term of 10, 12 or 15 years (depending on optional redemption terms of existing securities).
- Fixed interest rate between 1.5% to 2.5% above the interest rate or dividend rate of the existing securities (resulting in a range of 8% to 11%).
- Coupon cumulative but not deferrable.
- Direct, unsecured and subordinated obligations.
- Early redemption only at issuer's option upon a change in tax or regulatory treatment.

## Lloyds Enhanced Capital Notes — November 2009 (cont'd)

---

- Converts to a fixed number of common shares if Lloyds' core Tier 1 ratio falls below 5%.
- Intended to be lower Tier 2 bonds for regulatory purposes (core Tier 1 if converted into ordinary shares).
- 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.
- Coupon cumulative but not deferrable.
- Early redemption only at issuer's option upon a change in tax treatment.
- Subject to an automatic and permanent write-down of principal amount to 25% of par 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).

# Rabobank Senior Contingent Notes — March 2010 (cont'd)

---

- Sold to institutions.
- Intended to be lower Tier 2 bonds for regulatory purposes.
- U.S. federal income tax treatment uncertain.

## 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.
- Intended to be core Tier 1 securities for regulatory purposes.

## 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 initial coupon will be reset every five years and the coupon is not cumulative but is deferrable.
- 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, and may be redeemed at the issuer’s option five years from purchase or exchange or in certain other circumstances.
- 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 are subordinated notes.
- 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.
- Same conversion feature as the Tier 1 BCNs.

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

---

- The Tier 2 BCNs are subordinated notes with a 30-year maturity.
- Guaranteed on a subordinated basis by Credit Suisse Group.
- The initial coupon is reset every five years from August 2016 (equal to the mid market U.S. dollar swap rate LIBOR basis having a five year maturity plus 5.22%).
- Early redemption only at issuer's option after August 2016 or upon a change in tax or regulatory treatment or change in control.
- Coupon is cumulative but not deferrable.

# Tax Considerations

# 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
- 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 Internal Revenue 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 Debt (COD)

- 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.

# Selected Tax Issues (cont'd)

---

## Foreign Investor/Issuer 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**

## Lloyds Banking Group's Enhanced Capital Notes

- 10-year senior notes that convert to a fixed number of common shares if Lloyd's core Tier 1 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

# 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

# Issuer and Investor Considerations

# Options for Outstanding Hybrid Securities

---

- 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.

# Options for Outstanding Hybrid Securities (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).

- 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.

# 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?

# Conclusions

# 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

# Contacts

---

Peter Green  
Partner, London  
020 7920 4013  
[Pgreen@mofocom](mailto:Pgreen@mofocom)



Thomas Humphreys  
Partner, New York  
001 212 468 8006  
[Thumphreys@mofocom](mailto:Thumphreys@mofocom)



Anna Pinedo  
Partner, New York  
001 212 468 8179  
[APinedo@mofocom](mailto:APinedo@mofocom)

