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The Loss Absorbency Requirement and “Contingent Capital” Under Basel III

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The Basel Committee on Banking Supervision recently finalized minimum requirements for regulatory capital instruments under Basel III. For internationally active banks, these include a requirement that so-called Tier 1 instruments other than common stock as well as all Tier 2 instruments include a feature requiring a “write-off” or conversion into common stock. The requirement is one of several important international developments that have broadened interest in bank-issued contingent capital securities.

Under the Basel III contingent capital requirement, the home country supervisor of an internationally active bank would have the authority to trigger a write-off or a conversion of non-common Tier 1 and Tier 2 instruments issued by the bank. A trigger event may be declared as deemed necessary to help prevent the issuer from becoming insolvent. For purposes of Basel III, non-common Tier 1 capital instruments generally consist of perpetual preferred stock and perpetual debt instruments where the issuer has complete discretion to cancel distributions/payments on the instrument. Tier 2 capital mainly consists of subordinated debt with a minimum original maturity of at least five years.

The United States, the United Kingdom and other Basel Committee nations are expected to translate the new requirement (often referred to as either the “loss absorbency” or “non-viability” requirement) into national

law by January 1, 2013 as part of their adoption of the new Basel III capital and liquidity standards. Nations may, and will likely, adopt different approaches to implementing the requirement.

The Basel III “loss absorbency” requirement is an important international development that has already broadened banking and investor community interest in contingent capital instruments.

Tax considerations may be a driver in the adoption of different implementation approaches. In particular, while issuers of existing non-common Tier 1 and Tier 2 instruments in the form of debt generally enjoy tax deductions for any coupons paid to investors, instruments reflecting the loss absorbency requirement may not be tax deductible in certain jurisdictions, including the United States. Unless the United States implements the requirement in a manner that allows for tax deductibility (or changes or clarifies its tax laws on this point), U.S. issuers could find themselves at a competitive disadvantage as compared to banks in jurisdictions that allow for tax deductibility with respect to contingent capital securities.

In mid-February, Credit Suisse issued contingent capital notes with a Basel III conversion trigger as well as a second contingency conversion trigger linked to the bank’s core capital ratio. The strong market reception for the issuance has not only created additional interest in contingent capital instruments but could also possibly accelerate the development of regulatory standards in countries on both sides of the Atlantic.

This article addresses the following specific topics:

- The background and policy rationale for the new

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Basel III contingent capital requirement.

- The principal elements of the requirement.
- Key open questions regarding national and regional implementation.
- Recent market developments.
- Other significant developments, including ongoing studies on contingent capital securities.

Background

For several years leading up to the recent financial crisis, many internationally active banks issued a significant amount of preferred stock and debt instruments (in bank regulatory parlance, referred to as “hybrid” or “innovative” instruments) to satisfy part of their Tier 1 and Tier 2 regulatory capital requirements. During the crisis, governments and central banks were forced to rescue several of these banks through an injection of public funds in the form of equity. As a consequence, taxpayers, rather than holders of the capital instruments, were often first in line to bear any loss. Bank supervisors pointed out that the instruments failed to work as intended since the express purpose of bank regulatory capital is to act as a “buffer”, or first line of defense, against credit and other losses.

In response to the financial crisis, the Basel Committee, an international supervisory group with members from 27 countries, undertook to both raise and tighten minimum bank capital requirements under the existing international bank capital accord, “Basel II”. As part of this effort, the Basel Committee further restricted the types of instruments that qualify as bank regulatory capital. According to the Committee, objectives included to: (i) reduce the risk of, and / or mitigate the fallout from, a failure of an internationally active bank by ensuring that eligible capital would fully absorb losses when the bank is on the verge of insolvency, (ii) in the event that a government were to rescue a failing bank using public funds, reduce the risk that taxpayers would be left on the hook for the losses, and (iii) ensure that holders of the capital instruments will bear losses even if taxpayer funds are used to bail out the bank (and thereby provide incentives to banks to engage in less risky behavior as more risk-sensitive investors would demand higher returns to compensate for their increased exposure to risk).

The Basel Committee released a near final version of its amendments to Basel II, referred to as “Basel III”, in December 2010. The December release, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems, sets out a list of several requirements that capital instruments would need to meet in order to qualify as non-common Tier 1 and / or Tier 2 capital. On January 13, 2011, the Basel Committee issued a statement describing the further requirement addressed in this article, which the Basel Committee referred to as “minimum requirements to ensure loss absorbency at the point of non-viability” and characterized as a “final element” of Basel III.¹ The Basel Committee did not use

the specific term “contingent capital” to describe the requirement. Nonetheless, the term has been attached to it as it requires capital instruments to be automatically converted into common equity or written off when a “trigger event” occurs.

Under Basel III, (i) up to 25% of a bank’s Tier 1 requirement may be made up of non-common Tier 1 instruments (which the Basel Committee refers to as “Additional Tier 1” because 75% of the Tier 1 requirement must consist of common stock), and (ii) up to 25% of its total capital requirement may be made up of Tier 2 capital. Accordingly, Additional Tier 1 instruments and Tier 2 instruments (the instruments subject to the new loss absorbency requirement) may only constitute a minority portion of a bank’s required capital under Basel III. The remainder of a bank’s regulatory capital must be composed of common stock.

Basel III will require most existing “hybrid” instruments (preferred stock and debt) issued by internationally active banks to be phased out as regulatory capital over time by 2023 unless the terms/conditions of such instruments conform to the loss absorbency requirement.

The New “Loss Absorbency” Requirement

Under the new loss absorbency requirement, all Additional Tier 1 and Tier 2 instruments would either need to: (i) contractually incorporate a mandatory write-off or conversion into common equity feature, or (ii) if certain conditions are met, be subject to a statutory regime that produces the same outcome as the contractual approach. Whether required by contract or national law, the instruments would have to be either written off or converted into common equity upon the occurrence of a “trigger event”.² Where the issuer is a bank subsidiary of a holding company, any common stock issued to holders of the instruments could be either that of the issuing bank or of the parent holding company.

Basel III grants to national bank supervisors the authority to declare a “trigger event” for these instruments. More specifically, a trigger event is the earlier decision by a “home country” regulator of the bank issuer of the capital instrument: (i) to write-off the instrument, under circumstances where the bank would no longer be viable (or solvent) as a going concern without such write-off, or (ii) to make a public sector injection of capital, or equivalent

support, without which the bank would have become non-viable. Accordingly, a bank supervisor should only declare a trigger event at a very late stage of financial distress. The loss absorbency requirement does not mandate that instruments have an additional conversion or write-off trigger based on, e.g., a pre-defined stock market price (or “market-based trigger”) or capital-equity ratio (or “capital ratio-based trigger”).³

Where the issuer of the Additional Tier 1 or Tier 2 instrument is a bank subsidiary of a bank holding company located in a different jurisdiction, the regulatory capital may be counted at the bank holding company level (as well as at the bank level) provided that the national bank regulator in the jurisdiction of the holding company is also capable of declaring a trigger event. Otherwise, the instrument would only count as regulatory capital at the bank level.

The Basel III loss absorbency requirement is specifically designed to ensure that holders of Additional Tier 1 and Tier 2 instruments would fully absorb losses before taxpayers in the event government assistance is provided to the issuing bank. In these cases, holders could either lose the value of their investment (i.e., a write-off) or, alternatively, receive some amount of common stock of the bank or the bank’s parent company (i.e., a conversion and recapitalization of the bank). In the latter scenario, the instruments would need to convert into common stock prior to any public sector injection of capital into the bank. Whether the instrument would be written off or converted into common stock would depend either upon the terms and conditions of the instrument and/or the applicable law of the home country of the bank.

As noted above, the scheduled date for implementation of Basel III is January 1, 2013. In this regard, Basel III specifically requires (i) capital instruments issued after September 12, 2010 to conform with all of the eligibility requirements for regulatory capital treatment (including the loss absorbency requirement), and (ii) Additional Tier 1 and Tier 2 instruments issued prior to that date that do not conform to be phased out over a 10-year period, with 90% recognition of such instruments commencing January 1, 2013, 80% recognition commencing January 1, 2014, 70% recognition commencing January 1, 2015, and so on. As a practical matter, this means that Basel III will require most existing “hybrid” instruments (preferred stock and debt) issued by internationally active banks to be phased out as regulatory capital over time by 2023 unless the terms/conditions of such instruments conform to the loss absorbency requirement.

National Implementation of the Loss Absorbency Requirement

Basel Committee member states have pledged to apply the Basel III framework in their respective countries. Nonetheless, since Basel III is not legally binding in any jurisdiction, the precise manner in which the new standards will be applied in member states will be determined

through future regional (in the case of the European Union member states) and national rulemaking.

The fact that existing tax laws, bankruptcy laws, corporate laws and banking laws differ across jurisdictions, coupled with the fact that the new requirement leaves several issues open to national interpretation, suggests that there will likely be at least some regional variation in its adoption. Variations in the implementation of the requirement may reflect differing national and regional laws and attitudes towards: (i) protections afforded to common stock owners against the dilution of their shares, (ii) rights of creditors to receive compensation for their interests, and (iii) use of taxpayer funds to rescue an operating bank (e.g., the Dodd-Frank Wall Street

Several nations (including the Netherlands, the United Kingdom and the United States) and international supervisory groups (including the Financial Stability Board) have shown interest in contingent capital requirements.

Reform and Consumer Protection Act (the “Dodd-Frank Act”) generally restricts the U.S. government from using taxpayer funds to rescue a bank unless government assistance is provided on a system-wide basis). Moreover, some contend that the new federal resolution authority provided for under the Dodd-Frank Act should render it unnecessary for the United States to adopt the loss absorbency requirement. Proponents of this view point out that the so-called “orderly liquidation authority” of the Act is designed to ensure that the creditors of a failed systemically-important financial institution suffer losses while shielding taxpayers from loss (i.e., effectively accomplishing a principal policy objective of the loss absorbency requirement).⁴ At the same time, there will likely also be a push by some bank issuers and regulators to ensure some level of consistency across jurisdictions in order to establish a deeper and more liquid market.

The following appear to be potential areas for some national/regional variation in terms of the implementation of the Basel III loss absorbency requirement:

- *The type of public assistance to banks that would be considered a “public sector injection of capital, or equivalent support” which would trigger a write-off or conversion.* For example, U.S. law currently prohibits the use of taxpayer funds to rescue individual banks. This begs the question of what type of system-wide assistance made available to banks

(which would be permissible under U.S. law in certain limited cases) could be deemed to constitute an “injection of capital or equivalent support”?

- **The standard that would be used for identifying “internationally active” banks subject to the loss absorbency requirement.** For example, in the United States, Basel II was only implemented with respect to banks with \$250 billion or more of total assets or \$10 billion or more of foreign exposures. Will this or a different standard be used in the United States? What approach to this question will be taken in other countries?
- **Whether the loss absorbency requirement would be implemented through a nation’s statutory resolution regime and/or be used as a tool to avoid resolution/liquidation.** Some national supervisory authorities may determine to use a “trigger event” as a means to help keep a bank on the brink of failure afloat as a going concern in order to avoid the possible damaging effects of a large bank failure. Others may use it more as a resolution/liquidation tool to minimize losses to senior creditors/depositors and ultimately the government.
- **To the extent a trigger event is declared and Additional Tier 1 and Tier 2 instruments are converted into common equity, the mechanism by which the conversion ratio would be determined.** Basel III does not specify any maximum or minimum conversion rate upon a “trigger event”. The conversion rate (which would determine the extent to which existing shareholders are diluted) would affect the relative incentives and burdens placed on shareholders relative to holders of Additional Tier 1 and Tier 2 instruments.
- **The tax treatment of Additional Tier 1 and Tier 2 instruments may vary by country.** Generally, existing instruments in the form of debt that qualify as non-common Tier 1 or Tier 2 capital provide the issuing bank with a tax deduction for the coupon. In some jurisdictions, however, including the United States, it is not clear that a tax deduction will be available to the issuer of an instrument in the form of debt that contains a “write-off” or conversion feature without a change in tax law or guidance from the relevant taxing authority. Accordingly, variations could develop to satisfy the home country’s tax laws regarding deductibility of coupons on instruments in the form of debt.

Other Contingent Capital Proposals and Studies

The Basel III proposal is only one of several recent “contingent capital” proposals that are being discussed and studied by bank supervisors, banks, investors and academics. Several nations (including the Netherlands, the United Kingdom and the United States) and international supervisory groups (including the Financial Stability Board) have shown interest in contingent capital requirements and Switzerland has already proposed

incorporating a mandatory contingent capital requirement into its bank capital adequacy requirement for its two largest banks (UBS and Credit Suisse).

The Swiss proposal, expected to be enacted into Swiss law by 2012, requires UBS and Credit Suisse to meet a ratio of regulatory capital to risk-weighted assets of 19% by 2019. This is well in excess of the 10.5% (including the minimum requirement and “capital conservation buffer”) stipulated under Basel III.⁵ Significantly, under the proposal, at least 6% of the required regulatory capital must be in the form of contingent capital bonds with a “low level” capital ratio-based trigger (i.e., convert to common equity if the bank’s ratio of Tier 1 common equity to risk-weighted assets falls below 5%). As much as an additional 3% may also be in the form of contingent capital bonds with a “high level” trigger (i.e., convert to common equity if the bank’s ratio of Tier 1 common equity to risk-weighted assets falls below 7%).

Two European banking groups, Lloyds Banking Group and Rabobank Group, attracted significant attention by issuing in 2009 and 2010, respectively, contingent capital bonds with capital ratio-based conversion triggers.

A major objective of ongoing studies in the area is to provide some greater insight into, and develop strategies to address, remaining concerns regarding the use of contingent capital instruments. The concerns range from the possibility of creating adverse incentives for market participants (e.g., creating a “death spiral” near trigger points), low marketability (e.g., due to the unpredictability of when a supervisory agency may declare a trigger event where the agency is given discretion in this regard), and difficulties associated with cross-border implementation of proposals for banks with operations in several different jurisdictions. Important studies and developments in the area include:

- In the United States, the new systemic-risk body – the Financial Stability Oversight Council – is required to conduct a study of the feasibility, benefits, costs, and structure of a contingent capital requirement for systemically-important institutions by July 21, 2012.⁶
- At the international level, the Basel Committee has indicated that it will be doing additional work in the area of contingent capital (i.e., beyond the loss absorbency requirement) and systemically-important institutions. Recommendations in this regard are ex-

pected to address how different forms of contingent capital notes may be treated in terms of qualifying as Tier 1 regulatory capital under Basel III. These recommendations are expected to be released by mid-year.

The outcome of the studies identified above may greatly influence approaches to the design of contingent capital securities and the potential size of the market for such securities.

Recent Market Developments

Two European banking groups, Lloyds Banking Group and Rabobank Group, attracted significant attention by issuing in 2009 and 2010, respectively, contingent capital bonds with capital ratio-based conversion triggers. More recently, in January 2011, Rabobank issued contingent capital notes with a write-down feature (triggered if Rabobank's consolidated equity capital ratio falls below 8%). These offerings, however, were not generally considered to be reliable indicators of a broader market for contingent capital instruments, given that the Lloyds bonds were offered as part of a discounted debt exchange, and Rabobank is mutually owned.

On February 14, 2011, Credit Suisse agreed to place U.S. \$6.2 billion of non-common Tier 1 contingent capital bonds with two large existing shareholders (Qatar Holding and the Olayan Group) as part of an exchange of outstanding "hybrid" capital instruments.⁷ The proposed Credit Suisse offering is notable for several reasons including the "dual conversion triggers" of the instruments. The instruments, which pay a coupon at 9.5%, will include both a (i) capital ratio-based trigger point, and (ii) a supervisory-based trigger in line with Basel III's loss absorbency requirement. In particular, the Credit Suisse bonds would convert to common equity if either (i) Credit Suisse's ratio of Tier 1 common equity to risk-weighted assets were to fall below 7% (the capital ratio-based trigger event), or (ii) the Swiss banking authority (FINMA) were to determine that Credit Suisse needed 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 supervisory trigger).⁸

Conclusion

The Basel III "loss absorbency" requirement is an important international development that has already broadened banking and investor community interest in contingent capital instruments. Within the next couple of years the market for such securities will likely grow as several jurisdictions determine how to implement the Basel III requirement and possibly other "contingent capital"-related rules and requirements into national law. The banking and investor communities will carefully watch international and national rulemaking as rules and standards that emerge from the process will have a meaningful impact on both the design features of,

and potential size of the market for, contingent capital securities. □

1 See Bank for International Settlements, Press release (January 13, 2011): Basel Committee issues final elements of the reforms to raise the quality of regulatory capital. The Basel Committee uses the term "write-off" suggesting the elimination of the entire obligation of the bank under the instrument. Questions have been raised by commentators relating to whether a partial and/or temporary write-off would be sufficient to satisfy the condition.

2 A few days later on February 17, Credit Suisse closed a U.S. \$2 billion public sale of Tier 2 contingent capital bonds outside of the United States. The bonds contain a "dual conversion trigger" like those in the exchange transaction.⁹ Features that appear to have enhanced the valuation predictability and marketability of the bonds include: the pre-defined trigger based on a "high" minimum capital ratio (rather than solely a Basel III loss absorbency trigger which is inherently subjective in nature), the fact that the bonds will mandatorily convert into common stock upon a trigger event (as discussed, under the Basel III loss absorbency requirement either a write-off or conversion into common stock is acceptable), and the fact that a formula for conversion was established at issuance (rather than, e.g., leaving it to supervisory discretion upon the occurrence of a trigger event). Importantly, the Credit Suisse public offering provides additional insight into market demand for these securities among a broader universe of investors and indicates that price discovery is improving.

3 As described below, the recently issued Credit Suisse contingent capital notes contain both a capital ratio-based trigger (to satisfy proposed Swiss requirements) and a supervisory trigger (to satisfy the Basel III loss absorbency requirement).

4 The orderly liquidation authority, which is provided for in Title II of the Dodd-Frank Act, may be invoked by the U.S. federal government in situations involving the failure or near failure of a systemically important U.S. financial business.

5 A "capital conservation buffer" made up of common equity and amounting to 2.5% of risk-weighted assets above the minimum capital requirements is due to be fully phased in under Basel III by 2019; an institution with capital falling within the buffer range will be subject to restrictions on dividend payouts, share buybacks and bonuses.

6 See Section 115(c) of the Dodd-Frank Act.

7 See Credit Suisse press release, dated February 14, 2011 "Credit Suisse Group executes agreement to put in place CHF 6 billion of Tier 1 buffer capital notes a form of contingent capital". The contingent capital notes will replace existing Credit Suisse Tier 1 hybrid instruments currently held by the shareholders no earlier than October 2013.

8 The conversion price will be the higher of a floor price of U.S. dollar 20/ Swiss Francs 20 per share, subject to customary adjustments, or the daily weighted average sale price of the shares over a trading period preceding the notice of conversion.

9 See Credit Suisse press release, dated February 17, 2011 "Credit Suisse Group places 7.875% Tier 2 Buffer Capital Notes".

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