A requiem for hybrids?

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IS IT TIME TO START COMPOSING A REQUIEM FOR HYBRID SECURITIES? READING RECENT HEADLINES AND STUDYING RECENTLY ADOPTED LEGISLATION MAKES FANS OF HYBRID SECURITIES MOURNFUL. CRITICS OF HYBRID SECURITIES WERE QUICK TO NOTE THAT THESE FINANCIAL INSTRUMENTS DID NOT PERFORM AS EXPECTED DURING THE FINANCIAL CRISIS AND FAILED TO ABSORB LOSSES OR PROVIDE FINANCIAL INSTITUTIONS WITH MUCH-NEEDED FLEXIBILITY DURING A PERIOD OF STRESS. REGULATORS, WHO WERE ALREADY WELL ON THEIR WAY TO REVISITING 'INNOVATIVE' HYBRIDS BEFORE THE WORST DAYS OF THE FINANCIAL CRISIS WERE UPON US, HAVE JOINED IN A DIRGE.

In unison, the Group of Central Bank Governors and Heads of Supervision agreed that the Basel Committee on Banking Supervision (BCBS) should raise the issue of "the quality, consistency and transparency of Tier 1 capital." As we discuss in this chapter, the proposed Basel III framework restricts the types of instruments that would qualify for Tier 1 treatment. Similarly, financial regulatory reform legislation in the US, referred to as the Dodd-Frank Act, implements various measures that together will limit the types of instruments that may be counted for Tier 1 capital purposes. Financial institutions will be left with fairly limited capital raising options. The options are even fewer if financial institutions seek a tax-efficient instrument. Regulators have indicated that they will consider mandating a contingent capital requirement for financial institutions. Contingent capital instruments have been hailed as a form of loss-absorbing, high quality capital that will serve as a 'cushion' for financial institutions in all of the same ways that hybrids were expected to have functioned. In fact, contingent capital may prove to be just the reincarnation of the hybrid. So, should we start working on an overture instead?

Below we provide some background on hybrid capital, an update on rating agency and regulatory developments, and some preliminary thoughts on contingent capital instruments.

A brief review

Hybrid securities are tax-efficient, regulatory and rating agency-qualifying capital that lower an issuer's cost of

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capital and that, in times of financial distress, are intended to conserve cash for the issuer. Hybrids have some equity characteristics and some debt characteristics. The securities are structured to obtain favourable equity treatment from ratings agencies, permit issuers to make tax-deductible payments, and qualify as Tier 1 capital for bank holding companies. Generally, the more equity-like the hybrid, the more favourable the rating agency treatment for the issuer and the more significant the investment risks for holders. The more debt-like the hybrid, generally, the more favourable the tax treatment for the issuer. From the perspective of financial ratios, issuing a long-dated security that is treated like equity by ratings agencies, makes a hybrid less 'expensive' for the issuer. From a ratings agency perspective, a longer maturity makes a hybrid more akin to common equity than debt. This is so because it provides greater financial flexibility for the issuer as it poses no refinancing risk, or at least the refinancing risk is far out in the future. The analysis also considers the issuer's ongoing payment obligations in respect of the securities, including the issuer's ability to defer payments and the holder's rights to enforce payment obligations. In order to obtain debt for tax treatment, a security must represent an "unconditional obligation to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future." Tier 1 capital, or core capital, for bank holding companies includes, among other things, common stock and non-cumulative perpetual preferred securities – or securities having no 'maturity'.

There was significant hybrid product innovation in recent years as issuers became interested in securities with longer or bifurcated maturities and modified interest triggers. These enhanced features improve the 'efficiency' of the securities, from the perspective of issuers. Investors who sought attractive yields were active buyers. However, with increasing complexity came less transparency. It became more difficult to compare various hybrid products. Moreover, from a bank regulatory perspective, there was no standardised approach to the treatment of hybrid capital instruments. The Basel framework did not address the features of hybrid instruments. The only available guidelines for banks and regulators were contained in the Sydney Press Release issued by the Basel Committee on Banking Supervision on October 27, 1998. Of course, a lot had changed since then, leaving regulators essentially on their own with respect to formulating assessments, occasionally one-off assessments, of hybrid capital instruments.

Hybrids during the financial crisis

It may be too early to reach any conclusion regarding the performance of hybrids during the financial crisis. There have been many empassioned debates, but few empirical studies. Now, it seems that mandated studies will take place only after regulatory action has already determined the fate of these securities. In any case, commentators noted that hybrids did not perform as expected and rating agencies observed that the securities did not provide sufficient loss absorbency for their financial institution issuers.

A lot turned on expectations. 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.[1] 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. However, rating agencies and regulators would likely counter that these were isolated occurrences and that financial institutions, as a general matter, were reluctant to exercise payment deferral options. From an issuer's perspective, exercising a deferral or principal writedown option might send negative signals and reduce investor confidence in the institution. For banks, for which preserving investor confidence is essential, this would be detrimental. We saw the lack of investor confidence in certain institutions play itself out

during the financial crisis to alarming results. Investor confidence and expectations also remain relevant to the discussion of contingent capital instruments.

Governments intervened in the banking sector to restore investor confidence, and, in certain cases, conditioned capital injections or other emergency assistance on the deferral by the issuers of payments on their outstanding hybrids. Rating agencies downgraded a number of hybrids – noting increased risk of deferral and of losses. The downgrades created their own domino-effect. Investors were left to wonder whether these securities had been mispriced all along (with insufficient attention paid to deferral and extension risk). Investors became quite focused on 'tangible common equity' levels, driving financial institutions that needed to bolster capital levels to resort to common stock issuances. It is difficult to factor out all of these dynamics and objectively conclude that hybrids were less able to absorb losses during periods of financial stress than common equity.

Rating agency and regulatory developments

Rating agencies

As noted above, during the financial crisis, rating agencies downgraded the ratings of a number of hybrids. In 2009, the rating agencies announced changes to the notching methodology for hybrids – essentially removing systemic and regional support from hybrid ratings, providing for wider notching among different classes of bank hybrids and providing flexibility to position hybrid ratings based on case specific and country specific considerations. Earlier this year, one of the rating agencies announced proposed revisions to its 'basket' approach for assigning equity credit to hybrids.[2]

European regulators

Before the financial crisis, in April 2007, the European Commission invited the Committee of European Banking Supervisors (CEBS) to harmonise the treatment of hybrid capital instruments in the EU. The CEBS issued a draft proposal for a common EU definition of Tier 1 hybrids in December 2007 (the CEBS Proposal).[3] Also in December 2007, the UK's Financial Services Authority (FSA) issued a consultation paper on the definition of capital, which included a discussion of the criteria for hybrid capital instruments. The final CEBS Proposal was released in March 2008. The European Commission began a public consultation in 2008 and published a proposal to amend the Capital Requirements Directive (which sets out regulatory capital requirements for financial institutions in the EU) (CRD) in October 2008. The European Parliament and Council adopted changes to the CRD in May 2009,[4] in order, among other things, to agree common definitions and descriptions of hybrid capital instruments that would be regarded as 'innovative' Tier 1 capital. The CEBS has been focused on providing more detailed guidelines for national bank supervisors in Europe to follow in connection with their supervision of banks' use of hybrid instruments for regulatory capital purposes.

In September 2009, amendments to the CRD were passed that revised the definition of 'capital' and introduced criteria for assessing which hybrids are eligible to be included within a financial institution's 'own funds.'[5] In December 2009, the CEBS published final guidelines on hybrids. In June 2010, the CEBS published its implementation guidelines on other capital instruments (referred to as the Article 57(a) Guidelines).[6] The guidance as it relates to hybrid and other capital instruments focuses on an assessment of an instrument's permanence, redemption provisions, payment flexibility, including the inclusion of alternative coupon settlement mechanisms, and loss absorbency features. This analysis is consistent with the framework set out in the Basel III proposals; however, EU members are required to incorporate the CRD provisions into national law by October 2010 and implement them beginning on December 31, 2010 – before there is any certainty regarding the Basel III capital requirements.

Basel III framework

On December 17, 2009, the BCBS announced far-reaching proposals for comment, referred to as the Basel III framework.[7] The Basel III proposals emphasise the quality,

consistency and transparency of the capital base; provide for enhanced risk coverage through the implementation of enhanced capital requirements for counterparty credit risk; introduce changes to a non-risk adjusted leverage ratio, and incorporate measures designed to improve the countercyclical capital framework.[8] To rectify perceived deficiencies relating to regulatory capital, the Basel proposals emphasise that: Tier 1 capital must help a bank remain a going concern; regulatory adjustments must be applied to the common equity component of capital; regulatory capital must be simple and harmonized for consistent application across jurisdictions; and regulatory capital components must be clearly disclosed by financial institutions in order to promote market discipline.

Tier 1 capital must consist predominantly of 'common equity', which includes common shares and retained earnings. The new definition of Tier 1 capital is closer to the definition of 'tangible common equity'. The proposals set out 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 recapitalisation. Several 'innovative' Tier 1 instruments will be phased out, including, for example, step up instruments, cumulative preferred stock and trust preferred stock. The grandfathering period is uncertain, as is the actual implementation period. Given the strong reactions of national bank regulators, it is now likely that the capital provisions will be phased in over an extended period.

The Dodd-Frank Act

Recently adopted financial regulatory reform legislation in the US, the Dodd-Frank Act,[9] also addresses regulatory capital. In many respects consistent with the proposed Basel III framework, the Dodd-Frank Act will have the effect of raising the required level of Tier 1 for banks, as well as the proportion of Tier 1 capital that must be held in the form of tangible common equity. The Dodd-Frank Act requires that the new Financial Stability Oversight Council (Council) make recommendations to the Federal Reserve regarding the establishment of heightened prudential standards for risk-based capital, leverage, liquidity and contingent capital. For the very largest institutions – those considered systemically important and that have total consolidated assets equal to or greater than US$50bn – the Federal Reserve must establish stricter requirements, including a maximum debt-to-equity ratio of 15-to-1. The Collins amendment provisions incorporated in the Dodd-Frank Act and applicable to all financial institutions 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. In addition, the legislation limits regulatory discretion in adopting Basel III requirements in the US and raises the specter of additional capital requirements for activities determined to be 'risky', including, but not limited to derivatives.

By virtue of applying the prompt corrective action provisions for insured depository institutions to bank holding companies, certain hybrids, like trust preferred securities, will no longer be included in the numerator of Tier 1. 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 January 2016. Mutual holding companies and thrift and bank holding companies with less than US$15bn in total consolidated assets are not subjection to this prohibition. Within 18 months of the enactment of the legislation, the General Accounting Office must conduct a study on the use of hybrid capital instruments and make recommendations for legislative or regulatory actions regarding hybrids.

Pre-financial crisis, financial institutions were accustomed to relying on the issuance of hybrid securities as a significant component of their capital-raising plans. Now, these institutions face a fair bit of uncertainty. Financial institutions have been waiting on the sidelines, holding back on any new offerings of hybrid instruments, until there was regulatory

certainty. With the passage of this legislation, US financial institutions have some clarity as it relates to trust preferred securities, but must continue to wait for leverage and capital requirements to be adopted and to reconcile these requirements with the final Basel III requirements.

Contingent capital

Basel III and the Dodd-Frank Act still leave open the door to certain hybrid instruments. In addition, both raise the possibility of permitting financial institutions to use contingent capital instruments. Contingent capital instruments have received many endorsements by regulators. These may be premature.

In their discussions, 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."[10] This is but one formulation. The basic premise of a contingent capital instrument is that financial institutions will offer securities that constitute high quality capital during good times, which will provide a 'buffer' or enhanced loss absorbency and payment flexibility during times of stress when the financial institution requires, but may not be able to raise, additional capital. Academics that form part of the Squam Lake Group have suggested a number of 'contingent capital' arrangements for financial institutions.[11] Professor Raghuram G. Rajan has suggested that contingent capital is "like installing sprinklers….when the fire threatens, the sprinklers will turn on."

Although many discussions focus on instruments that are effectively mandatorily convertible debt securities with regulatory triggers, it is possible to envision a number of other forms of securities. For example, a financial institution might issue a security that has a principal write down feature, or enter into a 'contingent' committed funding facility, like those used by certain insurance companies. Another version of contingent capital would require a systemically important financial institution to buy a fully collateralised insurance policy that will infuse capital into the institution during periods of financial stress. Thus far, there have been only two recent issuances of contingent capital instruments.

In November 2009, the HM Treasury announced[12] that Royal Bank of Scotland (RBS) and Lloyds Banking Group, both recipients of substantial capital injections from the UK government in the form of preference shares, would offer holders of subordinated debt, contingent convertibles/ mandatory convertible notes to raise capital in the private sector and reduce their exposure to the UK Government's Asset Protection Scheme.[13] Lloyds completed an exchange offer in which it issued £7.5bn of Enhanced Capital Notes, which are fixed rate debt securities with a 10-year term that convert into a fixed number of common shares if Lloyd's core Tier 1 ratio falls below a trigger. In March 2010, Rabobank issued €1.25bn of its 6.875% Senior Contingent Notes, which are senior unsecured notes with a 10-year term, the principal of which are subject to a write down on the occurrence of a regulatory capital trigger event.

A number of questions remain concerning contingent capital instruments. Indeed, these securities may provide an institution with high quality capital at issuance, but upon exercise of the relevant 'trigger', the securities do not provide new capital. In most formulations of these instruments, the regulatory capital deck just gets reshuffled once the trigger is breached. It is true that the securities provide loss absorbency and that by setting triggers at the outset and making these mandatory, a financial institution issuer does not have to make the painful deferral determination that would be required if it had issued a conventional hybrid. As we noted, financial institutions have proven reluctant to deferring payments given that a deferral would provoke a loss of confidence. A mandatory trigger changes the dynamic. However, with a contingent capital instrument, you have another equally tricky dynamic. It is not clear how one would determine the contingency. If it is set to be tripped early as a stress scenario is just emerging, so that the issuer receives the maximum benefit, it could be argued that investors will be put off. For convertible instruments, it is also difficult to strike the right balance in order to avoid having the security take on a 'death spiral' element.

Of course, there are more practical questions. If the instrument converts to equity, will a rating agency provide a rating? Will there be an investor base for such instruments? Just when an investor would want the full range of senior security holder creditors' rights, the investor would be relegated to being an equity holder. In the US, this issue raises a tax issue. An issuer may not be able to claim a deduction for interest payable on a contingent capital instrument that converts into equity.

Conclusion

The BCBS has said that further studies will be conducted on contingent capital instruments. The Dodd-Frank Act requires that the Council must conduct a study on contingent capital within two years of enactment and make recommendations to the Federal Reserve. Given all of these moving pieces and the need on the part of financial institutions to raise capital efficiently, it is safe to predict that we are only just starting in on a new overture in the world of capital instrument symphonics.

Notes:

1. For example, in February 2009, Deutsche Bank was among the first issuers to announce that it would not call an outstanding hybrid security on its first call date.
2. See for example, Moody's Investors Service, "Proposed Changes to Moody's Hybrid Tool Kit" and 'Frequently Asked Questions: Proposed Changes to Moody's Hybrid Tool Kit', March 2010.
3. See further, 'Defining Hybrid Capital', Morrison & Foerster LLP, August 15, 2008.
4. Proposal for a Directive amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management (October 1, 2008), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2008:0602:FIN:EN:PDF.
5. See further, 'What Counts? An Update on the Debate Concerning Regulatory Capital' Morrison & Foerster LLP, November 18, 2009.
6. See further 'CEBS Guidelines for Equity Capital Requirements of Financial Institutions', Morrison & Foerster LLP, July 7, 2010.
7. BCBS Consultative Document: Strengthening the resilience of the banking sector (December 17, 2009), http://www.bis.org/publ/bcbs164.pdf?noframes=1, and BCBS Consultative Document: International framework for liquidity risk measurement, standards and monitoring (December 17, 2009), http://www.bis.org/publ/bcbs165.pdf?noframes=1.
8. For an overview of the Basel III framework, see 'More, More, More: A Summary of the Basel Proposals', Morrison & Foerster LLP, February 2, 2010.
9. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376.
10. The Wall Street Reform and Consumer Protection Act of 2009 (HR 4173) included this formulation of 'contingent capital'.
11. See Written Statement by Raghuram G. Rajan to the Senate Banking Committee Hearings on May 6, 2009, as well as the Squam Lake Group's proposal at http://www.cfr.org/publication/19001/reforming_capital_requirements_for_financial_institutions.html.
12. HM Treasury press notice: Implementation of Financial Stability Measures for Lloyds Banking Group and Royal Bank of Scotland (November 3, 2009), http://www.hm-treasury.gov.uk/press_99_09.htm.
13. Under EU state aid rules the European Commission has granted approval to national support schemes on condition of the banks not paying dividends or coupons on Core Tier 1 capital instruments.

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