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The Role of Contingent and Convertible Capital

Regional Seminar on Basel III and Capital Management by Banks

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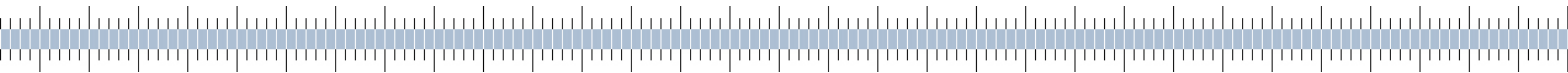
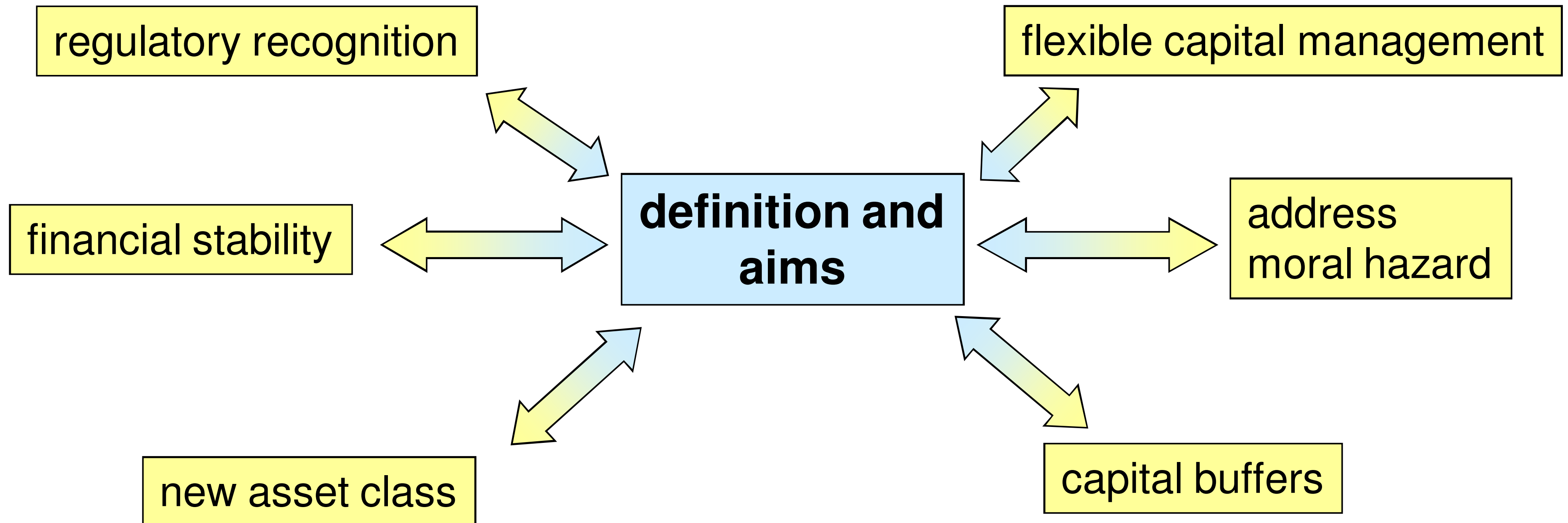


Contingent Capital



Policy objectives under discussion

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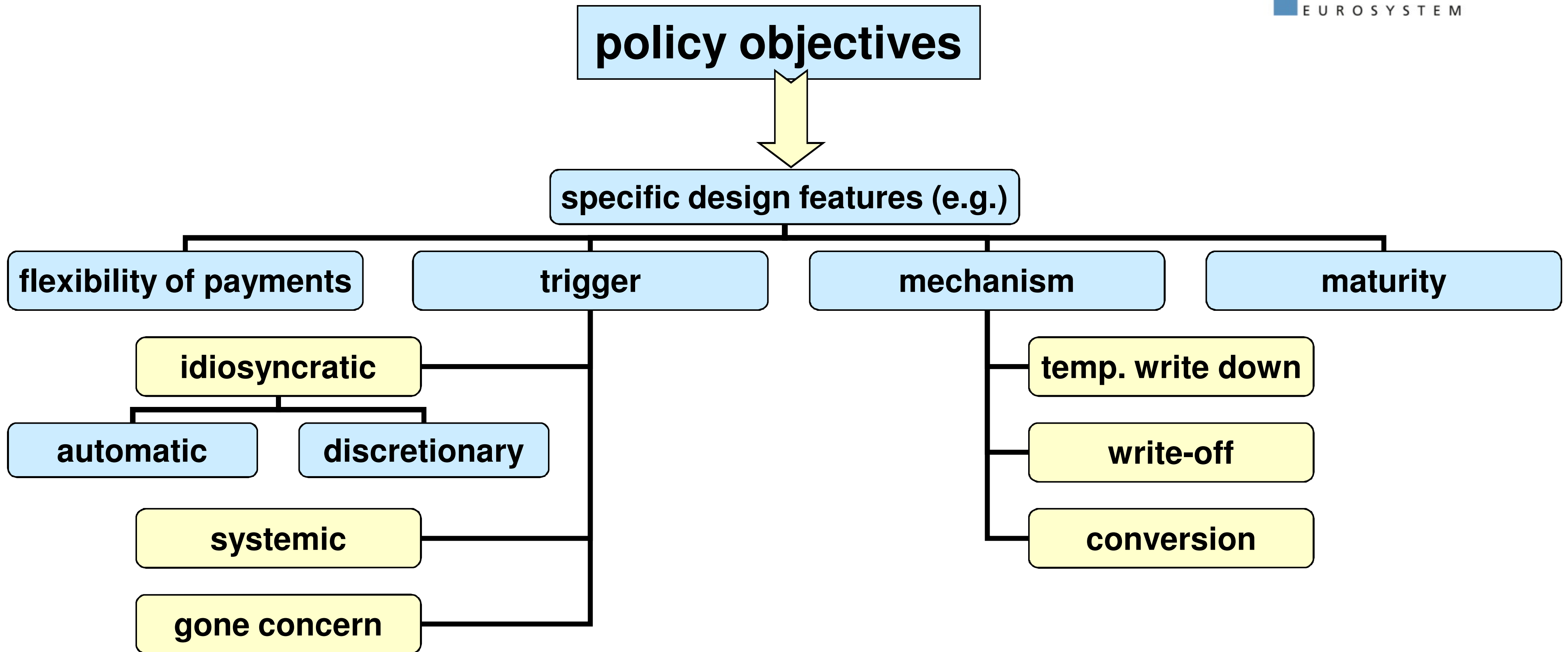
Gone concern or near gone concern proposals

- regulatory capital proposals
- wider bank funding proposals / bail-in capital

Going-concern proposals

- enhance the going-concern loss absorbency of Tier 1 instruments
- provide an alternative form of capital to enhance the loss absorption capacity of systemically important banks
- provide insurance against long-tail risks

Contingent Capital



restrictions: company law, accounting, cost of capital, potential investor base etc.

Loss absorption of instruments eligible for inclusion in Additional Going Concern Capital

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Criterion 11 of the Criteria for inclusion in Tier 1 Additional Going Concern Capital:

Instruments classified as liabilities for accounting purposes must have principal loss absorption through either

(i) conversion to common shares at an objective pre-specified trigger point or

(ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:

a. Reduce the claim of the instrument in liquidation;
b. Reduce the amount re-paid when a call is exercised; and
c. Partially or fully reduce coupon/dividend payments on the instrument.

The negative retained earnings approach (I)

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initial balance sheet

Assets	Liabilities and equity	
100	**Liabilities**	**90**
	Equity	**10**
	preferred stock	2
	common stock	3
	retained earnings	5

end of year 1

Assets	Liabilities and equity	
96	**Liabilities**	**90**
	Equity	**6**
	preferred stock	2
	common stock	3
	retained earnings	1

The negative retained earnings approach (II)

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end of year 2

Assets	Liabilities and equity	
91	**Liabilities**	**90**
	Equity	**1**
	preferred stock	2
	common stock	3
	retained earnings	**-4**

end of year 3

Assets	Liabilities and equity	
97	**Liabilities**	**90**
	Equity	**7**
	preferred stock	2
	common stock	3
	retained earnings	2

Loss absorbency of regulatory capital at the point of non-viability

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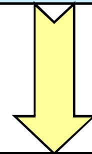
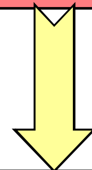
Observation during the financial crisis: in case of public support for a bank, investors in hybrid Tier 1 instruments and Tier 2 investors have not participated in any losses of the otherwise no longer viable bank (beside several cases where coupon/dividend payments were cancelled). The claims of these investors were supported by taxpayers‘ funds.



Loss absorption only effective to a very limited extent, moral hazard of investors



All non-common Tier 1 instruments and Tier 2 instruments at internationally active banks must have a clause in their terms and conditions that requires them to be written-off or converted into common equity.
The trigger event is the earlier of: (1) the decision that the write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and (2) the decision to make a public sector injection of capital, without which the firm would become non-viable, as determined by the relevant authority

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Report of the FSB G 20 Leaders dated 25th September 2009 (Improving Financial Regulation):

"We will also examine the use of "contingent capital" and comparable instruments as a potentially cost-efficient tool to meet a portion of the capital buffer in a form that acts as debt during normal times but converts to loss-absorbing capital during financial stress, thus acting as a shock-absorber for the capital position."

Capital buffers and Contingent Capital

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Capital conservation buffer: to be met solely with Common Equity Tier 1

Countercyclical buffer: to be met solely with Common Equity Tier 1; recognition of „other fully loss absorbing capital“ still under review by the Basel Committee

Enhanced loss absorpion capacity for systemically important banks: could include combinations of capital surcharges, contingent capital and bail-in debt

Contingent Capital (II)

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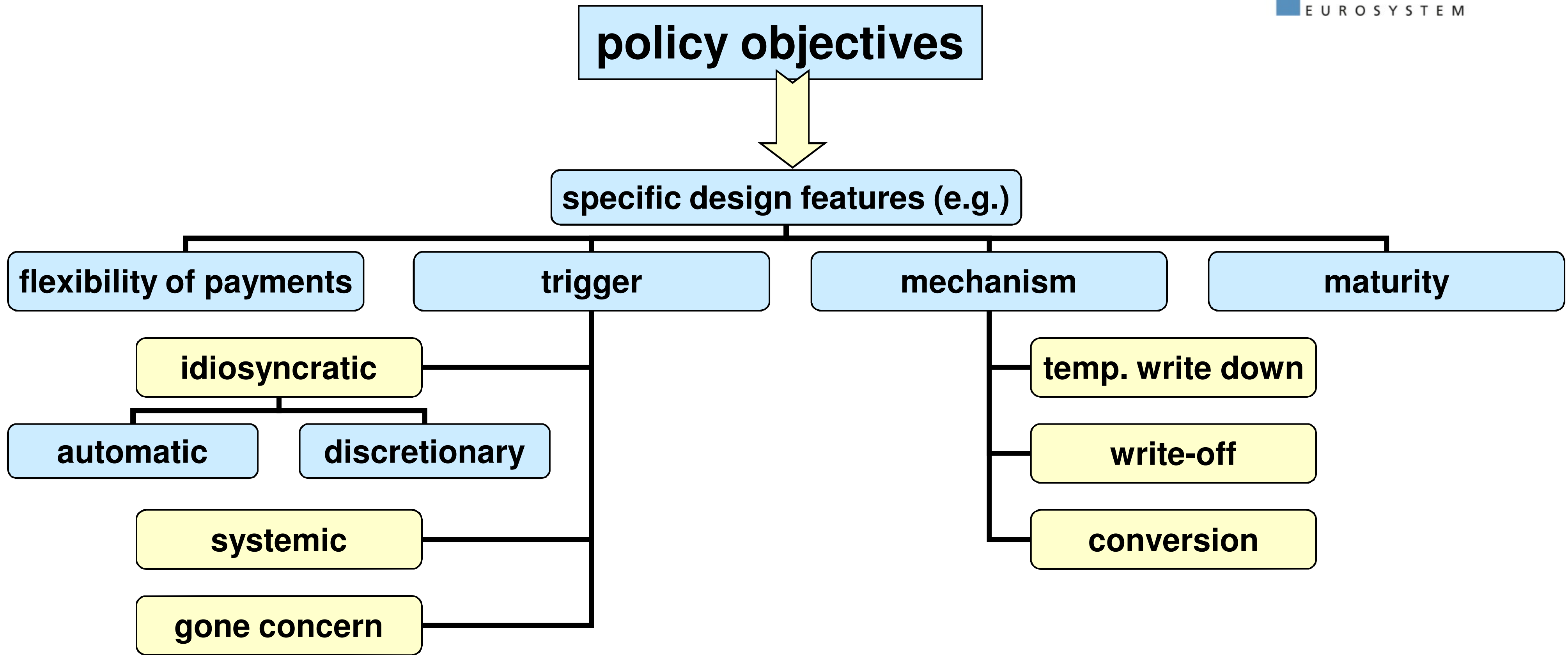

restrictions: company law, accounting, cost of capital, potential investor base etc.

Trigger events

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Bank reported data:
- can be directly aligned to regulatory aims
- lagging indicator

Market data
- timely signal for capital need
- subject to manipulation, potentially destabilising

Systemic trigger
- avoids stigmatising of an individual bank
- negative incentives for risk management at individual banks

Supervisory discretion
- ability to adress special circumstances
- limited or no transpareny for investors

Case study: Lloyd's Enhanced Capital Notes (ECNs)

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LLOYDS BANKING GROUP

No stand-alone issuance but part of a 13.5 bn GBP rights issue and a liability management exercise targeting 16.5 bn GBP of outstanding securities

aim: avoidance of the UK GAPS

Firm- and situation-specific solution

- **Exchange offer of a range of existing capital instruments (non-core Tier 1, Upper Tier 2 and Lower Tier 2) into new ECNs**
- **ECN structure works in the context of the current UK regime (including stress testing approach)**

Case study: Lloyd‘s Enhanced Capital Notes (ECNs)

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- ECNs are Lower Tier 2 with a range of fixed maturities (to broadly match with maturities of existing instruments) or Upper Tier 2 instruments
- Automatic conversion into ordinary shares should the Core Tier 1 ratio of LBG fall to 5%
- The rate of conversion is fixed at the outset (i.e. conversion into a fixed number of ordinary shares)
- The current FSA definition of CT1 is used (i.e. LBG have not “future-proofed” the feature/instrument)
- **The ECNs are eligible as LT2 or UT2 capital (until they convert) BUT they are eligible as CT1 for stress testing purposes IF the stress tests show that the conversion trigger would be hit**

Case Study: Rabobank Senior Contingent Note

Rabobank decided to issue Contingent Notes (SCN) as a means to:

- **further enhance its creditworthiness: the transaction represents an additional buffer in case of unidentified tail-risk events**
- **anticipating the expected more stringent future regulatory requirements (currently no benefit)**

Firm specific trigger:
If the Equity Capital ratio (= equity capital/RWA, equity capital consists of retained earnings and member certificates) is less than 7%, as certified by two Executive Board members, on any two observation dates appr. 23 business days apart

To breach the trigger (as of end 2009):

- **risk weighted assets need to grow by nearly 80% at constant Equity Capital**
- **equity capital needs to decrease by more than 40%, at constant risk weighted assets**

Case Study: Rabobank Senior Contingent Note

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operational mechanism: permanent write down

- **In the event that Rabobank's Equity Capital Ratio falls below 7%, the trigger will be breached and 75% of the senior bond nominal value written down, thereby strengthening Rabobank's capital; the other 25% will immediately be repaid to the investors.**
- **The transaction represents an additional buffer in case of unidentified tail-risk events**

Recent developments around Contingent Capital

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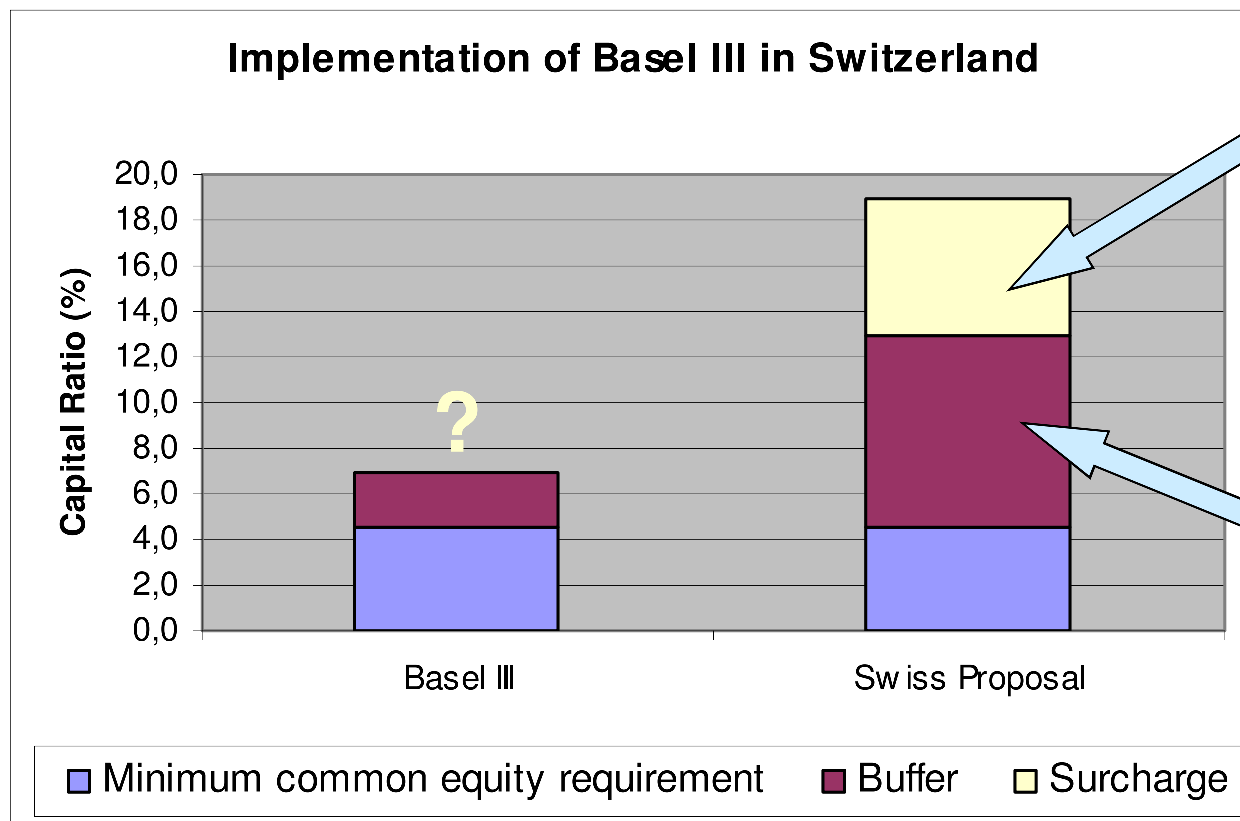

6% CoCos, trigger at 5% common equity ratio

8.5% of which

- **min. 5.5% common equity**
- **max. 3% CoCos, trigger at 7% common equity ratio**

In addition, the Basel minimums for total capital and Tier 1 must be satisfied. CoCos are eligible as long as they meet the relevant criteria. All CoCos must at least meet the criteria for Tier 2 capital.

Recent developments around Contingent Capital

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- **In January, Barclays announced its intention to pay a large part of bonuses to employees in the form of contingent convertible bonds.**
- **The European Commission consults on proposals for crisis management and early intervention which include considerations of using debt write downs as a resolution tool (bail-in).**
- **Credit Suisse announced the placement of CHF 6 billion contingent convertible bonds which convert into ordinary shares in case of its common equity ratio fallig below 7%. Issuance shall not occur before October 2013 and is subject to regulatory and shareholders' approval. The bank plans additional placements of contingent capital to meet the new Swiss capital rules.**

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Thank you very much for your attention!