



A Blueprint for Contingent Convertible Securities?

It has probably not escaped the attention of the reader that European banks, and their ability to meet their continuing funding needs, have been some of the principal victims of the continuing uncertainty surrounding the future of the Eurozone, due to their exposures to Eurozone sovereign debt. As part of its general efforts to increase market confidence in European banks, the European Banking Authority (EBA) published a Recommendation¹ on 8 December 2011 as to the creation and maintenance of temporary capital buffers by European banks.

The EBA recommends that European banks should have created, by 30 June 2012, a temporary capital buffer by attaining a Core Tier 1 capital ratio of at least 9 percent.

The Core Tier 1 capital ratio is to be calculated by comparing a bank's Core Tier 1 capital to its risk-weighted assets. "Core Tier 1 capital" is defined to include ordinary shares or similar instruments, but also newly-issued contingent convertible instruments if their terms comply with a new common term sheet for such instruments ("Buffer Convertible Capital Securities" or "BCCS") set out by the EBA in Annex III to the Recommendation. This represents the first time that a European banking authority has laid down in such detail the core terms that such an instrument should possess in order to count as Tier 1 capital. Existing convertible capital instruments of European banks will not be counted towards the 9 percent ratio, unless they convert into Core Tier 1 capital by the end of October 2012.

Background

In Europe, the Capital Requirements Directive² implements the Basel II framework, and the so-called CRD2 amendments³ were introduced in 2009 partly to harmonise the features which instruments needed to possess in order to be counted by a bank as part of its regulatory capital. Regulators had concluded that certain instruments, sometimes referred to as "hybrid capital," had proven less effective than ordinary shares, or common equity, at absorbing losses in the financial crisis. Therefore, one of the main points of focus of regulators and lawmakers since the financial crisis has been on ensuring that banks hold sufficiently large amounts of common share capital,

¹ EBA Recommendation on the creation and supervisory oversight of temporary capital buffers to restore market confidence (EBA/REC/2011/1),

<http://stress-test.eba.europa.eu/capitalexercise/EBA%20BS%202011%20173%20Recommendation%20FINAL.pdf>.

² Directives 2006/48/EC, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0001:0200:EN:PDF>, and 2006/49/EC, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0201:0255:EN:PDF>.

³ Directive 2009/111/EC, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF>. See Morrison & Foerster client alert "What Counts? An Update on the Debate Concerning Regulatory Capital," http://www.mofo.com/files/Uploads/Images/091113Regulatory_Capital.pdf.

or instruments considered sufficiently close in nature to common share capital, to be counted as the bank's regulatory capital.

The final Basel III framework⁴ set out the recommendations of the Basel Committee of Banking Supervisors as to the quality of regulatory capital, and these recommendations are intended to be implemented in Europe via the so-called CRD4 package of amendments⁵ to the Capital Requirements Directive. The draft CRD4 package is still going through the applicable legislative processes in Europe and is therefore not yet in its final form. The EBA has stated that it is not, by this capital exercise, attempting to pre-empt the effect of the CRD4 package, but it does intend that any Buffer Convertible Capital Securities issued will be eligible for Tier 1 capital treatment under the current Capital Requirements Directive, and eligible for Additional Tier 1 capital treatment under the CRD4 package when this is finalised. However, BCCS will not count as Core Tier 1 or Common Equity Tier 1 capital unless or until converted into common equity.

The Term Sheet

The common term sheet prepared by the EBA for BCCS consists mainly of provisions which are intended to be applied by each country's banking supervisor on a conformed basis. However, there are certain provisions which the EBA has indicated should be determined by national supervisors on a case-by-case basis, subject to a minimum requirement specified by the EBA.

Status and Subordination

The BCCS must be fully paid-up, direct obligations of the bank (and so cannot be issued by another member of the group) and must be unsecured and rank equally as between themselves.

The holders of BCCS will be subordinated to all depositors and unsubordinated creditors of the bank. They will also be subordinated to all other subordinated creditors of the bank, except those whose claims rank *pari passu* with the BCCS holders. They will rank *pari passu* with holders of all other junior capital which qualifies as Tier 1 capital, and will rank senior to the holders of common equity. It is interesting to note that the term sheet does not specifically allow for the holders of BCCS to rank senior to holders of other Tier 1 instruments who have agreed to be subordinated to the BCCS holders – the term sheet seems to expect them always to rank *pari passu* with the holders of such instruments.

Permanence

In line with the Basel III proposals for Tier 1 instruments, the BCCS must be perpetual. The bank may elect to redeem in whole (but not in part) the BCCS on the fifth anniversary of their issuance, or on any interest payment after that date, so long as it has the prior approval of its national banking supervisor, and as long as it meets two further conditions.

Firstly, the BCCS must be replaced by regulatory capital of equal, or better, quality (from the point of view of its permanence and its ability to absorb losses on a going-concern basis).

Secondly, the bank must demonstrate to its national supervisor that, following the exercise of such a call option by the bank, its Core Tier 1 ratio (calculated by reference to the criteria set in the Recommendation) would exceed 9 percent, or, if the Recommendation has been repealed, its regulatory capital would exceed the minimum

⁴ See Morrison & Foerster client alert "Basel III: The (Nearly) Full Picture," <http://www.mofo.com/files/Uploads/Images/101223-Basel-III-The-Nearly-Full-Picture.pdf>.

⁵ See Morrison & Foerster client alert "CRD4 – Maximum Harmonisation but Minimal Harmony?," <http://www.mofo.com/files/Uploads/Images/110822-CRD4.pdf>.

requirements to be set in the CRD4 Regulation, when this is finalised. In each case, it must exceed the minimum requirements by a margin which its national supervisor considers “significant and appropriate.”

The term sheet also prescribes one more scenario in which the BCCS can be redeemed. In the case of a change of EU or national laws, as a result of which the BCCS would cease to qualify as Additional Tier 1 capital after January 2013, in accordance with the finalised CRD4 legislation, the bank may, with its regulator’s consent, redeem all of the BCCS.

As an alternative to redemption in these circumstances, the BCCS may be exchanged, or their terms amended, so that the resulting instrument would continue to qualify as Additional Tier 1 or Tier 2 capital once the CRD4 legislation is effective, or as senior debt of the bank. The term sheet specifies that any such substitution or variation may not contain terms “materially less favourable to the investors,” except to the extent these are required for qualification under the CRD4 legislation. The term sheet does not specify, but presumably the determination of whether a variation is materially less favourable to investors would be made by the national supervisor. It remains to be seen how useful this alternative option becomes in practice, since it is difficult to imagine too many circumstances in which a non-CRD4-qualifying provision could be varied in a way that is not less favourable for investors.

Coupons and Cancellation of Payments

The coupon rate for the BCCS is one of the matters which the EBA is leaving for the banks to agree with their national supervisors. The only minimum requirement set by the EBA is that there be no incentive in the coupon provisions for the bank to exercise its call option (such as a coupon step-up provision). The term sheet does not specifically mention the Basel III requirement that the coupon may not be credit-sensitive, but it seems likely that national supervisors would apply this requirement, since the BCCS are intended to qualify as Additional Tier 1 capital under the CRD4 legislation, when finalised. Under the current draft legislation, there is a prohibition on credit-sensitive coupons for Additional Tier 1 capital.

Similarly, the coupon payment dates are to be determined between the bank and its national supervisor, subject to the minimum requirement that the dates be aligned with the dates for payment of dividends on common shares.

As prescribed by Basel III, the bank will have discretion, at any time, to cancel any coupon payment, on a permanent, non-cumulative basis. In addition, the bank will be compelled to cancel coupon payments if it is in breach of applicable solvency requirements, if there are insufficient distributable funds available (based on applicable national laws) for the coupon payment, or if directed by its national supervisor to cancel the coupon payments.

Whether the coupon cancellation is considered discretionary or mandatory, cancellation will not constitute a default by the bank and will not entitle any BCCS holder to commence insolvency proceedings.

The term sheet does not mention another Basel III requisite, which is that the terms of the instrument may not include any feature which could hinder the recapitalisation of the bank. The current draft CRD4 legislation specifically provides, in this regard, that so called coupon-pushers, dividend-stoppers, and alternative coupon satisfaction mechanisms are prohibited for Additional Tier 1 instruments, whereas the term sheet is silent on these provisions. Again, the intention is for the BCCS to qualify as Additional Tier 1 instruments in 2013, so it will be interesting to see what the approach of individual regulators will be in this regard, particularly in relation to dividend-stoppers, which were not prohibited by the Basel III provisions.

Conversion

The Basel III requirements for Additional Tier 1 capital prescribe that the instrument must be able to absorb losses by being written down, or converted into common equity, at a pre-specified trigger point (so-called “going-concern” loss absorption). In addition, the Basel Committee has separately proposed that Additional Tier 1 and Tier 2 capital should be able to be written down, or converted into common equity, at the instigation of regulators in circumstances where the institution has become non-viable without such loss absorption, or where public sector support is needed to avoid the institution’s failure (“gone-concern” loss absorption).

The EBA term sheet therefore provides that the BCCS will be mandatorily converted into ordinary shares upon the occurrence of a Contingency Event or a Viability Event, and the issuer is required to have obtained, prior to the issuance of the BCCS, all necessary shareholder consents to the increase of its authorised share capital sufficient for the mandatory conversion of all the BCCS.

Two Contingency Events are specified. The first is the bank giving notice that its Core Tier 1 capital ratio (calculated by reference to the criteria set in the Recommendation) has fallen below 7 percent. The second is the bank giving notice, after 1 January 2013 (the date by which the CRD4 legislation is intended to become effective), that its Common Equity Tier 1 capital ratio (calculated in accordance with the criteria set in the CRD4 legislation) has fallen below 5.125 percent (or such higher percentage as may be specified by the bank for the purpose of the particular BCCS). The term sheet specifies that the second Contingency Event becomes applicable from 1 January 2013 and that the first Contingency Event also remains applicable after such date, to the extent that the Recommendation has not been repealed or cancelled.

A Viability Event is either (a) a decision by the national supervisor that a conversion of the BCCS is necessary to prevent the bank becoming non-viable, or (b) a decision to make a public sector capital injection, or similar support, without which the bank would become non-viable in the determination of the national supervisor.

The term sheet acknowledges that such a Viability Event provision in the terms and conditions of the BCCS may not be necessary where the bank’s jurisdiction has an “equivalent regime” in place and the terms of the BCCS clearly disclose this fact. The Basel Committee’s recommendations were that a Tier 1 or Tier 2 instrument should not have to provide for non-viability write-down/conversion where a peer group review confirms that the bank’s jurisdiction has in place laws that require such instruments to be written off, or otherwise to absorb losses, before taxpayers are exposed to loss, and where this is disclosed by the relevant issuance documents. The current draft of the CRD4 legislation does not purport to implement these recommendations of the Basel Committee, but they are referred to in the recitals to the draft CRD4 Regulation and the expectation is that the forthcoming EU Directive on a Framework for the Recovery and Resolution of banks and investment firms will establish the basis for each EU member state to develop such a regime for its banks.

In addition to the above “issuer-driven” convertibility events, the term sheet also allows for the possibility of the BCCS including terms entitling the holders of the BCCS to elect for conversion into shares, or providing for such conversion to take place mandatorily upon a fixed date. The inclusion of these provisions is not mandated by the EBA, but is left to the discretion of the bank and its regulator.

In relation to the conversion rate at which the BCCS would convert to ordinary shares, the EBA envisages this being agreed between the bank and its supervisor on a case-by-case basis, subject to the minimum requirement that the terms of the instrument should specify either a pre-determined range of conversion rates, or a rate of conversion and a limit on the permitted amount of conversion.

As to the applicable conversion period, the EBA also envisages this being set on a case-by-case basis, but specifies that the provisions may not undermine the instrument’s conversion features and in particular may not restrict the automatic nature of the conversion.

Next Steps

The Recommendation has been issued pursuant to Article 16(1) of the EBA Regulation.⁶ The competent authorities of individual member states are obliged by Article 16(3) of the EBA Regulation to make all efforts to comply with the Recommendation, by incorporating it into their supervisory practices. The competent authorities are further expected to indicate to the EBA by 8 February 2012 that they do, or will, comply with the requirements of the Recommendation, or to provide reasons for any non-compliance.

Those European banks which have been identified as having a capital shortfall, calculated on the basis of market prices as of 30 September 2011, are to be required by their national supervising authorities to submit capital plans by 20 January 2012 as to how they intend to reach the 9 percent target.

Now that the EBA term sheet has been published, the capital-raising exercises of European banks in the next six months may give a clearer indication of the extent to which contingent capital securities, which qualify to form part of a bank's Tier 1 capital, can be issued on terms that are acceptable to both banks and investors.

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⁶ Regulation 1093/2010, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0012:0047:EN:PDF>.