Hybrid securities: an overview

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The history of hybrid securities may well be divided into two periods: pre-financial crisis and post-financial crisis. Before the crisis, hybrid issuances were quite significant and product structuring efforts resulted in a vast array of hybrid products. Following the financial crisis, regulators have been focused on enhancing the regulatory capital requirements applicable to financial institutions and ensuring that there is greater transparency regarding financial instruments. Regulatory reform will continue to affect the future of hybrid capital.

This chapter provides a brief overview of the principal structuring, legal, tax, regulatory and accounting considerations related to the issuance of hybrid securities. In particular, it:

- Provides a general overview of hybrid securities.
- Considers some specific examples of hybrid securities.
- Examines how hybrid securities performed during the financial crisis.
- Outlines the regulatory reform that has been introduced in the wake of the crisis.
- Considers the emergence of contingent capital instruments and their potential to replace hybrid securities like trust preferred securities.

The chapter is a summary and does not purport to be a full discussion of the regulatory and tax issues, which are quite complex and differ jurisdiction by jurisdiction.

**OVERVIEW OF HYBRID CAPITAL SECURITIES**

Hybrid capital securities, or securities that have some equity characteristics and some debt characteristics, have been popular for over a decade. Hybrid securities lie somewhere along the equity-debt continuum, but where exactly, is the subject of great debate, and depends largely on the terms of the instruments as well as the provisions of applicable national laws. In fact, over its life, a hybrid security may exhibit different proportions of equity-like or debt-like traits, sliding along the continuum.

This section outlines:

- The format that hybrid securities can take.
- The objectives associated with hybrid capital.
- Some common types of hybrid securities.
- The types of companies that have issued hybrid securities.
- The relevant legal framework to consider in structuring a hybrid capital security.

- The main bank regulatory requirements and how these differ by jurisdiction.
- The main tax considerations and how these differ by jurisdiction.
- The accounting considerations.
- The ratings considerations.
- How hybrid securities can be offered and how and to whom they are usually marketed.

**Format**

Hybrid securities include:

- Certain classes of preferred stock.
- Trust preferred securities.
- Convertible debt securities.
- Debt securities with principal write-down features.
- Mandatorily convertible instruments.

**Objectives**

Issuers like hybrid securities because they are considered an attractive, cost-efficient means of raising non-dilutive capital. Hybrid securities are issued by financial institutions, including banks and insurance companies, as well as by corporate issuers, which are generally utilities. Hybrid securities often receive favourable treatment by ratings agencies and regulators when they analyse an issuer’s capital structure. Many hybrids also provide a lower after-tax cost of capital for issuers compared to common stock.

Historically, an issuer and its advisers sought to structure a hybrid security that:

- Qualified for favourable equity treatment from rating agencies.
- Allowed the issuer to make tax-deductible payments.
- Qualified as Tier 1 capital for bank holding companies (see below, Bank regulatory requirements).

The benefits of a hybrid security depend on its “equity-like” or “debt-like” characteristics. From a rating agency and bank regulatory-perspective, more equity-like hybrids generally receive more favourable treatment. From a tax perspective, more debt-like hybrids offer more favourable tax treatment for issuers.

When structuring a hybrid security, it is helpful to identify the core elements of common equity and the core elements of debt.
There are a number of characteristics associated with “pure equity”, including no maturity, no ongoing payments that could trigger a default if unpaid, and loss absorption for all creditors. For example, common stock has no compulsory or fixed repayment obligation or term.

In contrast, debt usually has fixed payments and a stated maturity. An issuer can elect not to pay dividends on its common stock, but non-payment of principal or interest on a debt security generally constitute an event of default. Common stock provides “loss absorption” for an issuer, meaning that common stockholders are the last class of security holders to receive distributions in a liquidation. By contrast, debt holders have a right to receive payments before equity holders.

Preferred stock may entitle the holder to a dividend, subject to declaration by the issuer, and may entitle the holder to some voting rights. As with common stock, non-payment of a preferred stock dividend will not trigger an event of default. However, non-payment may breach a covenant or other contractual undertaking by the issuer. Dividend payments may be cumulative, or non-cumulative.

Preferred stock may be convertible, at the option of the issuer or the holder, or mandatorily on the occurrence of certain events. While senior to common stock in liquidation, preferred stock provides some measure of loss absorption, by ranking behind unsecured debt in terms of priority of payment, in a bankruptcy or other degraded financial situation.

Most hybrids contain a deferral feature (optional or mandatory) that permits the issuer to defer the payment of interest or dividends. Hybrids also generally are deeply subordinated within the issuer’s capital structure. Like an equity security, non-payment of distributions does not result in an event of default. In fact, a hybrid security holder has limited rights against the issuer for deferred interest payments.

In certain structures, deferred interest may be permanently cancelled if certain conditions are satisfied and, as a result, the holder of the hybrid security may forfeit its claim for deferred interest amounts. In other structures, the treatment of deferred payments is bifurcated. After some deferral period, the issuer must pay deferred interest through the issuance of capital (an alternate payment mechanism) up to a cap.

An alternate payment mechanism requires that deferred distributions on the hybrid can only be paid out of the proceeds from the issuance of more junior or parity securities or through payment-in-kind. In bankruptcy, however, the security holder’s claim is limited to a maximum deferred interest amount.

Common types

The most common hybrid securities are preferred securities with additional features designed to achieve enhanced economics or other efficiencies. These may include trust preferred securities, real estate investment trust (REIT) preferred securities, perpetual preferred securities and so on.

Types of issuers

Before the financial crisis, many banks and insurance companies relied on the issuance of hybrid securities as an important component of their funding plans. Financial institutions appreciated that hybrid securities provided a tax efficient means of raising capital, while at the same time qualifying for favourable regulatory treatment. Corporate issuers also use hybrid securities, and tend to focus on the tax and rating benefits associated with them. In addition, hybrids typically are non-dilutive at issuance and contain limited or no voting rights.

Relevant legal framework

Any issuer contemplating the offer and sale of a hybrid security should consider whether it has the necessary corporate authority. The creation of a new hybrid security may require that the issuer designate a new class of securities, having special rights and preferences.

If the security will be issued directly or through a special purpose trust, additional actions are required. Potentially, there are ongoing reporting requirements that may be applicable to any new special purpose trust.

A hybrid security may be offered in a private or a public offering (see below, Offer format and marketing), and in either case, the issuer must consider disclosure matters. Structuring of the hybrid security should involve close collaboration with the issuer’s tax and accounting advisers.

Where the instrument provides for its possible conversion into common stock, the issuer needs to consider the effect of this instrument on the rights of existing common stockholders, and the steps needed to effect such a conversion.

In the case of a regulated institution, the issuer should be in close touch with its principal regulator to ensure that the offered security will receive the intended regulatory capital treatment (see below, Bank regulatory requirements). The issuer should also consult with rating agencies.

Bank regulatory requirements

From a bank regulatory perspective, there has not been a standardised approach to the treatment of hybrid capital instruments. In fact, following the financial crisis, regulators have identified the fact that there was no common approach to hybrid instruments as a concern. The Basel framework of the time did not address the features of hybrid instruments. The only available guidelines for banks and regulators were contained in the so-called “Sydney Agreement” of 1998. The Sydney Agreement stated that internationally active bank holding companies generally would be expected to limit restricted core capital elements to 15% of Tier 1 capital (see below).

Banks have particular concerns when it comes to hybrid securities. Bank hybrid capital instruments constitute capital for regulatory capital purposes, but are usually treated as debt for tax purposes.

The Basel Accord, or Basel I, sets criteria for measuring capital adequacy. Basel I divides bank capital into two categories:

- Tier 1, or core capital.
- Tier 2, or supplementary capital.

Tier 1 capital includes:

- Common stock.
- Non-cumulative perpetual preferred stock.
- Disclosed reserves.
- Minority interests in the equity accounts of consolidated subsidiaries.
Tier 2 capital includes:
- Undisclosed reserves.
- Asset revaluation reserves.
- General provisions/loan loss reserves.
- Hybrid (debt/equity) capital instruments (like mandatory convertible debt and cumulative perpetual preferred stock).
- Term subordinated debt.
- Intermediate term preferred stock.

Under Basel capital requirements, banks are required to maintain certain ratios between Tier 1 and total capital to assets.

Regulated insurance companies are also subject to regulatory capital limits for hybrids. Ratings agencies consider the insurance regulators’ views in assessing equity credit for hybrid securities issued by insurance companies. Most insurance companies issue hybrid securities through their holding company, rather than through the regulated entity.

The international prudential framework for capital requirements has recently been reformed (known as Basel III), which has implications for hybrid instruments (see below, International reform: Basel III and Practice note, Basel III: an overview).

Main tax considerations
The main tax consideration is whether interest-like payments made (or accrued) by the issuer with respect to any hybrid security are deductible for tax purposes. Such a deduction is necessary for any hybrid security to provide a lower after-tax cost of capital for the issuer. Whether payments are in fact deductible depends on the characterisation of the instrument for tax purposes and the particular terms of any offering.

The tax characterisation of hybrid securities differs by jurisdiction as there is no uniformity across national tax laws in this respect.

Accounting considerations
The accounting considerations differ depending on whether the issuer prepares its financial statements in accordance with US generally accepted accounting principles (GAAP), international financial reporting standards (IFRS) or other national accounting rules.

From an accounting perspective, there are a few key issues:
- First, for hybrid securities that involve the use of a trust or other special purpose vehicle, the issuer should consider the treatment of its interest in this entity and whether the entity will be consolidated or de-consolidated or treated as a variable interest entity.
- For hybrids that involve a forward contract or other derivative instrument, the issuer should consider the treatment of the derivative contract, especially given the evolving views on issuer derivatives.
- Finally, there are important differences under GAAP and IFRS regarding the treatment of instruments having certain characteristics of equity securities and certain characteristics of debt securities.

Ratings considerations
Hybrid securities receive varying degrees of “equity content” from rating agencies based on their features and their anticipated effect on the issuer’s capital structure. Rating agencies limit the overall amount of traditional hybrids to which they give equity treatment when considered relative to the issuer’s overall capital structure.

Historically, rating agencies viewed hybrids favourably, because hybrids were believed to have some of the loss-absorbing features associated with common equity securities. It was believed that, to varying degrees, hybrid securities would provide a “cushion” within an issuer’s capital structure in bankruptcy or on the occurrence of other adverse events. Rating agencies also considered the effect of the hybrid security on the issuer’s cash flows. The analysis of the hybrid security is separate and distinct from the rating agency analysis of the issuer’s overall credit rating.

In 2005, Moody’s published its “Tool Kit” relating to its methodology for analysing hybrid securities. Publication of the Tool Kit led to greater certainty regarding the features of hybrid securities that would be viewed favourably from a ratings perspective, and, as a result, a wave of new hybrid products were introduced.

The Tool Kit featured a continuum of five baskets, from the A basket, which is 0% equity and 100% debt, at one extreme, to the E basket, which is 100% equity and 0% debt, at the other extreme. To assign a hybrid security to a basket, Moody’s assesses the instrument’s equity-like characteristics.

During the financial crisis, the rating agencies took a number of actions related to hybrid securities. In July 2010, Moody’s published “Revisions to Moody’s Hybrid Tool Kit” in which it reaffirmed the basket approach, but outlined “revised basketing guidance.” Moody’s stated that, in analysing a hybrid security, it would consider the following:
- Does the hybrid absorb losses for a “going concern”?
- Does the hybrid absorb losses for a “gone concern”?
- Is the loss absorbing hybrid there when needed?

As a general matter, hybrids that absorb losses for a going concern are generally eligible for D basket classification, while hybrids that absorb losses for a gone concern, depending on maturity, are generally eligible for a C basket classification. The July 2010 statement also provided a chart illustrating the features or characteristics present in most common hybrid securities and the manner in which these would be considered for the purposes of assessing basket categorisation.

Offering format and marketing
Hybrid securities can be offered in private or public offerings. In the US, for example, the securities can be issued pursuant to a registration statement or an exemption from registration, such as that provided by Rule 144A of the US Securities Act 1933, as amended (Rule 144A). If an offering relies on Rule 144A and involves the issuance of securities by a trust, the trust can rely on an exemption for offerings to an unlimited number of investors who are “qualified purchasers” to avoid registration as an investment company under the Investment Company Act of 1940 (section 3(c)(7)). The securities may also be offered outside of the US in reliance on Regulation S under the Securities Act.
The principal investors in hybrid securities include other banks, insurance companies, pension funds, bond funds, and other institutional investors. Small denomination hybrid securities are also offered to retail investors.

**SPECIFIC EXAMPLES**

This section examines various types of hybrid securities from a US law perspective, including:

- Trust preferred securities.
- Enhanced trust preferred securities.
- REIT preferred structures.
- Paired or stapled hybrid structures.

**Trust preferred securities**

To issue trust preferred securities (TRUPs), an issuer first organizes a Delaware statutory trust and then buys and holds all of the common interests in the trust. The security offered to investors represents an undivided preferred beneficial interest in the trust. The trust sells these beneficial interests and invests the offering proceeds in a subordinated long-dated debt security (for conventional trust preferred securities, usually at least 30 years) of the issuer; frequently a bank holding company.

The trust preferred security and the issuer’s subordinated debt security will have substantially identical terms. The issuer of the debt security has the option to defer interest payments without triggering an event of default for a period of (usually) five years. Distributions on the securities typically are cumulative.

See box, *A basic TRUP*.

For tax purposes, the trust is a pass-through and its income is not subject to separate tax. The interest payments on the underlying debt securities are treated as tax deductible. The issuance of the trust preferred securities are not dilutive to the issuer. For bank holding companies (subject to certain regulatory capital limitations (see above, *Bank regulatory requirements*), these securities count as Tier 1 capital for regulatory purposes (for now). Trust preferred securities are assigned some measure of equity credit due to their deep subordination, long maturity, interest deferral feature and equity conversion option.
Enhanced trust preferred securities

Following publication of the Toolkit (see above, Ratings considerations), there was quite a bit of product innovation as financial engineers introduced new features for hybrid securities, like longer maturities, bifurcated maturities, alternative payment mechanisms, replacement capital covenants and interest deferral triggers. These features were intended to ensure that the hybrid securities received equity credit, while preserving debt for tax treatment. There were a variety of enhanced trust preferred instruments issued, including the Lehman E-CAPs, Capital Efficient Notes (CENts) introduced by JPMorgan, ETRUPs introduced by Citigroup and the USBancorp ICONs.

REIT preferred structures

Beginning in the mid to late 1990s, a number of bank holding companies sponsored REITs. Generally, the bank holding company would organise a REIT and contribute cash and mortgage-related assets in exchange for the REIT’s common stock. The REIT offered non-cumulative perpetual preferred stock to the public, and used the offering proceeds to purchase additional mortgage-related assets from the bank holding company. Income on the REIT’s mortgage-related assets is distributed to the holders of the REIT securities, including the preferred stockholders. The REIT deducts the dividends paid on the preferred and common stock. The income stream resulting from the mortgage-related assets is not subject to corporate level tax. The transaction results in Tier 1 capital for the bank holding company.

As an example of a REIT preferred structure, in February 2006, Washington Mutual completed a financing in reliance on Rule 144A, involving an issuance by a Delaware statutory trust of fixed-to-floating rate perpetual non-cumulative trust securities (bearing terms identical to the trust securities) issued by Washington Mutual Preferred Funding LLC. The limited liability company, a partnership for income tax purposes, purchased an interest in a real estate mortgage investment conduit (REMIC) for federal income tax purposes. The REMIC owns mortgage loans contributed by Washington Mutual Bank.

Since the REMIC is a pass-through entity and Washington Mutual Preferred Funding LLC is a partnership for tax purposes, the income stream on the mortgage loans is effectively carved out from corporate income tax. Washington Mutual is a federal savings bank regulated by the Office of Thrift Supervision, which, unlike the Federal Reserve Board, does not treat trust preferred securities as Tier 1 capital. The preferred securities are non-cumulative; however, if dividends are not paid, then the parent company, Washington Mutual Inc, covenants not to pay dividends on its publicly traded common stock.

The preferred securities are also subject to conversion into perpetual non-cumulative preferred stock of the parent company on the occurrence of certain regulatory events. Washington Mutual agreed that if it repurchases or redeems trust securities, it will do so only if and to the extent that the total redemption or repurchase price is equal to or less than designated percentages of the net cash proceeds that it receives during the 180 days before the redemption date from the issuance of other securities having similar equity content.

See box, Washington Mutual REIT preferred structure for the basic features of this transaction.
**Paired or stapled hybrid structures**

Another conventional hybrid structure is the mandatory convertible security structured as a unit comprised of two securities, or a perpetual non-cumulative security paired with a fixed-term cumulative security. An example is a non-convertible trust preferred security paired with a forward stock purchase contract. The forward stock purchase contract commits the issuer to deliver, and investors to purchase, a variable number of shares of common stock of the issuer some time from issuance.

As an example of a paired hybrid structure, in January 2006, Wachovia Corporation, a bank holding company, issued through a trust an investment unit (Wachovia Income Trust Securities (WITS)) that consisted of a subordinated debt security with a 37-year term and a five-year forward stock purchase contract on Wachovia perpetual preferred stock. The subordinated debt security is issued by a trust, the Wachovia Capital Trust III. The trust holds remarketable junior subordinated notes of Wachovia Corporation and a forward stock purchase contract on non-cumulative perpetual preferred stock. The WITS and the perpetual preferred stock have a 5.8% coupon. Interest on the notes is deferrable and is cumulative.

After five years, the subordinated debt security can be remarketed, and the proceeds from the remarketing will be used to exercise the forward contract to purchase the non-cumulative perpetual preferred stock. If the note is not remarketed, then the trust can deliver the notes to the issuer as payment for the non-cumulative perpetual preferred stock. The contractual replacement language requires that funds for redemption be from proceeds of the issuance of common stock, other perpetual or long-dated non-cumulative preferred stock, or certain other allowed instruments received within 180 days of redemption. Redemption is subject to regulatory approval.

In relation to ongoing payments, distributions are deferrable for seven years and must be settled using common stock. The forward contract obligates Wachovia to sell non-cumulative perpetual preferred stock to holders in five years. The perpetual preferred stock is immediately callable subject to binding replacement language.

From a tax perspective, the components (the note and the forward contract) are treated as two separate instruments. Interest on the note is deductible for federal income tax purposes.

Many other bank holding companies have issued similar securities.

See box, *Wachovia paired hybrid structure*, for the principal features of these transactions.

**HYBRIDS DURING THE FINANCIAL CRISIS**

Early on in the financial crisis, commentators noted that many hybrid securities absorbed “significant losses”. Hybrid issuers had become accustomed to purchasing these securities and thinking of them, or treating them, as bonds. Investors often assumed that hybrid issuers would exercise early redemption options on hybrids as they arose.

Hybrid issuers surprised the market when they opted (or were encouraged by regulators) not to exercise their option to redeem outstanding hybrids because alternative (or replacement) capital would have been more expensive or possibly unavailable. As the crisis worsened, and governments intervened in the banking sector, taking extraordinary measures to restore confidence in the
financial system, hybrid investors became more concerned about their prospects. In certain instances, hybrids also suffered from principal writedowns.

However, commentators noted that these securities were less able to absorb losses on a going concern basis during periods of financial stress than common equity. Commentators also noted that many governments conditioned their aid to ailing banks on an agreement that the bank issuers would not pay hybrid coupons. Many issuers were also forced (or chose) to undertake exchange offers or other liability management exercises in relation to their outstanding hybrid securities as part of recapitalisation transactions.

Commentators also raised concerns, particularly in relation to a number of Tier 2 instruments, that principal write-down features were never triggered as they were designed to kick-in only in an insolvency scenario, while most bail-ins and injections of public funds occurred in advance of an insolvency in view of the perceived systemic consequences of a failure - the “too big to fail” concern.

The remainder of this section considers how the rating agencies, investors and regulators reacted to concerns about hybrids during the financial crisis.

Rating agencies
Rating agencies downgraded a number of hybrids, noting increased risk of coupon deferral and the possibility that hybrid investors would bear losses. During this period, the rating agencies announced changes to their rating methodology. In its announcement regarding its new rating methodology for hybrid securities, Moody’s noted that given these crisis-related developments, hybrid ratings should eliminate any assumption of systemic support and should instead focus on the intrinsic creditworthiness of the bank issuer. Moody’s also noted that its ratings would take into account the special features of the particular hybrid security.

Investors
Investors were frustrated that there was a lack of comparability among the types of financial instruments used by banks organised in different jurisdictions that received Tier 1 treatment and by the difficulty of assessing the relative features of these securities.

As a result, investors became increasingly focused on tangible common equity and reserves as the true indicator of a bank’s regulatory capital strength. (Tangible common equity equals common shareholders’ equity (excluding non-controlling minority interests) minus goodwill, intangibles, preferred shares and mortgage servicing rights (MSRs).)

Regulators
The G20 leaders committed to working together toward implementation of regulatory reform, including adoption of stronger capital requirements. The Group of Central Bank Governors and Heads of Supervision agreed that the Basel Committee on Banking Supervision (BCBS) should raise “the quality, consistency and transparency of Tier 1 capital.” This objective was a guiding principle in the formulation of the Basel III framework (see below, International reform: Basel III).

POST-FINANCIAL CRISIS: REGULATORY REFORM
In the wake of the financial crisis, legislative reform internationally, and in the US and Europe, has had an impact on hybrid capital.

International reform: Basel III
On 17 December 2009, the BCBS announced far-reaching draft proposals for comment, referred to as the Basel III framework. The final proposals were published by the BCBS on 16 December 2010 and are intended to be implemented by countries into their national laws, so as to be effective from 1 January 2013 onwards.

The Basel III reforms:

- 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.
- Incorporate measures designed to improve the countercyclical capital framework.

To rectify perceived deficiencies relating to regulatory capital, the Basel III framework emphasises 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 harmonised for consistent application across jurisdictions.
- Regulatory capital components must be clearly disclosed by financial institutions 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” (see above, Investors).

The Basel III framework sets criteria that must be satisfied 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 (including subordinated 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 (including a mandatory conversion to common shares or principal write-down at a pre-specified trigger point).
- Cannot hinder recapitalisation.

Principal redemption can only be made, whether on redemption or buy-back, with prior regulatory approval. Several “innovative” Tier 1 instruments will be phased out, including, for example, step up instruments, cumulative preferred stock and trust preferred stock.
The new minimum capital requirements will be phased in between 1 January 2013 and 1 January 2015 and regulatory adjustments will be phased in between 1 January 2014 and 1 January 2018. The recognition of existing capital instruments that do not comply with the new rules will be phased out from 1 January 2013, with their recognition capped at 90% from such date, the cap reducing by 10% in each subsequent year. Instruments that do not qualify as Tier 1 capital may still constitute Tier 2 capital if they meet certain criteria, including:

- Having a minimum original maturity of at least five years with no incentive to redeem.
- Being callable only by the issuer after a minimum of five years with prior supervisory approval.

Such instruments must also have no credit-sensitive dividend feature and in liquidation must be subordinated to depositors and unsubordinated creditors.

In January 2011, the Basel Committee published minimum requirements for loss absorbency features at the point of non-viability of an entity to be included in all Tier 1 and Tier 2 capital instruments. The principal requirement is that, on a specified trigger event, the relevant instrument must be subject to a write-down or conversion into equity. The trigger event is when the relevant authorities either: decide that a write-off or conversion is necessary, or decide to make a public sector injection of capital (or equivalent support), whichever is the earliest.

The Basel Committee has proposed that instruments that are issued on or after 1 January 2013 must meet these minimum requirements as a pre-condition to receiving the relevant regulatory capital instrument.

The BCBS has published a set of FAQs on the Basel III definition of capital, most recently updated on 20 October 2011 (Basel III definition of capital - Frequently asked questions, www.bis.org/publ/bcbs204.htm).

US

In many respects consistent with the proposed Basel III framework, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 has 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$50 billion (as at 1 February 2012, US$1 was about EUR0.76)) the Federal Reserve must establish stricter requirements, which may include a maximum debt-to-equity ratio.

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 currently applicable 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 spectre 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 19 May 2010.

Bank holding companies and systemically important non-bank 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$15 billion in total consolidated assets are not subject 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.

Additional regulatory guidance will be required in the US regarding the types of hybrid securities (in addition to non-cumulative perpetual preferred securities) that will benefit from favourable regulatory capital treatment. At this time, product structurers are re-evaluating hybrid securities that were used in the past and considering whether some may have use in a post-Dodd-Frank, post-Basel III world.

Europe

In July 2011, the European Commission published a draft of its proposed legislation to implement the Basel III requirements. The proposals, when finalised and approved by the European legislature, will also recast the existing Capital Requirements Directive (2006/48/EC and 2006/49/EC) in the EU, and are referred to as CRD4. The Commission proposes to achieve this with the combination of:

- A new directive that will need to be separately implemented into the national laws of the EU member states.
- A new regulation that will have direct effect in member states (and will limit the scope for national legislators to put their own interpretation on the EU rules).

The proposed CRD4 regulation implements the Basel III recommendations very closely as to the minimum levels of capital that a financial institution must issue, although it provides a greater degree of detail as to regulatory adjustments and deductions. One departure from Basel III is that under the proposed regulation, instruments do not have to be common shares to be treated as common equity Tier 1 capital as long as they meet the detailed criteria set out in the Basel III rules.

In relation to instruments that previously qualified for regulatory capital treatment, but cease to be recognised as Tier 1 or 2 capital under Basel III, the Basel III rules specify a cut-off date of 12 September 2010. Any instrument issued before that date can be de-recognised gradually over a ten-year phase-out period and any instrument issued on or after that date would be fully
Some of the contingent capital products that have been envisaged these will come into force on 1 January 2013, in line with the Basel III proposals.

The system is in crisis, either based on an assessment by regulators or based on objective indicators such as aggregate bank losses.

The bank’s capital ratio falls below a certain value.

There are a number of other permutations of contingent capital instruments, including some that have been used by insurance companies in the past. These approaches all attempt to address the fact that in difficult times, banks (which rely on investor confidence) find it difficult to raise capital. Contingent capital would act as equity and provide a cushion to convince depositors and other creditors that their money is safe.

This section considers:
- Why regulators are focusing on contingent capital instruments.
- Whether contingent capital instruments have the potential to replace hybrid securities like trust preferred securities.
- Some of the contingent capital products that have been issued to date.
- The tax treatment of contingent capital products.

Focus of regulators

Regulators are keenly focused on the need to bolster regulatory capital levels at financial institutions. In addition, regulators would like to avoid (to the extent possible) having taxpayers bear the brunt of a financial institution bailout. As a result, regulators are focused on setting higher regulatory capital requirements, as well as other tools, such as “bail in” features for certain debt securities, “buffers” or extra capital cushions and contingent capital instruments.

Potential of contingent capital instruments

The role of contingent capital instruments remains to be seen. In November 2011, the BCSB issued its final principles as to the methodology for determining which banks are to be considered as Global Systemically Important Banks (GSIBs), as well as setting additional minimum capital requirements applicable to such banks, on top of the minimum capital requirements already intended to apply to all internationally active banks under Basel III.

Many global institutions had hoped that the Basel Committee would recommend that such additional capital requirements for GSIBs could be met, at least partially, with contingent capital instruments, but their final recommendations proposed that only “core” Tier 1 capital instruments would be used for this purpose.

excluded from the relevant class of regulatory capital from 2013. The proposed CRD4 regulation adopts the same concept but with a phase-out date of 20 July 2011, and with some discretion given to national regulators to accelerate the rate of phase-out if considered appropriate.

In relation to the requirement under the Basel III rules that Tier 1 capital instruments must provide for a “going-concern” write-down of principal or conversion into equity at a pre-specified trigger point, the draft CRD4 regulation provides that the trigger point will be the time when the institution’s common equity Tier 1 capital as a proportion of its total risk-weighted assets falls below 5.125%.

The European Banking Authority (EBA) is mandated to draft technical standards in respect of procedures and timings for the determination and notification of trigger points and the consequences of this. It must also specify the nature and extent of any such write-downs and whether the write-down has to be permanent or can be written back up again if the entity’s financial position subsequently improves. The EBA’s determinations on these points will therefore be crucial in determining the nature of contingent convertible bonds and their attractiveness to investors.

Under the Basel III rules, no Tier 1 capital instrument may contain any feature that would hinder the recapitalisation of the institution, and dividend pushers and alternative coupon satisfaction mechanisms are expressly prohibited. The CRD4 proposed regulation goes further and states that dividend stoppers will also not be permitted in Tier 1 instruments.

The CRD4 proposals do not yet contain the EU’s proposed legislation for the Basel Committee’s proposal for all Tier 1 and Tier 2 instruments to include triggers to ensure that such instruments absorb losses at the point of an entity’s non-viability (see above, International reform: Basel III).

The CRD4 proposals remain subject to amendment and approval of the European Parliament and European Council. It is currently envisaged these will come into force on 1 January 2013, in line with the Basel III proposals.

CONTINGENT CAPITAL

Broadly speaking, contingent capital is just another hybrid security. A contingent capital instrument is supposed to provide financial institutions leverage in good times, but provide a buffer in bad times. Academics have suggested various contingent capital arrangements. One version of contingent capital is for banks to issue debt that automatically converts to equity when two conditions are met (Squam Lake Working Group on Financial Regulation):

- The system is in crisis, either based on an assessment by regulators or based on objective indicators such as aggregate bank losses.
- The bank’s capital ratio falls below a certain value.

There are a number of other permutations of contingent capital instruments, including some that have been used by insurance companies in the past. These approaches all attempt to address the fact that in difficult times, banks (which rely on investor confidence) find it difficult to raise capital. Contingent capital would act as equity and provide a cushion to convince depositors and other creditors that their money is safe.

This section considers:
- Why regulators are focusing on contingent capital instruments.
- Whether contingent capital instruments have the potential to replace hybrid securities like trust preferred securities.
- Some of the contingent capital products that have been issued to date.
- The tax treatment of contingent capital products.

Focus of regulators

Regulators are keenly focused on the need to bolster regulatory capital levels at financial institutions. In addition, regulators would like to avoid (to the extent possible) having taxpayers bear the brunt of a financial institution bailout. As a result, regulators are focused on setting higher regulatory capital requirements, as well as other tools, such as “bail in” features for certain debt securities, “buffers” or extra capital cushions and contingent capital instruments.

Potential of contingent capital instruments

The role of contingent capital instruments remains to be seen. In November 2011, the BCSB issued its final principles as to the methodology for determining which banks are to be considered as Global Systemically Important Banks (GSIBs), as well as setting additional minimum capital requirements applicable to such banks, on top of the minimum capital requirements already intended to apply to all internationally active banks under Basel III.

Many global institutions had hoped that the Basel Committee would recommend that such additional capital requirements for GSIBs could be met, at least partially, with contingent capital instruments, but their final recommendations proposed that only “core” Tier 1 capital instruments would be used for this purpose.

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<th>Issuer tax treatment</th>
<th>Lloyds enhanced capital notes</th>
<th>Rabobank senior contingent notes</th>
<th>Rabobank 8.40% perpetual non-cumulative capital securities</th>
<th>Credit Suisse Tier 2 buffer capital notes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Treated as convertible debt for UK tax purposes.</td>
<td>Treated as debt for Netherlands tax purposes; interest on senior contingent notes is tax deductible.</td>
<td>Treated as debt for Netherlands tax purposes; interest on capital securities is tax deductible.</td>
<td>Unclear.</td>
</tr>
</tbody>
</table>
The CRD4 legislative package, when introduced in July 2011, did not address the GSIB recommendations, so it is not yet certain whether there may be a role for contingent capital when Europe finalises its Basel III implementation legislation. However, in December 2011, the EBA published a Recommendation that European banks should maintain a minimum ratio of “core Tier 1” capital to risk weighted asset ratios of 9% by the end of June 2012. As part of this Recommendation, the EBA stated that newly-issued contingent convertible instruments are eligible to be considered as core Tier 1 capital if their terms are consistent with a common term sheet published as part of the Recommendation.

The EBA's stated intention is that such contingent capital instruments should constitute Additional Tier 1 capital instruments under the CRD4 legislative package, when finalised, and that the terms of the term sheet are consistent with the current draft of the CRD4 regulation. However, it is silent on certain features prohibited by CRD4 for Additional Tier 1 capital, such as credit-sensitive dividends, dividend pushers/stoppers, and alternative coupon satisfaction mechanisms. In addition to going-concern loss absorption, it goes further than the current draft CRD4 legislation in requiring loss absorption at the point of non-viability, in line with the Basel Committee's January 2011 recommendations.

The first half of 2012 will therefore be an important period in determining the role of contingent capital products for European banks.

Some contingent capital products

Several European banks have issued contingent capital products. In November 2009, HM Treasury announced 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 (under EU state aid rules the Commission has granted approval to national support schemes on condition of the banks not paying dividends or coupons on Core Tier 1 capital instruments).

Lloyds completed an exchange offer in which it issued GBP7.5 billion of enhanced capital notes (as at 1 February 2012, US$1 was about GB£0.6), which are fixed rate debt securities with a ten-year term that convert into a fixed number of common shares if Lloyds’s core Tier 1 ratio falls below a trigger.

In March 2010, Rabobank issued EUR1.25 billion of its 6.875% senior contingent notes, which are senior unsecured notes with a ten-year term, the principal of which is subject to a write down on the occurrence of a regulatory capital trigger event. Rabobank subsequently issued additional contingent capital instruments in two separate offerings in 2011.

In February 2011, Credit Suisse issued buffer capital notes, which are subordinated notes that convert into ordinary shares if Credit Suisse’s reported Basel III common equity Tier 1 ratio falls below 7% or if the principal regulator determines that conversion is necessary to prevent a capital injection or restructuring.

See pdf, Contingent capital securities: some examples, for information on the features of certain contingent capital products that have been issued to date.

Tax treatment

The tax treatment of contingent capital products differ by jurisdiction as there is no uniformity across national tax laws in characterising such products for tax purposes. Considered below are the tax issues to be addressed in the US. For information on the tax treatment of the contingent capital products mentioned above, see box, Tax treatment of some contingent capital products.

Tax issues in the US

The principal tax consideration in connection with hybrid securities is whether payments made (or accrued) by the issuer are deductible for tax purposes (see above, Main tax considerations). Such a deduction is necessary for any hybrid security (including contingent capital) to provide a lower after-tax cost of capital for the issuer.

Whether payments are in fact deductible for US federal income tax purposes depends on the characterisation of the instrument for those purposes. Payments with respect to instruments characterised as indebtedness are generally deductible for US federal income tax purposes while payments with respect to instruments characterised as equity are generally not.

Although many factors are included in the determination of an instrument’s characterisation for US federal income tax purposes, it must under current law generally represent an unconditional obligation to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future. As a result, there may be a need for Congressional or US Treasury Department action before a US issuer has reasonable certainty that distributions on a contingent capital instrument are deductible for US federal income tax purposes.

Where the conversion generates cancellation of debt income, under general US federal income tax principles such cancellation of indebtedness income is included in taxable income unless such income is specifically excluded (for example, if the taxpayer is insolvent or in a bankruptcy proceeding). To the extent indebtedness of a taxpayer is satisfied through an exchange for or conversion into equity, any cancellation of indebtedness income is calculated as the difference between the debt’s adjusted issue price and the fair market value of the equity exchanged or converted into.

Therefore, to the extent any contingent capital product were treated as a debt instrument for US federal income tax purposes, the issuer would realise cancellation of indebtedness income to the extent of the difference between:

- The instrument’s adjusted issue price.
- The fair market value of its equity exchanged or converted into.

(An issuer would also recognise cancellation of indebtedness income if the contingent capital instrument is permanently written down.)

To the extent any contingent capital product were not treated as a debt instrument but rather as an equity interest for US federal income tax purposes, the issuer would not realise cancellation of indebtedness income on the exchange or conversion into (a different class of) equity.
## CONTRIBUTOR DETAILS

<table>
<thead>
<tr>
<th>Name</th>
<th>Qualification</th>
<th>Areas of Practice</th>
<th>Recent Transactions</th>
</tr>
</thead>
<tbody>
<tr>
<td>PETER J GREEN</td>
<td>England and Wales, 1991; New York, 1991</td>
<td>Capital markets; securities; banking and finance.</td>
<td>Mr Green works closely with investment banks and issuers on developing new financial products and new securities offering methodologies. He has worked on a range of complex financial instruments, including hybrid securities and other subordinated debt instruments. He has spoken at a number of conferences and written a number of articles relating to capital instruments under the new Basel III rules and contingent capital securities.</td>
</tr>
<tr>
<td>JEREMY C JENNINGS-MARES</td>
<td>England and Wales, 1993</td>
<td>Capital markets; securities; banking and finance.</td>
<td>Mr Jennings-Mares works closely with investment banks and issuers on developing new financial products and new securities offering methodologies.</td>
</tr>
<tr>
<td>THOMAS A HUMPHREYS</td>
<td>California, 1977; New York, 1980</td>
<td>Federal tax; capital markets.</td>
<td>Mr Humphreys works with investment banks and issuers on developing new financial products. He has advised investment banks and banks on most of the major capital markets developments in the last decade including trust preferreds, Tier One capital instruments, mandatorily remarketed debt instruments, mandatorily exchangeable debt instruments and contingent convertible bonds. He currently works with several banks and investment banks on developing new capital markets products involving equity, debt and preferred stock.</td>
</tr>
<tr>
<td>ANNA T PINEDO</td>
<td>New York, 1993</td>
<td>Capital markets; securities; M&amp;A; corporate.</td>
<td>Ms Pinedo works closely with financial institutions to create and structure innovative financing techniques, including new securities distribution methodologies and financial products.</td>
</tr>
</tbody>
</table>
## Contingent Capital Securities: Some Examples

<table>
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<tr>
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<th>Credit Suisse Tier 2 buffer capital notes</th>
<th>Synovus tMEDSSSM</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Structure</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Tangible equity units, or T-DECSSM units, each composed of a prepaid stock purchase contract and a junior subordinated amortising note issued in 2011 and a scheduled final instalment paid in 2013.</td>
</tr>
<tr>
<td><strong>Securities offered</strong></td>
<td></td>
<td></td>
<td>Enhanced capital notes. (in exchange for existing securities, including capital securities, notes and preference shares).</td>
<td>Perpetual non-cumulative capital securities.</td>
<td>Perpetual non-cumulative capital securities.</td>
<td>Convertible enhanced capital securities.</td>
<td>Tier 2 buffer capital notes issued by Credit Suisse Group AG, Tier 1 Limited and irrevocably guaranteed on a subordinated basis by Credit Suisse Group AG.</td>
</tr>
<tr>
<td><strong>Offering format</strong></td>
<td>Registered.</td>
<td>Bearer or registered.</td>
<td>Bearer or registered.</td>
<td>Bearer or registered.</td>
<td>Registered.</td>
<td>Bearer or registered.</td>
<td>Registered.</td>
</tr>
<tr>
<td><strong>All-in coupon</strong></td>
<td>Rate on amortising notes.</td>
<td>Fixed premium between 1.5% to 2.5% above the interest rate or dividend rate of the existing securities.</td>
<td>Fixed rate of 6.875%.</td>
<td>Initial rate of 8.375% up to (but excluding) the first reset date (26 July 2016); after this, reset every five years based on the US Treasury benchmark rate plus 6.425%.</td>
<td>Initial rate of 8.40% up to (but excluding) the first reset date (29 June 2017); after this reset every five years based on the US Treasury benchmark rate plus 7.49%.</td>
<td>Initial rate of 8.50% for the first 10 years of the capital notes (April 2008); after this reset every five years based on the US Treasury benchmark rate plus 6.425%.</td>
<td>Rate on junior subordinated amortising notes.</td>
</tr>
<tr>
<td>Future coupon adjustment exposure</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
</tr>
<tr>
<td><strong>Term</strong></td>
<td>3 years for purchase contract. 5 years for amortising note.</td>
<td>10, 12 or 15 years (depending on optional redemption terms of existing securities).</td>
<td>10 years.</td>
<td>Perpetual.</td>
<td>Perpetual.</td>
<td>Perpetual.</td>
<td>30 years.</td>
</tr>
</tbody>
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<th>Credit Suisse Tier 2 buffer capital notes</th>
<th>Synovus tMEDSSM</th>
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</table>
| **Call/redemption** | Purchase contracts may be settled early at the option of the holder prior to the mandatory settlement date at the minimum settlement rate, subject to adjustment, or at the fundamental change early settlement rate in connection with a “fundamental change” (a person or group becoming a beneficial owner of more than 50% of the company’s common stock or a consolidation or merger or sale of all or substantially all of the company’s assets). Purchase contracts also may be settled early at the company’s option at the maximum settlement rate, unless the closing price of the common stock exceeds 130% of a threshold appreciation price for a certain period of time, in which case the minimum settlement rate is used. Amortising notes are redeemable at the option of the holder if the company elects to settle purchase contracts early. | Early redemption only at the issuer’s option and only on a change in tax or regulatory treatment. | Automatic and permanent write-down of original principal amount to 25% of par and automatic redemption of write-down amount plus accrued and unpaid interest one business day after the second of two observation dates about 23 business days apart on which the equity capital ratio (equity capital divided by risk weighted assets) falls below 7%; however, the occurrence of an event of default will temporarily delay the write-down. Issuer also has early redemption right (at par plus accrued and unpaid interest) following a withholding tax gross up event or loss of tax deductibility, in each case under Dutch tax law. No holder put. | Loss absorption is triggered if:  
- Equity capital ratio (equity capital divided by risk weighted assets) falls or remains below 8%.  
- 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. Issuer may redeem the capital securities, in whole but not in part, on or after 29 June 2017, but must redeem the capital securities on the first interest payment date on or after 29 December 2041 if certain conditions are met. | Early redemption only at the issuer’s option, in whole but not in part, on or after 26 July 2016, subject to the prior approval of the Central Bank of Cyprus and provided that the convertible enhanced capital securities will be replaced by Tier 1 capital of equal or better quality. Early redemption only at the issuer’s option either:  
- On the first optional redemption date or on any interest payment date after this, in whole or in part.  
- On a change in tax or regulatory treatment or change in control, in whole, but not in part. | Early redemption only at the issuer’s option five years from the purchase or exchange (that is, no earlier than 2018) and in certain other circumstances with the approval of the Swiss Financial Market Supervisory Authority (FINMA). | Early redemption only at the issuer’s option either:  
- On the first optional redemption date or on any interest payment date after this, in whole or in part.  
- On a change in tax or regulatory treatment or change in control, in whole, but not in part. |
## CONTINGENT CAPITAL SECURITIES: SOME EXAMPLES

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</tr>
</thead>
<tbody>
<tr>
<td><strong>Status/subordination</strong></td>
<td>Amortising notes are subordinate and junior to all senior indebtedness and pari passu with all junior subordinated indebtedness.</td>
<td>Direct, unsecured and subordinated obligations and rank at least pari passu with all other subordinated obligations, junior to all unsubordinated obligations and senior to all unsecured perpetual obligations and all share capital.</td>
<td>Unsecured and senior to all subordinated capital of the issuer, but rank junior to all unsubordinated obligations.</td>
<td>With respect to payment obligations, the capital securities and coupons constitute direct, unsecured and subordinated obligations and rank pari passu and without any preference among themselves.</td>
<td>Payment obligations are the same as those for Rabobank 8.375% perpetual non-cumulative capital securities.</td>
<td>Direct, unsecured and subordinated obligations of the issuer and rank pari passu without any preference among themselves.</td>
<td>The amortising notes are junior subordinated obligations. They rank junior both in liquidation and right of payment to all senior indebtedness, and rank equally with all unsecured and junior subordinated indebtedness that is designated as junior to the amortising notes.</td>
</tr>
<tr>
<td><strong>Optional deferral of payments</strong></td>
<td>Yes, but no later than maturity date. Settlement of purchase contracts not deferrable.</td>
<td>No.</td>
<td>No.</td>
<td>Interest payments are at the issuer’s discretion (not cumulative).</td>
<td>Interest payments are at the issuer’s discretion (not cumulative).</td>
<td>Interest payments are at the issuer’s discretion (not cumulative).</td>
<td>No.</td>
</tr>
<tr>
<td><strong>Retirement of trust preferred</strong></td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
</tr>
<tr>
<td><strong>Dividend payment</strong></td>
<td>Yes, if converted into ordinary shares and dividend declared.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>No.</td>
<td>No.</td>
<td>N/A.</td>
</tr>
<tr>
<td><strong>Mandatory dividend deferral</strong></td>
<td>N/A.</td>
<td>No.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>No.</td>
<td>N/A.</td>
</tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Conversion rights</td>
<td>Automatically converted into ordinary shares if core Tier 1 ratio falls below 5%</td>
<td>Not convertible</td>
<td>Not convertible. However, on the occurrence of a capital event or Basel III capital event that is, the Dutch Central Bank notifies the issuer in writing that the capital securities may no longer be treated as Tier 1 capital due to non-compliance with Dutch solvency rules as amended to implement Basel III, the issuer may substitute or vary the terms of the capital securities so that they remain regulatory compliant securities.</td>
<td>Not convertible, however, upon the occurrence of a capital event or Basel III capital event, the issuer may substitute or vary the terms of the capital securities so that they remain regulatory compliant securities.</td>
<td>Automatically converted into ordinary shares on a &quot;contingency event&quot; or a &quot;viability event&quot;. A contingency event occurs if the issuer gives notice that either:</td>
<td>Automatically converted into ordinary shares if either:</td>
<td>Automatically converted into ordinary shares if either:</td>
<td>None of the component securities are convertible.</td>
</tr>
<tr>
<td>Dividend stopper</td>
<td>N/A</td>
<td>No.</td>
<td>No.</td>
<td>No.</td>
<td>No.</td>
<td>No.</td>
<td>No.</td>
<td>N/A.</td>
</tr>
</tbody>
</table>
**Analysis**

### CONTINGENT CAPITAL SECURITIES: SOME EXAMPLES

| Citigroup T-DECSSM | Lloyds ECN | Rabobank SCN | Rabobank 8.375% perpetual non-cumulative capital securities | Rabobank 8.40% perpetual non-cumulative capital securities | Bank of Cyprus convertible enhanced capital securities | Credit Suisse Tier 1 buffer capital notes | Credit Suisse Tier 2 buffer capital notes | Synovus IMEDSSM |
|-------------------|------------|-------------|-------------------------------------------------------------|-------------------------------------------------------------|-------------------------------------------------------------|--------------------------------|--------------------------------|----------------|----------------|
| **Voting rights** | Yes, for underlying common stock. | Prior to conversion, only at meetings of enhanced capital note holders; on conversion, voting rights for ordinary shares. | No. | No. | No. | Voting rights for ordinary shares only on conversion. | Voting rights for ordinary shares only on conversion. | Voting rights for ordinary shares only on conversion. | Yes, for underlying common stock. |
| **Amount of stock issued** | Number of shares of common stock to be purchased under the terms of the purchase contract (at a settlement rate, subject to adjustment, dependent on the applicable market value of the common stock). | Amount of enhanced capital notes divided by the applicable conversion price. | N/A. | N/A. | N/A. | Amount of convertible enhanced capital securities divided by the applicable conversion price. | Amount of Tier 1 buffer capital notes divided by the applicable conversion price. | Amount of Tier 2 buffer capital notes divided by the applicable conversion price. | Number of shares of common stock to be purchased under the terms of the prepaid stock purchase contract (at a settlement rate, subject to adjustment, dependent on the applicable market value of the common stock). |
| **Early exercise by holder** | Holder may elect to settle purchase contract early, in whole or in part. | N/A. | N/A. | N/A. | N/A. | N/A. | N/A. | N/A. | Holder may elect to settle the prepaid stock purchase contract early, in whole or in part. |
| **Optional acceleration of put/forward** | No. | N/A. | N/A. | N/A. | N/A. | N/A. | N/A. | N/A. | N/A. |
| **Automatic acceleration of put/forward** | N/A. | N/A. | N/A. | N/A. | N/A. | N/A. | N/A. | N/A. | N/A. |
| **Fed capital treatment in US** | Tier 1, up to 25%. | Tier 2 hybrid debt for enhanced capital notes; core Tier 1 capital for ordinary shares. | Tier 2 hybrid debt for senior or contingent notes. | Tier 1, up to 25%. | Tier 1, up to 25%. | Tier 1, up to 25%. | Tier 1, up to 25%. | Tier 1, up to 25%. |
| **EU capital treatment** | See below**. | Lower Tier 2 regulatory capital; core Tier 1 capital if converted into ordinary shares. | Not used by the issuer as regulatory capital. | See below**. | See below**. | See below**. | See below**. | See below**. |

---

*The capital treatment in the US under Basel II is the same as the Fed capital treatment.*

**Note that there is still ongoing dialogue regarding regulatory capital treatment. The below is based on Capital Requirements Directive (Directives 2006/49/EC and 2006/49/EC (as amended by Directive 2009/111/EC (CRD2))) and the 10 December 2009 Implementation Guidelines for Hybrid Capital Instruments of the Committee of European Banking Supervisors. Based on the guidelines, limits would be imposed on hybrid Tier 1 instruments as follows:*

- A combined 15% limit on undated instruments with “moderate” incentive to redeem and dated instruments.
- A 35% limit on instruments which do not convert into core Tier 1 capital.
- A 50% limit on hybrid Tier 1 instruments generally.
- A possibility to exceed the limits in emergency/exigent circumstances.

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These directives and guidelines will be replaced by what is known as the CRD4 Regulation and the CRD4 Directive, when these are passed by the European Parliament. The CRD4 package will implement the final Basel III principles, published in December 2010 by the Basel Committee of Banking Supervisors, into EU law. Although the CRD4 package could be subject to further change before it is approved by the European Parliament, the current version of the legislation will make many substantive changes to the hybrid capital provisions and the above percentage limits will cease to apply when CRD4 becomes effective. CRD4 does, however, provide for grandfathering, for a period of time, of hybrid instruments issued before 20 July 2011, which were previously eligible for a certain treatment, but have ceased to become eligible as a result of the CRD4 changes.
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</tr>
</thead>
</table>
| **Replacement capital covenant/negative pledge** | No.       | No.         | No. However, there is a negative pledge that so long as any senior contingent notes remain outstanding, the issuer undertakes not to secure any of its other indebtedness, whether present or future, which is both:  
- Represented by bonds, notes or other securities which have an initial maturity exceeding 2 years and which are for the time being, or are intended to be, quoted, listed, ordinarily dealt in or traded on any stock exchange or over-the-counter or other similar securities market.  
- Not domestic indebtedness (indebtedness of the issuer which is denominated or payable (at the option of any party) in Euro unless 50% or more of this in aggregate principal amount is initially offered or sold outside The Netherlands). | No. | No. | No. | No. | No. | No. |
| **Tax treatment (issuer)** | T-DECS treated as units consisting of two separate financial instruments: an amortising note (treated as a debt instrument bearing original issued discount (OID) for US tax purposes) and a purchase contract (treated as a prepaid forward contract on common stock for US tax purposes). OID on an amortising note is tax-deductible. No gain or loss on settlement of a purchase contract. No deduction for dividends on underlying common stock. | UK: treated as convertible debt for UK tax purposes. US: under current law, enhanced capital notes would be treated as convertible equity and payment on enhanced capital notes likely would be treated as dividends for US tax purposes. | The Netherlands: treated as debt for Dutch tax purposes; interest on senior contingent notes is tax deductible. US: unclear if and/or what portion is treated as debt or equity or another instrument for US tax purposes. | The Netherlands: treated as debt for Dutch tax purposes; interest on capital securities is tax deductible. US: under current law, the capital securities likely would be treated as equity and payment on the capital securities likely would be treated as dividends for US tax purposes. | Cyprus to be determined. US: under current law, convertible enhanced capital securities would be treated as convertible equity and payment on convertible enhanced capital securities likely would be treated as dividends for US tax purposes. | Switzerland: to be determined. US: under current law, Tier 1 buffer capital notes would be treated as convertible equity and payment on Tier 1 buffer capital notes likely would be treated as dividends for US tax purposes. | Switzerland: to be determined. US: unclear if and/or what portion is treated as debt or equity or another instrument for US tax purposes. | IMEDS treated as units consisting of two separate financial instruments: a junior subordinated amortising note (treated as a debt instrument bearing OID for US tax purposes) and a prepaid stock purchase contract (treated as a prepaid forward contract on common stock for US tax purposes). OID on a junior subordinated amortising note is tax-deductible. No gain or loss on settlement of a prepaid stock purchase contract. No deduction for dividends on underlying common stock. |
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<tr>
<td><strong>Tax treatment (holders)</strong></td>
<td>Generally no withholding tax on payments made in respect of an amortising note. No gain or loss on settlement of a purchase contract. 30% withholding tax on dividends on underlying common stock; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption.</td>
<td>The Netherlands: generally no withholding tax on interest. US: if US issuer: 30% withholding tax on payments on the capital securities; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption. Payments to US corporations generally eligible for the DRD; payments to US individuals generally eligible as QDI. If foreign issuer: No US withholding tax on payments. Payments to US corporations not eligible for the DRD; payments to US individuals generally eligible as QDI if issuer is a qualified issuer.</td>
<td>Same as for Rabobank 8.375% perpetual non-cumulative capital securities.</td>
<td>Cyprus: generally no withholding tax on interest. US: if US issuer: 30% withholding tax on payments on convertible enhanced capital securities; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption. Payments to US corporations generally eligible for the DRD; payments to US individuals generally eligible as QDI. If foreign issuer: No US withholding tax on payments. Payments to US corporations not eligible for the DRD; payments to US individuals generally eligible as QDI if issuer is a qualified issuer.</td>
<td>Switzerland: generally no withholding tax on interest. US: if US issuer: 30% withholding tax on payments on convertible enhanced capital securities; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption. Payments to US corporations generally eligible for the DRD; payments to US individuals generally eligible as QDI. If foreign issuer: No US withholding tax on payments. Payments to US corporations not eligible for the DRD; payments to US individuals generally eligible as QDI if issuer is a qualified issuer.</td>
<td>Switzerland: generally no withholding tax on interest. US: unclear if and/or what portion is treated as debt or equity or another instrument for US tax purposes. Generally no withholding tax on payments made in respect of a junior subordinated amortising note. No gain or loss on settlement of a prepaid stock purchase contract. 30% withholding tax on dividends on underlying common stock; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption.</td>
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<td><strong>Moody’s treatment</strong></td>
<td>Basket C or Basket D. Ba2 if guaranteed by Lloyds TSB Bank; Ba3 if guaranteed by Lloyds Banking Group. N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>Basket C or Basket D.</td>
</tr>
<tr>
<td><strong>S&amp;P treatment</strong></td>
<td>100% up to 33% of adjusted common equity (ACE).</td>
<td>BB if guaranteed by Lloyds TSB Bank; BB if guaranteed by Lloyds Banking Group. N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>100% up to 33% of ACE.</td>
</tr>
<tr>
<td><strong>Balance sheet</strong></td>
<td>Equity as to purchase contract; debt as to amortising notes. Debt as to enhanced capital notes; equity as to ordinary shares.</td>
<td>Debt.</td>
<td>Debt.</td>
<td>Debt as to convertible enhanced capital securities; equity as to ordinary shares.</td>
<td>Debt as to Tier 1 buffer capital notes; equity as to ordinary shares.</td>
<td>Debt as to Tier 2 buffer capital notes; equity as to ordinary shares.</td>
<td>Equity as to prepaid stock purchase contract; debt as to junior subordinated amortising notes.</td>
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<td>Contingent Capital Securities: Some Examples</td>
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<td>Citigroup T-DECSSM</td>
<td>Lloyds ECN</td>
<td>Rabobank SCN</td>
<td>Rabobank 8.375% perpetual non-cumulative capital securities</td>
<td>Rabobank 8.40% perpetual non-cumulative capital securities</td>
<td>Bank of Cyprus convertible enhanced capital securities</td>
<td>Credit Suisse Tier 1 buffer capital notes</td>
<td>Credit Suisse Tier 2 buffer capital notes</td>
<td>Synovus tMEDSSM</td>
</tr>
<tr>
<td>Anti-dilution adjustments</td>
<td>Yes. Adjustments for increases in cash dividends; dividends or distributions in common stock or other property; issuance of stock purchase rights; certain self tenders; or subdivisions, splits or combinations.</td>
<td>Yes. Adjustments to conversion price for a consolidation, reclassification or subdivision of the ordinary shares, capitalisation of profits, capital distributions or cash dividends, rights issues or other adjustment which affects the ordinary shares.</td>
<td>None.</td>
<td>None.</td>
<td>None.</td>
<td>Yes. Adjustments to conversion price for a consolidation, reclassification or subdivision of the ordinary shares, capitalisation of profits, capital distributions or cash dividends, rights issues or other adjustment which affects the ordinary shares.</td>
<td>Yes. Adjustments to conversion price for a consolidation, reclassification or subdivision of the ordinary shares, capitalisation of profits, capital distributions or cash dividends, rights issues or grant of other subscription rights or other adjustment which affects the ordinary shares.</td>
<td>Yes. Adjustments for increases in cash dividends; dividends or distributions in common stock or other property; issuance of stock purchase rights; certain self tenders; or subdivisions, splits or combinations.</td>
</tr>
<tr>
<td>Potential stock price impact on announcement</td>
<td>Negative.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>Negative.</td>
</tr>
</tbody>
</table>
## Contingent Capital Securities: Some Examples

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<td><strong>Advantages</strong> (summary)</td>
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<td>- Appeals to hybrid/Tier 1 investors.</td>
<td>- Little to no stock price impact.</td>
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<td>- Investors retain downside exposure.</td>
<td>- Payments partially tax deductible.</td>
<td>- Favoured by hybrid/Tier 1 investors.</td>
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<td><strong>Disadvantages</strong> (summary)</td>
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<td>- Dilutive.</td>
<td>- Negative stock price impact.</td>
<td>- Less permanent than Tier 1 investors.</td>
<td>- Unclear whether such an instrument issued after 12 September 2010 would qualify for Tier 2 treatment after Basel III comes into effect; if not, then such instruments issued on or before 12 September 2010 will be progressively &quot;de-recognised&quot; between 2013 and 2022.</td>
<td>- Less permanent than stock alternatives.</td>
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<td>- Possible dilution if core Tier 1 ratio falls below 5%.</td>
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<td>- Dilutive.</td>
</tr>
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<td>- Limited Tier 1 capacity with Fed.</td>
<td>- Negative perception in the market.</td>
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