

FREQUENTLY ASKED QUESTIONS ABOUT CONTINGENT CAPITAL

How would you define contingent capital?

Contingent capital securities are hybrid securities issued by financial institutions that are intended to provide leverage in good economic times and provide a buffer (i.e., loss absorption) under stress scenarios when it would be difficult for financial institutions to raise new capital. One type of contingent capital instrument consists of a debt instrument that automatically converts to equity or the principal of which is written down when certain conditions are met, such as, for example: (1) if the financial system is in crisis (either based on an assessment by regulators or based on objective indicators such as aggregate losses) or (2) if the issuer's capital ratio falls below a certain level.

There also are other types of contingent capital instruments, including some that have been used by insurance and reinsurance companies as an alternative to traditional protection against catastrophic events (in which case, the company would suffer a loss of income but its balance sheet would be protected and the company would be in a good position to benefit from the premium rate increase pressure to follow such an event) and by financial guarantee companies (in conjunction with rating agency approval) as a source of "soft capital" to help reduce operating leverage ratios.

These various types of contingent capital instruments all attempt to address the fact that in difficult times

issuers, including financial institutions (which rely on investor confidence), find it difficult to raise capital. In such circumstances, contingent capital acts as equity and provides a cushion.

What is the difference between contingent capital and "bail-in" capital?

"Bail-in" capital refers to debt instruments or other creditor claims that are written down or converted into equity, in whole or in part, by a country's resolution authority at the point a failing financial institution enters resolution (i.e., bankruptcy). In such circumstances, the power exercised by the authorities is generally referred to as "statutory bail-in" or "bail-in within resolution." In contrast, in the case of contingent capital, the conversion to equity or the write-down of principal occurs before the failing financial institution enters resolution.

Which types of securities have been included in the "hybrid" bucket?

Hybrid securities are securities that have some characteristics of equity and debt and are considered an attractive, cost-efficient means of raising non-dilutive capital for financial institutions (including banks and insurance companies), as well as for corporate issuers (typically utilities). The types of securities in the "hybrid" bucket include certain classes of preferred

securities, mandatorily convertible debt securities and debt securities with principal write-down features. The most common of these hybrid securities had been preferred securities with additional features designed to achieve enhanced economics or other efficiencies, such as trust preferred securities, real estate investment (“REIT”) preferred securities and perpetual preferred securities. These preferred securities were also popular because they qualified for Tier 1 regulatory capital treatment and, in the case of trust preferred securities and REIT preferred securities, payments on such securities were tax-deductible.

Why has there been such a focus on the part of regulators on contingent capital instruments?

Regulators have been focused on contingent capital instruments because of the need to bolster regulatory capital levels at financial institutions in the wake of the financial crisis. 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 have been focused on setting higher regulatory capital requirements, as well as establishing other tools, such as “bail-in” features for certain debt securities, “buffers” or extra capital cushions, and contingent capital instruments with loss absorption features.

When or how did this discussion of contingent capital instruments begin?

The discussion of contingent capital instruments began in the aftermath of the financial crisis, when certain regulators and rating agencies concluded that certain hybrid capital securities did not provide the type of loss absorption during the financial crisis that they had anticipated. Early on in the financial crisis,

commentators noted that many hybrid securities absorbed “significant losses.” Academics from the Squam Lake Group, which was first organized in November 2008 in order to provide recommendations on how to fix the financial system, recommended in its June 2010 report that regulators aggressively encourage key financial institutions to invest in regulatory hybrid securities in the event that both the financial institutions and the economic system reach a certain defined level of financial stress.

Investors were accustomed to treating hybrid securities like debt instruments and had often assumed that hybrid issuers would exercise early redemption options on hybrid securities as they arose. Hybrid issuers, however, surprised investors when they opted (or were encouraged by regulators) not to exercise their option to redeem outstanding hybrid securities because alternative (or replacement) capital would have been more expensive or possibly unavailable. As the financial 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 and in certain instances also suffered from principal write-downs of the hybrid securities. Commentators noted that many governments conditioned their aid to ailing banks on an agreement that the bank issuers would not pay coupons on hybrid securities. Many issuers also were forced (or chose) to undertake exchange offers or other liability management exercises in relation to their outstanding hybrid securities as part of recapitalization transactions. In addition, commentators raised concerns, particularly in relation to a number of hybrid instruments qualifying as Tier 2 capital, that principal write-down features were never

triggered as they were designed to take effect only in an insolvency scenario, while most bail-ins and injections of public funds actually occurred in advance of an insolvency in view of the perceived systemic consequences of a failure (i.e., the “too big to fail” concern).

How have recent regulatory developments addressed this?

Recent regulatory developments in both the U.S. and Europe have addressed concerns with the loss absorption of hybrid securities and increasing regulatory capital levels and the quality of such regulatory capital for financial institutions.

International Reforms (Basel III)

The Basel III framework, among other things, emphasizes the quality, consistency and transparency of the capital base and provides for enhanced risk coverage through the implementation of enhanced capital requirements for counterparty credit risk. To rectify perceived deficiencies relating to regulatory capital, the Basel III framework also emphasizes that (1) Tier 1 capital must help a bank remain a going concern, (2) regulatory adjustments must be applied to the common equity component of capital, (3) regulatory capital must be simple and harmonized for consistent application across jurisdictions, and (4) regulatory capital components must be clearly disclosed by financial institutions to promote market discipline. Tier 1 capital also must consist predominantly of “common equity,” which includes common shares and retained earnings. Thus, the new definition of Tier 1 capital is closer to the definition of “tangible common equity.”

The new minimum capital requirements will be phased in between January 1, 2013 and January 1, 2015, and regulatory adjustments will be phased in between January 1, 2014 and January 1, 2018. The recognition of existing capital instruments that do not comply with the new rules will be phased out from January 1, 2013, with their recognition capped at 90% from such date and the cap reduced by 10% in each subsequent year.

Instruments, such as hybrid securities, 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 and being callable only by the issuer after a minimum of five years with prior supervisory approval. Such instruments also must have no credit-sensitive dividend feature and in liquidation must be subordinated to depositors and unsubordinated creditors.

U.S. Reforms

In many respects consistent with the proposed Basel III framework, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) has the effect of raising the required level of Tier 1 capital for banks, as well as the proportion of Tier 1 capital that must be held in the form of tangible common equity. The Collins amendment provisions (Section 171) of the Dodd-Frank Act, which are 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 capital 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 Collins amendment provisions limit regulatory discretion in adopting Basel III requirements in the U.S. and permit 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 hybrid securities, including trust preferred securities, will no longer be included in the numerator of Tier 1 capital. The legislation applies retroactively to trust preferred securities issued after May 19, 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.

Led by the U.S. Federal Reserve Board on June 7, 2012, the three U.S. federal banking agencies proposed a broad and comprehensive revision of the regulatory capital rules applicable to all U.S. banks and bank holding companies (except those with less than \$500 million in total consolidated assets). The new rules are intended to replace existing Basel I-based capital requirements, implement the Basel III capital standards, and comply with certain requirements under the Dodd-Frank Act, including the Collins Amendment provisions and the requirement that all references to external credit ratings be removed from federal agencies’ regulations and replaced with new standards of creditworthiness (Section 939A). The effectiveness of the new rules will be phased in according to different start dates, ranging from January 1, 2013 to January 1, 2018, and different phase-in periods, ranging from two years to nine years.

The new rules consist of the following three notices of proposed rulemaking (“NPRs”) and one final rule.

- The Basel III Capital NPR, introduces the Basel III standards for the components of, adjustments to and deductions from regulatory capital (the numerator in risk-based capital and leverage ratios), as well as the new minimum ratios under the prompt corrective action framework. The Basel III Capital NPR, among other things:
 - subjects U.S. banks and bank holding companies to the following minimum regulatory capital requirements: a common equity Tier 1 capital ratio of 4.5% (newly introduced requirement), a Tier 1 capital ratio of 6% (increased from the current 4%), a total capital ratio of 8% of total risk-weighted assets (unchanged from the current requirement) and a Tier 1 leverage ratio of 4%; and
 - introduces regulatory capital buffers above the minimum common equity Tier 1 ratio, including a capital conservation buffer of a further 2.5% of common equity Tier 1 capital to risk-weighted assets and, for those U.S. banks and bank holding companies subject to the Advanced Approaches NPR, a countercyclical buffer of up to 2.5% of common equity Tier 1 capital to risk-weighted assets that may be deployed as an extension of the capital conservation buffer.
- The Standardized Approach NPR, generally introduces a modified version of the Basel II standardized approach for calculating risk-

weighted assets (the denominator in risk-based capital ratios) and would, together with the Basel III Capital NPR, become the new Collins Amendment “floor” for certain U.S. banks and bank holding companies.

- The Advanced Approaches NPR, modifies the existing Basel II advanced approaches rules for calculating risk-weighted assets to implement Basel III and to comply with Section 939A and also applies both the advanced approaches risk and the Market Risk Final Rule to U.S. savings associations and savings and loan holding companies that meet the applicable thresholds.
- The Market Risk Final Rule, modifies the existing market risk rules to implement rules for calculating capital charges for market risk (commonly known as “Basel 2.5”) and to comply with Section 939A. This rule applies to U.S. banks and bank holding companies that have significant trading activity and became effective on January 1, 2013.

In January 2012, the U.S. General Accounting Office completed a study on the use of hybrid capital instruments and made recommendations for legislative or regulatory actions regarding hybrids. In July 2012, the Financial Stability Oversight Council (the “FSOC”) completed a study of a contingent capital requirement for certain non-bank financial companies and bank holding companies. Additional regulatory guidance will be required in the U.S. regarding the types of hybrid securities (in addition to non-cumulative perpetual preferred securities) that will benefit from favorable regulatory capital treatment.

On November 9, 2012, the three U.S. federal bank regulatory agencies announced that their proposed new capital rules based on Basel III (and other Basel standards) would not take effect on January 1, 2013, which was the date originally targeted, and it is unclear at this point what new date will be targeted.

EU Reforms

In July 2011, the European Commission published a draft of its proposed legislation to implement the Basel III requirements. The proposals, when finalized and approved by the European legislature, will also recast the existing Capital Requirements Directive (2006/48/EC and 2006/49/EC) in the European Union (“EU”), and are referred to as the proposed CRD4 regulation. The European Commission intends 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 and a new regulation that will have direct effect in member states (and will limit the scope for national legislators to apply 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 or ordinary 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 recognized as Tier 1 or 2 capital under Basel III, the Basel III rules

specify a cut-off date of September 12, 2010. Any instrument issued before that date can be de-recognized gradually over a ten-year phase-out period and any instrument issued on or after that date would be fully 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 July 20, 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 proposed 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”) has been mandated to draft technical standards regarding procedures and timing for the determination and notification of trigger points. The EBA also must 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 issuer’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 recapitalization of the institution, and dividend pushers and alternative coupon satisfaction mechanisms are expressly prohibited. The proposed CRD4 regulation goes further and states that dividend stoppers will also

not be permitted in Tier 1 capital instruments. The proposed CRD4 regulation does not yet contain the EU’s proposed legislation for the proposal of the Basel Committee on Banking Supervision (the “Basel Committee”) for all Tier 1 and Tier 2 capital instruments to include triggers to ensure that such instruments absorb losses at the point of an entity’s non-viability. The proposed CRD4 regulation also remains subject to amendment and the approval of the European Parliament and European Council. It was expected that the proposed CRD4 regulation would take effect on January 1, 2013, in line with the Basel III proposals. However, the implementation of the Basel III proposals in the EU has been delayed and at this time a new implementation date has not been set.

In addition to the Basel III proposals, the UK and Switzerland have formally adopted rules and guidance pertaining to capital buffers and bail-in capital. See “Have other jurisdictions adopted any guidance on contingent capital instruments?” below.

Are there any outstanding issues with respect to the regulatory treatment of contingent capital?

The final Basel III framework set out the recommendations of the Basel Committee as to the quality of regulatory capital, and these recommendations are intended to be implemented in Europe via the proposed CRD4 legislation. This legislation is still going through the applicable legislative processes in Europe and finalization will take several months. The EBA has stated that it is not, by this capital exercise, attempting to pre-empt the effect of the proposed CRD4 legislation, 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 proposed CRD4 legislation when the legislation is finalized. However, the Basel Committee will not count such buffer convertible capital securities as core Tier 1 or common equity Tier 1 capital unless or until converted into common equity.

In the U.S., the debate on the use of contingent capital in bank restructuring is still in the beginning stages. Although the Dodd-Frank Act authorizes the use of contingent capital, its design features and the extent of its potential applications are unclear. The Federal Reserve Board, through Section 165(b)(1)(B) of the Dodd-Frank Act, can impose “a contingent capital requirement” on both “nonbank financial companies supervised by the Board of Governors” and certain “bank holding companies.” This authority is contingent on the recommendations of a report to the U.S. Congress by the FSOC, mandated by Section 115(c) of the Dodd-Frank Act, regarding the feasibility, costs and structure of contingent capital for financial institutions. The Council’s report was issued in July 2012 and recommended that contingent capital instruments remain an area for continued private sector innovation, and encouraged the U.S. Federal Reserve and other financial regulators to continue to study the advantages and disadvantages of including contingent capital and bail-in instruments in their regulatory capital frameworks.

Is contingent capital a requirement in the United States?

No, at this time contingent capital is not required to be held by financial institutions or bank holding companies in the United States.

Have other jurisdictions adopted any guidance regarding contingent capital instruments or bail-in capital?

At this time, only the UK and Switzerland have formally adopted rules or guidance on contingent capital instruments or bail-in capital.

In September 2011, the Independent Commission on Banking recommended in a report (the “Vickers Report”) that the UK’s special resolution regime toolkit be augmented with an explicit bail-in power and the UK government supported the recommendation. The Vickers Report also recommended that all of the larger UK ring-fenced banks and UK-based systemically important banks be required to hold 17-20% of loss-absorbing capacity, with 10% of equity capital against risk weighted assets and an additional 7-10% which includes bail-in capital. In September 2012, the Bank of England’s Financial Policy Committee indicated that UK banks should seek to retain earnings and raise outside capital with the options including debt conversion and the issuance of suitable contingent capital instruments.

In October 2011, the Swiss government published a proposal for the implementation of the Basel III framework. The new regulatory capital requirements entered into effect on January 1, 2013, with an implementation period extending to the end of 2018. The size of required total capital (without taking into account required equity capital and countercyclical buffers) has not been changed, and remains at 8% of risk-weighted assets. However, Swiss banks must now hold common equity Tier 1 capital of 4.5% of risk-weighted assets (previously 2%) and they may hold additional Tier 1 capital of up to 1.5% and Tier 2 capital of up to 2% of risk-weighted assets. In addition, Swiss banks must create a capital buffer in the form of

common equity Tier 1 capital of 2.5% of risk-weighted assets, resulting in total common equity Tier 1 capital of 7% of risk-weighted assets. Under certain credit market circumstances, a countercyclical buffer of up to 2.5% of additional common equity Tier 1 capital may temporarily apply to all categories of Swiss banks. In line with the Basel III framework, all Swiss banks organized as stock corporations may make use of contingent capital instruments, including bonds with a write-off feature, reserve capital and convertible capital, for purposes of establishing sufficient additional Tier 1 capital and Tier 2 capital.

How does the Basel Committee's August 2010 consultation document entitled "Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability" relate to contingent capital?

The consultation document establishes a requirement that the contractual terms of capital instruments will allow the capital instruments at the option of the regulatory authority to be written-off or converted to common shares in the event that a bank is unable to support itself in the private market in the absence of such conversions. 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 upon breach of a specified trigger the relevant instrument must be subject to a write-down of principal or conversion into equity. The trigger occurs when the relevant authorities either (1) decide that a write-off of principal or conversion into equity is necessary or (2) decide to make a public sector injection of capital (or equivalent support), whichever takes place the earliest. The Basel Committee has proposed that instruments that are issued on or after

January 1, 2013 must meet these minimum requirements as a pre-condition to receiving the relevant regulatory capital treatment. The Basel Committee also has published a set of FAQs on the Basel III definition of capital, most recently updated on October 20, 2011 (Basel III definition of capital – Frequently asked questions, www.bis.org/publ/bcbs204.htm).

In November 2011, the Basel Committee published final rules setting out a framework on the assessment methodology for global systemically important banks ("GSIBs"), the magnitude of additional loss absorbency that GSIBs should have and the arrangements by which the requirement will be phased in. The assessment methodology for GSIBs is based on an indicator-based approach and comprises five broad categories: size, interconnectedness, lack of readily available substitutes or financial institution infrastructure, global (cross-jurisdictional) activity and complexity. The additional loss absorbency requirements will range from 1% to 2.5% common equity Tier 1 depending on a bank's systemic importance with an empty bucket of 3.5% common equity Tier 1 as a means to discourage banks from becoming even more systemically important. The higher loss absorbency requirements will be introduced in parallel with the Basel III capital conservation and countercyclical buffers (i.e., between January 1, 2016 and year-end 2018 becoming fully effective on January 1, 2019).

In October 2012, the Basel Committee published a new set of regulatory guidelines for domestically systemically important banks ("DSIBs"), similar to the process for identifying and supervising GSIBs, including a requirement for additional loss absorbency although no specifics were provided and it is unclear at

this time which banks would be captured under the DSIB framework.

Contingent capital has been referred to as the latest incarnation of hybrids. Do you think this is true?

This is partly true. In the aftermath of the financial crisis, financial institutions have focused predominantly on issuances of common equity, non-cumulative preferred securities and fixed or floating rate debt. A few non-U.S. banks have issued contingent capital instruments, but it remains to be seen what exactly will be the future role for contingent capital products for European banks and whether they will become more popular than issuances of equity or debt.

For example, the proposed CRD4 regulation (which is discussed above) specifies trigger points for Tier 1 capital that may impact the cost of capital for contingent capital instruments. Structuring contingent capital instruments in order to create a viable market will inevitably involve tradeoffs among the competing interests of issuers, investors and regulators. Regulators and issuers also will need to determine their objectives for contingent capital. Some issuers may opt for going-concern securities that create incentives for banks to reduce risk and leverage in times of stress, while other issuers may choose to use gone-concern contingent capital as part of a broader resolution regime.

Will contingent capital instruments replace hybrid securities, such as trust preferred securities?

It remains to be seen whether contingent capital instruments will completely replace hybrid securities, such as trust preferred securities, and exactly what role contingent capital products may have in the bank capital market. In November 2011, the Basel Committee issued its final principles as to the methodology for

determining which banks are to be considered by regulators as 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.

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 the Basel III implementation legislation is finalized. 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.

What types of instruments would be considered contingent capital?

Various types of instruments may qualify as contingent capital, including senior or subordinated debt securities with fixed or floating rate coupons and mandatory conversion to equity or write-down features in the event that certain regulatory capital ratios fall below certain levels or in the event of certain regulatory actions are taken with respect to the issuer (“triggers”).

What types of conversion features are possible?

There are two possible types of conversion features: (1) a conversion of debt to equity upon breach of the relevant trigger or (2) a write-down of debt upon the breach of the relevant trigger. In a conversion of debt to equity, the equity may be common shares or non-cumulative perpetual preferred shares.

Can you explain what happens in the event that the trigger is breached?

What happens once the trigger is breached depends on how the contingent capital instrument is structured. If the contingent capital instrument is convertible into equity upon breach of the relevant trigger, then the conversion is based on a specified conversion ratio. If the conversion ratio is set at a rate highly dilutive to existing shareholders (e.g., well in excess of 50%), then control of the issuer would automatically shift to the contingent capital holders. If the conversion to equity is paired with an early trigger (i.e., the capital ratio or market metric is set a high level), then the contingent capital holders would gain control of the issuer with significant remaining enterprise value. Once in control of the issuer, contingent capital holders could replace existing management and reduce risk and leverage in order to return the issuer to sounder economic footing. The conversion to equity is far less attractive if the trigger operates late (i.e., the capital ratio or market metric is set at a low level) because this would leave contingent capital holders owning an issuer with little remaining enterprise value and potentially little upside in the resulting equity.

If the contingent capital instrument is subject to a write-down of principal upon breach of the relevant trigger, then the write-down is based on a specified

percentage (which could be as high as 100%). Most fixed income investors appear to prefer a write-down of principal to an equity conversion. The write-down of principal could either be permanent or it could include a write-back feature if the issuer regains its financial health. A permanent write-down carries the risk that contingent capital holders could take losses ahead of shareholders, or even ultimately lose more than shareholders, and not have any upside, which would effectively invert the priority of claims in the capital structure and may result in investors requiring higher coupons to compensate for this risk. A write-back is attractive to many fixed income investors because (1) it may result in investors regaining some or all of their principal, which would result in investors requiring lower up front coupons, and (2) some fixed income fund mandates prohibit investing in securities with an embedded permanent write-down feature. A contingent capital instrument could also offer a partial return of principal to investors at the time of the write-down, but regulators most likely will not view this positively as such a feature would reduce liquidity at a time when it is needed most.

What are the possible conversion triggers and are some preferable to others?

There are three principal options for the conversion trigger: (1) capital ratios, (2) market metrics or (3) regulatory discretion.

A trigger based on capital ratios would force a mandatory conversion if and when the issuer's Tier 1 (core) capital ratio fell below a threshold specified either by regulators (in advance) or in the contractual terms of the contingent capital instrument itself. Some regulators and commentators believe that a capital ratio

is the most effective trigger because it is transparent and objective. Investors would be able to assess and model the likelihood of conversion based on the issuer's public disclosures. A capital ratio trigger also removes the uncertainty regarding regulatory discretion and the vulnerability to market manipulation that the other options entail.

A trigger based on market metrics would force a mandatory conversion, for example, if and when, the issuer's share price or CDS spread passes a certain level over a set period of time.

Some regulators and commentators believe that a market metric is the most effective trigger because market discipline is generally considered less forgiving than regulatory discipline. However, this theory has resulted in mixed results when implemented in the past. The notion that bond markets, for example, can discipline bank risk-taking may be overly optimistic. The financial crisis provides ample evidence that neither ratings agencies nor bond market investors possess any special informational advantages over regulators when it comes to the assessment of credit quality, and while market participants may have stronger incentives to monitor bank credit quality, their ability to do so is still constrained by the poor quality of available accounting data for banks. More importantly, there is a risk that market sentiment, or even market manipulation, could force a recapitalization unnecessarily through a share price or CDS spread "death spiral." Finally, equity holders and management could have incentives to take certain actions (such as fire-selling assets) in order to prevent a conversion.

A trigger based on regulatory discretion would force a mandatory conversion if and when a regulator decides that a conversion is necessary. This type of trigger

would presumably operate at the "point of non-viability" or just before either bankruptcy or an injection of public-sector funds. Regulators favoring discretion appreciate the flexibility it gives them and believe that the insight they have into the overall operations of the issuers they regulate allows them to make a thoughtful decision based on several inputs, as well as considerations about the stability of the financial system as a whole. Some regulators also prefer to retain the flexibility to determine how much contingent capital is ultimately converted, a decision that will be driven by the facts of the case at hand and that may be difficult to assess beforehand. While flexibility can be helpful, particularly given that no two crises are alike, recent experience has shown that some regulators may be hesitant to publicly announce that a financial firm is unhealthy, especially during the early stages of distress, in the hope that the firm's problems will be short-lived, or that an alternative solution to the triggering of contingent capital can be found. Thus, a regulator may be unlikely to pull the trigger, affecting not only the firm and all of its stakeholders, but also likely raising alarm about the health of other financial firms, unless it is certain of a high degree of distress. By then, however, losses may have already risen to untenable levels, which is why this type of trigger is associated with gone-concern contingent capital.

Is setting the trigger point a delicate balancing act?

Yes, setting the trigger point is a delicate balancing act. In the case of a capital ratio or market metric trigger, if the contingent capital is to be going-concern capital, then the trigger must be set at a high enough capital level so that it is not triggered while the issuer remains fully viable, but not so high that it is likely to be triggered in only a mild downturn. At the other end of

the spectrum, the trigger also cannot be so low that it allows losses to mount for too long, leaving little or no value left in the issuer and effectively making the contingent capital the gone-concern kind. Capital ratio and market metric triggers also are vulnerable to financial reporting that fails to accurately reflect the underlying health of the firm. Lehman Brothers, for example, reported a Tier 1 capital ratio of 11% in the period before its demise, well above the regulatory minimum and a level most would have considered healthy. The same was true for Bear Stearns and Washington Mutual before they were acquired under distress. This issue most likely must be resolved in order for investors to embrace capital ratio or market metric triggers.

The effectiveness of a capital ratio or market metric trigger point also depends on greater or enhanced bank disclosure. Greater transparency would allow investors to properly assess the likelihood of whether and when a trigger could be breached and how much debt might be converted once triggered, thus allowing them to assess the risk associated with a contingent capital instrument and therefore whether they should buy it and what is the appropriate price to pay. In the case of a discretionary trigger, greater transparency would make regulators less concerned about the market response to their decisions to require conversion because markets would have already had access to the information that would allow them to assess whether a problem had begun to emerge. It would also help investors make their own assessments, reassuring them that regulatory forbearance is not at play when a bank's health is in question but a conversion has not yet been required. Nevertheless, many traditional fixed-income investors

could be precluded by their fund mandates from investing in an instrument with a discretionary trigger.

It is also worth noting that investors and regulators might be able to find some common ground on the trigger. Investors might not object to giving regulators the flexibility to halt a trigger for a set period of time in disorderly markets. This would permit regulators to use their discretion to act in the best interests of the financial system.

Depending on the specifics, the conversion feature may raise the question whether the contingent capital holder has an entitlement to repayment regardless of the issuer's financial circumstances. Does the contingent capital holder have creditor's rights?

No, the contingent capital holder does not have creditor's rights as the contingent capital holder would be (1) subordinated to the rights of the issuer's depositors and debt holders and (2) equal in right of payment to equity holders.

Contingent capital has gained popularity with banks, notably Lloyds, Rabobank and Credit Suisse and more recently UBS and Barclays. Can you give us a brief overview of those transactions?

Several European banks have issued contingent capital products thus far, although no U.S. banks have issued such products.

Lloyds' Enhanced Capital Notes

In November 2009, HM Treasury announced that RBS and Lloyds, both recipients of substantial capital injections from the UK government in the form of preference shares, would offer subordinated debt holders contingent or mandatorily convertible notes in

order to increase regulatory capital and reduce their exposure to the UK Government's Asset Protection Scheme (under EU state aid rules the European Commission had 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, which are fixed rate, subordinated debt securities with a ten-year term that convert into a fixed number of ordinary shares if Lloyd's core Tier 1 ratio falls below 5%. The interest rate on the enhanced capital notes is equal to the interest or dividend rate on the exchanged securities plus a fixed premium between 1.5% to 2.5%. The enhanced capital notes received lower Tier 2 capital treatment and will only receive core Tier 1 capital treatment if the notes are converted into ordinary shares. The enhanced capital notes were not offered in the U.S. or to U.S. persons as defined under Regulation S ("Regulation S") under the U.S. Securities Act of 1933 (the "Securities Act").

Rabobank's Senior Contingent Notes and Perpetual Non-Cumulative Capital Securities

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 if the equity capital ratio (equity capital divided by risk weighted assets of the Rabobank Group) falls below 7% (the occurrence of an event of default will temporarily delay the write-down). Rabobank also has an 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. The

senior contingent notes though were not used as regulatory capital and were not offered in the U.S. or to U.S. persons as defined under Regulation S.

Rabobank subsequently issued fixed rate perpetual non-cumulative capital securities in two separate offerings in 2011 (each for US\$2 billion). One has an initial interest rate of 8.375% to (but excluding) the first reset date and thereafter reset every five years based on the U.S. Treasury benchmark rate plus 6.425%, while the other has an initial interest rate of 8.40% to (but excluding) the first reset date and thereafter reset every five years based on the U.S. Treasury benchmark rate plus 7.49%. In both cases though interest payments are at Rabobank's discretion (not cumulative). The principal of the capital securities is subject to a write-down if (i) the equity capital ratio (equity capital divided by risk weighted assets) falls or remains below 8% or (ii) either Rabobank or the Dutch Central Bank believes that there has been such a significant reduction in Rabobank's retained earnings or similar reserves causing a significant deterioration in Rabobank's financial and regulatory solvency position that the equity capital ratio will fall below 8% in the near term. If the trigger is breached, Rabobank will cancel any accrued but unpaid interest and write-down the prevailing principal amount of the capital securities. The write-down amount is determined by multiplying the losses precipitating the trigger relative to the equity capital ratio prior to the loss incurrence by the ratio of the aggregate outstanding principal amount of capital securities relative to equity capital and all similar loss absorbing securities. In addition, Rabobank may redeem the capital securities, in whole but not in part, prior to a specified date upon the occurrence of a tax event or a capital event, and upon the occurrence of a

capital event or Basel III capital event, Rabobank may substitute or vary the terms of the capital securities so that they remain regulatory compliant securities. The capital securities received core Tier 1 capital treatment. The capital securities were not offered in the U.S. or to U.S. persons as defined under Regulation S.

Credit Suisse's Buffer Capital Notes

In February 2011, Credit Suisse issued approximately US\$6.17 billion of its Tier 1 buffer capital notes (issued through Credit Suisse Group AG) and US\$2 billion of its Tier 2 buffer capital notes (issued through Credit Suisse Group (Guernsey) I Limited), 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 Swiss Financial Market Supervisory Authority ("FINMA") determines that conversion is necessary to prevent a capital injection or restructuring. The conversion price will be the higher of a floor price of USD 20/CHF 20 per share, subject to customary adjustments, or the daily weighted average sale price of Credit Suisse's ordinary shares over a trading period preceding the notice of conversion.

There are though some slight differences between the Tier 1 buffer capital notes and the Tier 2 buffer capital notes. The Tier 1 buffer capital notes (1) have no maturity, (2) pay interest only at Credit Suisse's discretion (not cumulative), (3) provide for early redemption only at Credit Suisse's option five years from the purchase or exchange and in certain other circumstances with the approval of FINMA, and (4) have an initial rate of USD 9.5% or CHF 9.0%, as applicable, to (but excluding) the first call date and thereafter reset every five years. The Tier 2 buffer capital notes (1) have a 30-year term, (2) are guaranteed

on a subordinated basis by Credit Suisse Group AG, (3) upon the occurrence of a capital event or a tax event allow Credit Suisse to substitute or vary the terms so that they remain regulatory compliant securities, (4) provide for early redemption only at Credit Suisse's option on (i) the first optional redemption date or on any interest payment date thereafter, in whole or in part, or (ii) upon a change in tax or regulatory treatment or change in control, in whole, but not in part, and (5) have an initial rate of USD 7.875% to (but excluding) a specified date and thereafter reset every five years based on the mid-market U.S. dollar swap rate LIBOR basis having a five year maturity plus 5.22%. The Tier 1 buffer capital notes received core Tier 1 capital treatment, while the Tier 2 buffer capital notes received lower Tier 2 capital treatment (and will only receive core Tier 1 capital treatment if the notes are converted into ordinary shares). The Tier 1 buffer capital notes and the Tier 2 buffer capital notes were not offered in the U.S. or to U.S. persons as defined under Regulation S.

UBS' Subordinated Notes

In August 2012, UBS issued (through its Stamford branch) US\$2 billion of its 7.625% Tier 2 subordinated notes, with a ten-year term, subject to a full write-down of the principal amount if (1) UBS' ratio of core Tier 1 capital plus high trigger loss absorption contingent capital to risk-weighted assets falls below 5% or (2) if FINMA determines that a write-down is necessary in order to prevent UBS' insolvency, bankruptcy or failure or UBS has received public support in order to prevent UBS' insolvency, bankruptcy or failure. The subordinated notes also may be redeemed prior to their maturity at UBS' option, in whole but not in part, (i) at

their aggregate principal amount, together with any accrued but unpaid interest thereon, upon the occurrence of a tax event, a regulatory event, or (ii) at 101 percent of their aggregate principal amount, together with any accrued but unpaid interest thereon, upon the occurrence of certain changes in Swiss banking laws or regulations that lower certain capital requirements that UBS subsequently meets or treats as Tier 2 capital securities with terms that if included in the subordinated notes would have resulted in the subordinated notes not having received Tier 2 capital treatment. The subordinated notes received lower Tier 2 capital treatment and were the first Basel III-compliant contingent capital securities to be offered in the U.S. The subordinated notes were exempt from registration with the Securities and Exchange Commission (the "SEC") pursuant to Section 3(a)(2) of the Securities Act.

Barclays' Contingent Capital Notes

In November 2012, Barclays issued (through Barclays Bank PLC) US\$3 billion of its 7.625% contingent capital notes, with a ten-year term, subject to the automatic transfer of the notes to the issuer's parent or other issuer group company if Barclays' equity capital ratio (core Tier 1 capital to risk weighted assets of the Barclays Bank Group) falls below 7% as of any quarterly financial period end date or any day the equity capital ratio is calculated upon the instruction of the Financial Services Authority ("FSA"). In the event of an automatic transfer, holders will no longer have any rights against Barclays with respect to repayment of the principal amount of the contingent capital notes or the payment of interest on such notes for any period from (and including) the interest payment date falling immediately prior to the occurrence of such automatic

transfer; and as a result, holders will lose their entire investment in the notes. The contingent capital notes also may be redeemed prior to their maturity at Barclays' option, in whole but not in part, at their aggregate principal amount, together with any accrued but unpaid interest thereon, upon the occurrence of a tax event or a regulatory event, but only with the prior approval of the FSA and compliance with the FSA's main Pillar 1 rules (as well as provision of a notice to the FSA regarding Barclays' capital adequacy in the case of a redemption within five years of the issue date). The contingent capital notes are subordinated notes and received lower Tier 2 capital treatment. The contingent capital notes were registered with the SEC.

Tax Treatment

Historically, what were the tax benefits associated with hybrid securities?

Historically, issuers and their advisers structured hybrid securities in order to allow issuers to make tax-deductible payments on such securities. From a tax perspective, the more debt-like hybrid securities are, the more favorable the tax treatment. For example, in the case of trust preferred securities, the interest payments on the underlying junior subordinated notes (which mirrored the economic terms of the preferred securities issued by the trust) would qualify for a tax deduction.

Can you explain the tax treatment for some of the contingent capital products that have been issued, such as those for Lloyds, Rabobank, Credit Suisse, UBS and Barclays?

In the case of Lloyds' enhanced capital notes, the notes should fall within the UK's "quoted Eurobond"

exemption and, therefore, there should be no withholding tax on interest. Some notes for UK tax purposes also may be deemed “deeply discounted securities” the disposal of which (including transfer, redemption or conversion) could be taxed as income. The notes would be treated as convertible equity and payments on the notes likely would be treated as dividends for U.S. tax purposes.

In the case of Rabobank’s senior contingent notes, the notes are treated as debt and interest on the notes is tax deductible for Dutch tax purposes and it is unclear if and/or what portion would be treated as debt or equity or another instrument for U.S. tax purposes.

In the case of Credit Suisse’s buffer capital notes, it is unclear how the notes and interest on the notes would be treated for Swiss tax purposes and the notes would be treated as convertible equity and payments on the notes likely would be treated as dividends for U.S. tax purposes.

In the case of UBS’ subordinated notes, payments by the issuer of interest on, and repayment of principal of, the notes, will not be subject to Swiss federal withholding tax, provided that the proceeds from the offering and sale of the notes are used outside of Switzerland (unless use in Switzerland is permitted under the Swiss taxation laws in force from time to time without payments in respect of the notes becoming subject to withholding for Swiss withholding tax as a consequence of such use of proceeds in Switzerland). The notes would be treated as convertible equity and payments on the notes likely would be treated as dividends for U.S. tax purposes.

In the case of Barclays’ contingent capital notes, the notes should fall within the UK’s “quoted Eurobond” exemption and, therefore, there should be no

withholding tax on interest. The notes would be treated as convertible equity and payments on the notes likely would be treated as dividends for U.S. tax purposes.

Does the tax treatment differ by jurisdiction?

Yes, the tax treatment of contingent capital instruments varies by jurisdiction as there is no uniformity across national tax laws in characterizing such instruments for tax purposes.

Why is the tax treatment so important?

The tax treatment is very important because one of the main purposes of hybrid capital is to provide a lower after-tax cost of capital for issuers. The lower after-tax cost of capital results from the tax deductibility for issuers of interest payments on the hybrid securities.

Are there tax issues to be addressed in the United States?

Whether payments on contingent capital instruments are in fact deductible for U.S. federal income tax purposes depends on the characterization of the instrument for those purposes. Payments with respect to instruments characterized as indebtedness are generally deductible for U.S. federal income tax purposes while payments with respect to instruments characterized as equity are generally not.

Although many factors are included in the determination of an instrument’s characterization for U.S. 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 U.S. Treasury Department action before a U.S. issuer has reasonable certainty that distributions on a contingent capital

instrument are deductible for U.S. federal income tax purposes.

Are there tax issues to be addressed in the UK?

The UK tax authorities issued guidance in June 2012 setting forth their views on the tax treatment of regulatory capital instruments intended to comply with the new Basel III regime and the EU's CRD IV and Solvency II regimes. According to June 2012 guidance, interest on new Tier 2 instruments (which would include contingent capital instruments) may be deductible until the new regime becomes effective. However, in October 2012, the UK tax authorities proposed draft legislation changing their views on the treatment of Tier 2 instruments.

Under the existing tax regime, the interest on debt securities (whether term debt or perpetual debt) is not deductible if under the debt securities the consideration given by the company for the use of the principal depends (to any extent) on the results of (a) the company's business or (b) any part of the company's business, in which case such interest will be deemed to be a distribution and taxed like a dividend. According to the June 2012 guidance, an instrument containing contractual provisions for a principal write-down or conversion to common equity would fall under the rule from the date of issuance (since the consideration given to holders would be dependent on the results of the issuing company's business), but an instrument without such provisions would only fall under the rule when the statutory regime that applied to it came into force. However, the proposed draft legislation ensures that interest payable on Tier 2 instruments complying with the new regulatory regime will not be deemed a "distribution" simply because the consideration given

by the issuer is affected by features required by the new regulatory regime. Therefore, interest payable on Tier 2 instruments should be deductible for UK tax purposes. The proposed draft legislation will be treated as having come into effect on October 26, 2012, and will apply to outstanding Tier 2 instruments as well as those yet to be issued.

What is the relevance of Section 163(l) of the Internal Revenue Code of 1986?

Section 163(l) of the Internal Revenue Code of 1986 ("IRC") provides that no deduction will be allowed for interest paid on a "disqualified debt instrument." This provision only affects issuers of debt, not debt holders. A disqualified debt instrument is defined as one where: (A) a substantial amount of the principal or interest is required to be paid or converted into the equity of the issuer, or at the option of the issuer is payable in or convertible into the equity of the issuer, (B) a substantial amount of the principal or interest is required to be determined, or at the option of the issuer is determined, by reference to the value of such equity, or (C) the indebtedness is part of an arrangement which is reasonably expected to result in a transaction described above.

Neither the statute nor the legislative history relating to IRC Section 163(l) addresses contingent capital instruments. Rather, the section was directed at instruments then being issued in the market that were mandatorily convertible into equity at maturity or could be converted into equity at the option of the issuer. If a contingent capital instrument is not mandatorily convertible into equity and the issuer in fact does not expect the instrument to be converted into equity and the issuer has no option to convert the instrument into

equity, then the tax treatment may turn on whether clause (C) above applies to the instrument. Unfortunately, this is a gray area and one probably incapable of a precise determination in the absence of guidance from the U.S. tax authorities.

What is the tax position where the conversion generates cancellation of debt income?

Where the conversion generates cancellation of debt income, under general U.S. 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 U.S. federal income tax purposes, the issuer would realize cancellation of indebtedness income to the extent of the difference between the instrument's adjusted issue price and the fair market value of its equity exchanged or converted into. An issuer would also recognize 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 U.S. federal income tax purposes, the issuer would not realize cancellation of indebtedness income on the exchange or conversion into (a different class of) equity.

Ratings Agencies

Are the rating agency concerns relating to hybrid securities applicable to contingent capital instruments?

Yes, the rating agency concerns relating to hybrid securities are still applicable to contingent capital instruments. 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 hybrid securities to which they give equity treatment when considered relative to the issuer's overall capital structure.

Historically, rating agencies have viewed hybrid securities favorably because they were believed to have some of the loss-absorbing features associated with common equity securities. The view was that, to varying degrees, hybrid securities would provide a "cushion" within an issuer's capital structure in the event of a 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, although the analysis of the issuer's overall credit rating was treated as separate and distinct.

However, contingent capital instruments with conversion features present additional concerns for rating agencies. In such cases, the assessment of the "equity content" of the contingent capital instruments is difficult if the conversion triggers are not clearly defined or if the regulators have significant discretion to force a conversion, which makes it difficult to predict the likelihood of conversion. The rating agencies have issued statements and/or new methodologies regarding the treatment of contingent capital instruments.

Moody's

Moody's has not published ratings criteria for contingent capital instruments to date. However, in November 2009, Moody's issued guidelines ("*Moody's Guidelines for Rating Bank Hybrid Securities and Subordinated Debt*," also included in "*Moody's Consolidated Global Bank Rating Methodology*") stating that it is likely that a rating will not be assigned to contingent capital instruments whose potential losses to investors are difficult to measure. The guidelines indicate that the contingent capital instruments most likely to fall into this category are those that contractually give the issuer and/or the regulator the discretion to convert the "host" security into common equity. To the extent that there are triggers, Moody's will focus on whether or not the contingent capital instruments provide an objective threshold for conversion enabling an investor to reasonably measure the risk associated with conversion.

Moody's has indicated that it will continue to assess its ability to rate contingent capital instruments subject to fixed income characteristics. If Moody's decides that certain types of contingent capital instruments can be rated, Moody's will focus its analysis on the ability of the "host" security to absorb losses as a "going concern," the probability of conversion and the loss severity given conversion based on the conversion ratio. To date, Moody's has not changed its position on contingent capital instruments and it appears that Moody's fully recognizes the difficulties of going concern assessment of banks. It remains to be seen how Moody's will further develop the concept of "hybrid default" and incorporate the analysis of risk of principal loss outside liquidation in its rating methodology for contingent capital instruments.

Fitch

In December 2012, Fitch published a revised rating criteria report ("*Assessing and Rating Bank Subordinated and Hybrid Securities*"), replacing its previously published contingent capital rating methodology ("*Rating Bank Regulatory Capital and Similar Securities*," dated December 2011) and rating criteria report ("*Treatment of Hybrid in Bank Capital Analysis*," dated July 2012). Fitch rates subordinated and hybrid securities, which includes contingent capital, by notching down from a rating anchor, which is the issuer's viability rating ("VR"). The VR represents Fitch's view of the intrinsic creditworthiness of the issuer, excluding external support and constraints, and thus the capacity of the issuer to maintain ongoing operations and avoid failure. Fitch's notching methodology is based on an end-game scenario (either resolution or liquidation), and the notching is divided into two parts (loss severity and non-performance risk) which are additive and relate to the same anchor. For contingent capital securities, the base case for loss severity is two notches. If a bank issues a Tier 2 contingent capital instrument whose only loss-absorption feature is a contingent conversion/write-down feature at a pre-determined trigger, the trigger can give rise to incremental non-performance risk relative to the bank's VR, in which case Fitch may add up to two notches for incremental non-performance risk, dependent on whether it is minimal (i.e., the trigger is set so low that it is effectively "gone concern" capital), moderate or high.

In the revised report, Fitch defines contingent capital as instruments that are written-down, written-off or converted into a more junior instrument (usually common equity) upon a defined trigger, and indicates

that it is only able to rate securities with triggers whose likelihood of being hit can be reasonably analyzed or assessed. Fitch also clarifies that securities where loss absorption arises only at the point of non-viability do not qualify as contingent capital for the purposes of the revised report.

S&P

In November 2011, S&P published its contingent capital rating methodology ("*Bank Hybrid Capital Methodology and Assumptions*"), which is similar to Fitch's approach and also provides for notching down from anchor ratings, including the issuer's stand-alone credit profile or the issuer's credit rating. In October 2012, S&P published additional guidance clarifying its methodology and assumptions for classifying the equity content of hybrid capital instruments that have step-up features, issuer call options or replacement provisions.

Will rating agencies rate contingent capital instruments?

Yes, rating agencies will rate contingent capital instruments in certain instances. For example, Rabobank's perpetual non-cumulative capital securities were assigned a rating of 'A' by Fitch (they were not assigned any rating by Moody's or Standard & Poor's), Credit Suisse's Tier 2 buffer capital notes were assigned a rating of 'BBB+' by Fitch (they were not assigned any rating by Moody's or Standard & Poor's), UBS' subordinated notes were assigned a rating of 'BBB-' by Fitch and Standard & Poor's (they were not assigned any rating by Moody's), and Barclays' contingent capital notes were assigned a rating of 'BBB-' by Fitch and Standard & Poor's (they were not assigned any rating by Moody's).

Miscellaneous

Is contingent capital likely to be expensive and risky for issuers?

It remains to be seen whether contingent capital will be expensive and risky for issuers. There have been only a few issuances of contingent capital instruments thus far and it is not clear how new offerings of contingent capital instruments will be received by investors and what yields investors will require and what conversion triggers or write-down features will be satisfactory in exchange for being subordinated to equity during a financial crisis. Many of the contingent capital instruments that have been issued thus far have had fairly high coupons (comparable to coupons on high yield bonds) in order to compensate investors for the risk of a conversion or a full or partial write-down. It is also unclear how effective these instruments will be at loss absorption for issuers in the event of another financial crisis as there are varying amounts of regulatory discretion built into triggers and the conversion or write-down mechanisms.

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