



Defining Hybrid Capital

In the current environment of bank recapitalisations, it has never been more important for banks to know what capital-raising tools are at their disposal. However, despite the implementation of Basel II in Europe by the introduction of the Capital Requirements Directive (“CRD”), a common approach to the definition and treatment of eligible hybrid capital has eluded European member state regulators.

This in turn means that a level playing field for European banks as they compete for new capital is some way off.

One of the main purposes of the European Commission’s recent Public Consultation on possible changes to the CRD is to provide clarity and uniformity as to the treatment of hybrid capital. It builds on the 1998 public statement on hybrid Tier 1 capital by the Basel Committee on Banking Supervision, known as the Sydney Press Release, and follows on from the “Proposal for a common EU definition of Tier 1 hybrids” published in April 2008 by the Committee of European Banking Supervisors (“CEBS”), which was commissioned by the European Commission on this subject.

The proposed changes to the CRD are to introduce criteria that need to be fulfilled by hybrid capital instruments in order for these instruments to be eligible as Tier 1 capital of credit institutions. The criteria focus on three main eligibility criteria of hybrid capital instruments - permanence, flexibility in payments and loss absorption.

In addition to establishing these criteria, the proposed changes also set quantitative limits on the use of different types of hybrid capital instruments towards satisfying a credit institution’s Tier 1 capital requirements.

The proposed changes also provide for a “grandfathering” clause with regard to instruments already issued and prescribe a transitional period before compliance with the amended CRD provisions will be mandatory for European credit institutions.

Tier 1 Eligibility Criteria

The proposed Tier 1 eligibility criteria are:

(a) As to permanence:

- (i) the instrument must be undated, or have a maturity of at least 30 years (the CEBS Proposal recommended that only undated instruments should be eligible);
- (ii) the instrument may include a call option at the issuer’s sole discretion, but this may not be exercisable earlier than 5 years from the issue date;

(iii) the instrument may include a “moderate” incentive (such as a step-up in interest rate) for the issuer to redeem the instrument, but such incentive may not become operative earlier than 10 years from the issue date. There is no guidance on what a moderate incentive is in this context, despite the CEBS

Proposal having recommended that “moderate” in this context means no greater than (i) 100 basis points or (ii) 50% of the initial credit spread, in each case less the swap spread between the initial index basis and the stepped-up index basis. Instead, the European Commission Consultation states that the competent authorities will determine whether an incentive exists and whether it is “moderate,” the implication being that if they determine that it is more than moderate, they should not allow such an instrument to count towards the institution’s Tier 1 capital, although this is not expressly stated. It also does not expressly limit the hybrid instrument to one coupon step-up, as recommended in the CEBS Proposal;

(iv) the instrument may be redeemed only with prior permission of the competent authorities, who may grant such permission subject to certain conditions, such as that the financial condition or solvency of the issuer is not affected and that the instrument is replaced by instruments which are at least as “equity-like” as the instrument being redeemed;

(v) the instrument may not be redeemed for so long as the issuer is not in compliance with its minimum capital requirements set out in Article 75 of the CRD; and

(vi) the competent authority may permit early redemption of the instrument in the event of a change in national tax treatment or regulatory classification which was unforeseen at the issue date of the instrument.

(b) As to flexibility of ongoing payments:

(i) the issuer must be allowed (whether by the terms of the instruments or by any relevant statutory provisions) to cancel, when necessary, the payment of interest and dividends for an unlimited period of time, on a non-cumulative basis;

(ii) the issuer shall be obliged to cancel such payments if it does not comply with its capital requirements in Article 75 of the CRD;

(iii) the competent authorities may require the cancellation of such payments based on the issuer’s financial condition and solvency; and

(iv) any such cancellation does not preclude the payment of interest or dividend in the form of common stock, provided that any such mechanism allows the issuer to preserve financial resources, and such a scrip payment may be subject to specific conditions imposed by the competent authorities. This is an important clarification for issuers which are tax-resident in the UK. In the order for them to obtain tax deductions on coupons paid on hybrid instruments, the instrument must not constitute a “results-driven” instrument, i.e. under the terms of the instrument payments of coupon must not be dependent upon the issuer’s financial results or condition. Therefore, the concept of cancellation of coupons is a problem for UK tax resident issuers, unless the coupon is replaced with an alternative payment, such as under an Alternative Coupon Satisfaction Mechanism. These have been common features of UK hybrid instruments to date and it appears that these mechanisms will be able to continue being used.

(c) As to loss absorption:

(i) in the event of the bankruptcy or liquidation of the issuer, the instrument shall rank after claims of subordinated creditors and cumulative preferential shares, i.e. it will rank immediately ahead of ordinary share capital; and

(ii) the statutory or contractual provisions governing the instrument must provide for principal, unpaid interest and dividends to be such as to absorb losses, and to not hinder recapitalisation of the issuer.

(d) Generally:

- (i) only fully paid-up amounts of such instruments can be taken into account in determining compliance with the issuer's Article 75 minimum capital requirements;
- (ii) the instrument may not be redeemed at the option of the instrument holder; and
- (iii) the terms of the instrument must provide for debt and unpaid interest to be such as to absorb losses, whilst leaving the issuer in a position to continue trading.

The proposed quantitative limits are as follows:

- (a) hybrid instruments that are convertible in emergency situations into a pre-determined fixed number of common stock may not exceed 50% of the issuer's total Tier 1 capital, after deducting the book value of own shares held by the issuer, intangible assets and current year losses ("Total Net Tier 1 Capital");
- (b) hybrid instruments not falling within the descriptions in (a) above or (c) below may not exceed 35% of the issuer's Total Net Tier 1 Capital;
- (c) hybrid instruments which are dated and which, by their contractual terms or the statutory provisions governing them, provide for an incentive for the issuer to redeem (such as a step-up coupon) may not exceed 15% of the issuer's Total Net Tier 1 Capital; and
- (d) the aggregate amount of all instruments specified in paragraphs (a) to (c) above may not exceed 50% of the issuer's Total Net Tier 1 Capital.

Existing hybrid Tier 1 instruments that do not meet all the proposed eligibility criteria will nevertheless remain eligible as Tier 1 capital for 30 years from the effective date of the CRD amendments, provided that after 10 years from the effective date they do not, in aggregate, exceed 20% of Total Net Tier 1 Capital, and after 20 years from the effective date they do not, in aggregate, exceed 10% of Total Net Tier 1 Capital.

Important Considerations

Responses to the consultation which were published by the European Commission raised various issues with the proposed CRD changes.

The most common criticism was directed at the requirement that the loss absorbing provisions of the hybrid instrument should "not hinder recapitalisation" of the issuer and should leave the institution "in a position to continue trading." No guidance has been provided as to how national regulators are to interpret these provisions and it is thought that they are likely to have regard to the more detailed proposals set out in the CEBS Proposal.

In the CEBS Proposal, it was stressed that hybrid instruments should be able to absorb losses both in a liquidation (by virtue of the instrument ranking senior only to ordinary share capital in terms of priority of payment in a liquidation), and also on a going concern basis. The concept of absorption of losses on a going concern basis has so far proved to be the most difficult proposed feature to define clearly.

CEBS suggested that absorption of losses on a going concern basis means that the instrument should (i) help to prevent the issuer's insolvency (which the subordination of the instrument on liquidation does not achieve), and (ii) make the recapitalisation of the issuer more likely.

As to helping to prevent the issuer's insolvency, CEBS recommend that the following conditions should be met:

- the instrument should be permanent;

- the issuer should have the ability to cancel payments of coupons/dividends;
- the instrument would not be taken into account for the purposes of determining whether the issuer is insolvent; and
- the holder of the instrument should not be in a position to trigger an insolvency procedure against the issuer (and therefore must have no right to demand redemption of the instrument or payment of a coupon/dividend).

In relation to the requirement of the instruments not being taken into account in a determination of solvency, CEBS suggested two possible features that would allow the instrument to achieve this – first the ability of the issuer to convert the instrument into common equity, and second the ability of the issuer to “write-down” (whether on a permanent or temporary basis) the principal amount of the instrument.

Respondents noted that a hybrid instrument that can be converted into common shares at the issuer’s option may be unattractive to some investors and therefore increase the pricing of the instrument for the issuer. Even less attractive for investors is a permanent “write-down” of principal, which may put the holder of the hybrid instrument in a worse position than an ordinary shareholder, since the shareholder may benefit from future rises in the share price and is, therefore, inconsistent with the general principle that a hybrid instrument should rank ahead of ordinary shares.

Other problems surrounding the concept of conversion into ordinary shares and principal write-downs are the quantum. No suggestions were made by the CEBS as to how to determine the appropriate amount of principal to be written down, or converted into ordinary shares, especially where there are multiple series of hybrid instruments in issue.

For UK-tax resident issuers, the concept of a write-down or a conversion may also create problems for the issuer if the write down or conversion gives rise to a credit in accounting terms, as this could create an additional tax liability for the issuer at a time when it is in financial distress.

Conclusions

These attempts to harmonise the meaning of hybrid Tier 1 capital across Europe are a major step forward. However, the proposed CRD changes still leave open many questions about the detailed interpretation of certain of the proposals, meaning that there will still be significant scope for differing interpretations of the provisions by different national regulators and, therefore, will not fully achieve the goal of a level playing field for European credit institutions.

The European Commission has stated that it expects to publish its firm proposals for changes to the CRD in September 2008. However, the Basel Committee is also currently conducting a review of capital and its meaning and it would seem desirable for the proposed changes to the CRD to be delayed until it is clearer what recommendations the Basel Committee will suggest, since this could lead to a further round of changes to the CRD.

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