



## What Counts? An Update on the Debate Concerning Regulatory Capital

### Background to the regulatory capital initiatives

Since the outbreak of the subprime crisis in mid-2007, the world's financial markets have suffered unprecedented turmoil. Many banks, even large institutions which had previously been considered icons of stability, failed or had to be rescued or nationalised by their governments. The financial crisis has prompted regulators in the U.S. and Europe to re-examine how much capital is enough capital for banks. Regulators generally agree that banks were too highly leveraged and that, in the future, banks should be required to have more capital. Policymakers also agree that there should be greater "uniformity" across jurisdictions as to bank regulatory capital requirements and as to the treatment accorded to specific financial instruments. Regulators and commentators posit that if regulatory capital standards and product definitions are harmonised, there will be fewer opportunities for "arbitrage" by banks. That's about as far as regulators have gotten in terms of coming to a common understanding.

Regulators face a number of challenges as they seek to formulate frameworks that implement these general principles. First, the dialogue concerning regulatory capital long precedes the financial crisis. The financial crisis has simply brought more attention to the somewhat arcane world of capital requirements and has introduced many new participants, with their respective political agendas, to the ongoing debate regarding the components of regulatory capital. Second, regulators tend to react sharply following crises, and many have noted that the most valuable (from the perspective of withstanding stress scenarios) form of capital is common stock and preferred stock. Third, investors, who faced unprecedented losses from their investments in financial institutions, have become quite sceptical about the value of more engineered financial products as components of regulatory capital. Investors have become mistrustful of Tier 1 regulatory capital calculations and have begun to rely on "tangible common equity" calculations. Fourth, rating agencies reviewing the performance of various financial products during the financial crisis have announced their intention to revisit the credit afforded many products. Finally, banks, investors, and, even regulators, agree that it would be quite costly (from a number of different perspectives) for banks to be constrained to common stock and preferred stock as the only building blocks of regulatory capital.

Many of the tensions we outline above have been exposed recently in connection with the issuance by Lloyds of a "contingent capital" instrument. Contingent capital instruments are another form of hybrid capital. That is, they are instruments that have some elements or characteristics of equity securities and some characteristics of debt securities.

### The role of hybrid capital instruments

Regarded as 'innovative' capital instruments, hybrid securities became particularly popular among European banks in the past decade, and have formed an important part of their capital management toolbox. These

instruments permit banks to replenish regulatory capital in a tax-efficient manner, without diluting existing shareholder base, whilst offering predictable returns.

These securities are structured to obtain favourable equity treatment from ratings agencies, permit issuers to make tax-deductible payments, and qualify as Tier 1 capital for banks and bank holding companies. The benefits of a hybrid depend on its “equity-like” or “debt-like” characteristics. From a ratings agency perspective, the more equity-like the hybrid, generally, the more favourable the treatment for the issuer. From a tax perspective, the more debt-like the hybrid, generally, the more favourable the tax treatment for the issuer. An efficient hybrid achieves these seemingly contradictory objectives.

In thinking about a hybrid security for rating agency and/or regulatory capital purposes, it is often useful to analyze the features of the hybrid instrument and contrast those to the features associated with an equity security, like common stock, in order to assess the resiliency or utility of a hybrid security under “stress scenarios.” For example, common stock has no 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 will 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 prior to equity holders.

During the financial crisis, numerous hybrid instruments were downgraded by rating agencies and these securities were criticised as being less able to absorb losses on a going concern basis during periods of financial stress, compared to common equity. Hybrid securities have consequently featured prominently in discussions regarding proposed regulatory capital reforms.

We summarise below the recent proposals to reform the regulatory capital framework, with particular focus on the treatment of hybrid capital instruments, by the EU, the Basel Committee on Banking Supervision (BCBS), the UK Financial Services Authority (FSA) and the G20 and consider their likely implications for banks considering raising capital through the issuance of hybrid securities.

## 1. European Initiatives on Hybrid Tier 1 Capital Instruments

The Capital Requirements Directive implemented the Basel II Accord in the European Economic Area. Following lengthy consultations, various amendments to the CRD were adopted in May 2009<sup>1</sup> in order, among other things, to agree common definitions and descriptions of hybrid capital instruments that could be regarded as “innovative” Tier 1 capital. Prior to this, the only available guidelines for banks and regulators were contained in the Sydney Press Release. Our earlier client alert “Defining Hybrid Capital” detailed the Tier 1 eligibility criteria proposed by the Committee of European Banking Supervisors (CEBS) which was subsequently enacted in the May 2009 amendment.

However, the stated goal of providing a level playing field for banks in all European member states remained partially thwarted due to the “principles” nature of the new criteria, which left significant detail missing, or in some cases completely unanswered questions.

As envisaged by the CRD amendments, CEBS is now focused on providing more detailed guidelines for national bank supervisors in Europe to follow in connection with their supervision of banks’ use of hybrid instruments for their regulatory capital purposes. CEBS launched a consultation in June 2009 which closed to comments on 23 September 2009, following a public hearing.

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<sup>1</sup> Proposal for a Directive amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management (1st October 2008), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2008:0602:FIN:EN:PDF>

The most material elements of guidance to emerge from the consultation are as follows:

- as to permanence of the instruments:
  - undated (or perpetual) instruments may provide for a “moderate” incentive to redeem, arising not earlier than 10 years after issuance.<sup>2</sup> As to what constitutes a “moderate” incentive, CEBS has followed the earlier BCBS recommendation that where the incentive consists of an interest rate “step-up,” the step-up should not be greater than 100 basis points, or 50% of the initial credit spread, in each case less the swap spread between the initial index basis and the stepped up index basis. Further, where the incentive consists of a principal stock settlement mechanism in conjunction with an issuer call option, the conversion ratio should be capped at 150% of the conversion ratio at the date of issuance of the hybrid instrument. Other incentives to redeem would need to be assessed individually by the relevant national bank supervisor;
  - dated instruments (which must, in any case, have a maturity of at least 30 years) may not provide for an incentive to redeem. (Both dated instruments and undated instruments with an incentive to redeem are, in aggregate, limited by the CRD to a maximum of 15% of a bank’s Tier 1 capital);
  - under the CRD, both dated and undated instruments require the prior consent of the competent authorities to be redeemed or called, and the authorities may consent if the request is made by the issuer and its financial condition and solvency would not be affected by doing so. The authorities must require the issuer to suspend redemption of a dated instrument if the issuer is not in compliance with its regulatory capital obligations, and may also require such a suspension in other circumstances, based on financial and solvency considerations. The competent authority may also permit early redemption of both dated and undated instruments in the event of a change in tax treatment or regulatory classification, which was unforeseen at the issue date.

CEBS has now provided guidelines as to the process involved for an issuer to request approval to exercise a redemption or call option, including:

- the requirement for a well-founded explanation of the reason for redeeming or calling the instruments;
- the provision of current solvency data, including the capital position before and after the redemption;
- a confirmation that the issuer remains in compliance with all its other regulatory requirements following the redemption/call; and
- a 3-5 year plan for the development of the above solvency data and an evaluation of the risks to which the issuer might be exposed and whether the level of Tier 1 capital ensures coverage of those risks, including in stressed circumstances.

CEBS also states that the relevant authority may also ask the issuer to demonstrate that it can re-access the hybrids market.

The competent authority should not permit the redemption/call where it would put the financial condition or solvency of the institution in material jeopardy in the foreseeable future, and its capital buffers should remain sufficiently above the regulatory minimum levels for the foreseeable future.

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<sup>2</sup> This is often referred to as a step-up.

- although the CRD outlines when redemptions/calls can take place, it is silent as to “buybacks” of hybrid instruments by the issuer. CEBS regards buybacks as equivalent to a call or redemption, in economic and prudential terms, since the end result is still that the hybrid may not be available as high quality capital when the institution needs it the most. However, competent authorities are allowed to permit limited market making or market smoothing activities, so that an institution could repurchase up to 5% of the relevant issuance for these purposes (although the amount of the instruments repurchased would usually remain outstanding in these circumstances, rather than being cancelled).

CEBS also stated that it is considering whether buy backs should be allowed in limited circumstances, before 5 years and without replacement. Certain national bank supervisors seem to be in favour of this, where the buyback would result in a lasting improvement of the institution’s solvency situation. Other supervisors have concerns about this compromising the permanence of the instrument by enhancing pressure from investors on the institution to buy back the instrument and by providing incentives for banks to reduce their overall capital position at a time when their own credit quality is decreasing.

- as to flexibility of payments:

- the CRD provides that competent authorities may require the cancellation of interest/dividend (“coupon”) payments based on the financial condition or solvency of the institution, but exempts from this provision a mechanism where the institution satisfies such payment obligation by issuing shares in lieu,<sup>3</sup> so long as such mechanism allows the institution to preserve financial resources. Competent authorities may impose conditions on such substitutions.

CEBS concludes that regulator intervention to cancel coupons is mandatory where the institution is not complying with its regulatory capital requirements, but should otherwise be based on the supervisor’s own assessment of the financial condition or solvency of the institution, including the type of information referred to in paragraph (a)(iii) above.

- the CRD does not specifically address “dividend pushers/stoppers.”

A dividend pusher requires the issuer to pay the hybrid coupon if it pays a dividend on its common stock and, conversely, a dividend stopper prevents the issuer from paying a dividend on the common stock unless it also pays the hybrid coupon.

CEBS has decided that although a dividend pusher is generally acceptable, it must be waived if, in between the date of the coupon push and the date for payment, the institution breaches its regulatory capital requirements or the competent authority requires cancellation of the coupon based on financial condition/solvency concerns. CEBS has stated that, in addition to these situations, where the majority of the dividend on common stock is paid in shares, rather than cash, the dividend pusher should be waived.

The CEBS did not make any recommendations as to dividend stoppers, other than noting that they should operate in a way that does not hinder recapitalisation (as to which see below).

- CEBS has stated that an ACSM is only acceptable if it achieves the same economic result as cancellation of the coupon (i.e., there is no decrease in capital). In order to meet this condition, the deferred coupons should be satisfied without delay using newly issued instruments having an aggregate fair value, at a maximum, equal to the coupon amount.

<sup>3</sup> Referred to by rating agencies as an alternative payment mechanism or alternative coupon satisfaction mechanism (ACSM).

Those shares may, afterwards, be sold in the market by the holders of the hybrid instruments, but the holders need to bear the risk of the sale proceeds being less than the substituted coupon amount. The ACSM should also operate so that it does not hinder recapitalisation (see below) and the issuer should be able to cancel use of the ACSM in order to absorb losses.

Notably, the CEBS did not answer the question of whether the substituted shares could be sold, on behalf of the hybrid holders, and the net cash proceeds paid to the holders, so the approach of national supervisors to such a proposed mechanism will be interesting to see.

- as to loss absorbency, CEBS looked at providing guidance on the issues of payments under the instruments being such as to absorb losses and not hinder a recapitalisation.

The CRD provides that hybrids must be able to absorb losses both on a “going concern” basis and in a liquidation.

- CEBS stated that the capacity of an instrument to absorb losses in a liquidation is always going to depend on the degree of subordination and the CRD provides that hybrids, to count as Tier 1 capital, may be senior only to common stock, and holders of the hybrid must not have the benefit of any guarantee or security which would enhance their seniority.

As to absorbing losses on a going concern basis, CEBS considers that the instrument must (A) help to prevent the institution’s insolvency and (B) not hinder the recapitalisation of the institution, if recapitalisation is necessary to keep it as a going concern and help it rebuild its capital position.

In preventing an insolvency, the most important factors are that no redemption is permitted, the issuer can cancel the coupon, the hybrid holder cannot petition for the issuer’s insolvency and the hybrid instrument would not be taken into account in any determination of whether the issuer is insolvent.

This last requirement is arguably the most difficult to achieve where the insolvency test is based on a consideration of the balance sheet. If the instrument would qualify as debt under the relevant insolvency law, then this part of the test may be achieved by a mechanism such as a conversion into an equity instrument, or a write-down of principal (whether permanent or temporary).

when considering whether the instrument makes a recapitalisation more likely, CEBS is of the opinion that the hybrid would need to strike a balance between the hybrid holders’ rights and those of the potential new shareholders. Possible mechanisms proposed were, again, a permanent write down of principal or a temporary write down of principal, in each case to a meaningful extent (i.e. at least *pari passu* with shareholders, although there is no explanation from CEBS as to how a share can be “written down” in a meaningful way) or a conversion into an equity instrument.

CEBS envisages that one or a combination of these mechanisms could be approved by a relevant competent authority. It intends that the mechanism should take effect immediately after losses cause a significant deterioration of the institution’s financial condition or solvency, and before the share capital is exhausted. This should mean in practice that the trigger point would occur when losses have significantly reduced retained earnings and other reserves, but before the institution has breached any required solvency level.

- as to the features of hybrids that are eligible beyond the 35% limit (as to which see the attached diagram), CEBS considered the details of the necessary convertibility feature.

CEBS considers that there must be a mandatory conversion into equity at least in the event of a breach by the institution of its required capital ratio, and perhaps also in other “emergency situations.” In addition, the competent authority would have an option to trigger conversion of the hybrid if necessary, having regard to its financial condition and solvency, in other words applying the same considerations as it would in connection with an approval to call/redeem a hybrid instrument or a cancellation of coupons.

We now await the publication of the results from the feedback to the CEBS consultation and any proposed refinements by the CEBS of these guidelines for national bank supervisors.

## 2. International agreement on the framework for reforms

The G20 Leaders’ Statement at the Pittsburgh Summit, 24<sup>th</sup>-25<sup>th</sup> September 2009<sup>4</sup> represented a broad international consensus on the recommended regulatory approaches to the recovery and reform of the global financial system. Building on the G20 Communiqué at the Meeting of Finance Ministers and Central Bank Governors in London on 4<sup>th</sup>-5<sup>th</sup> September 2009<sup>5</sup>, the Leaders’ Statement placed stronger capital standards (and mitigation of procyclicality) at the heart of its “multi-faceted reform” of the financial system involving stronger capital requirements and liquidity standards, counter-cyclical capital and liquidity buffers, higher capital requirements for risky products and off-balance sheet activities, forward-looking provisioning as part of the revised Basel II framework supplemented by the introduction of a leverage ratio as well as improved supervision and regulation of the financial sector with greater cross-border coordination.

As part of the G20 Summit, the Group of Central Bank Governors and Heads of Supervision, the oversight body of the BCBS, agreed that BCBS should issue concrete proposals by the end of 2009 to:

- 1) raise “the quality, consistency and transparency of Tier 1 capital,” with the predominant form being common shares and retained earnings;
- 2) introduce a leverage ratio as a supplementary measure to the Basel II framework, with details of the leverage ratio being harmonised internationally to adjust for differences in accounting; and
- 3) introduce a framework for counter-cyclical capital buffers above the minimum requirement – the framework to include capital conservation measures such as constraints on capital distributions.

In addition to the ongoing work above, the BCBS has already issued final standards to raise capital requirements for the trading book, re-securitisations and the treatment of liquidity lines to asset-backed commercial paper conduits, as a result of which average trading book capital requirements for the major international banks are expected to more than double by the end of 2010, in addition to the higher charges for securitisations that will be applied to the trading book.

The Financial Stability Board (FSB) of the G20<sup>6</sup> supports the revision of the Basel II framework undertaken by the BCBS. The FSB will specifically examine “the use of ‘contingent capital’ and comparable instruments as a potentially cost-efficient tool to constitute a portion of the capital buffer in a form that acts as debt during normal

<sup>4</sup> G20’s The Pittsburgh Summit: Leaders’ Statement (24<sup>th</sup>–25<sup>th</sup> September 2009), <http://www.pittsburghsummit.gov/mediacenter/129639.htm>

<sup>5</sup> G20 Communiqué of the Meeting of Finance Ministers and Central Bank Governors: “Declaration on Further Steps to Strengthen the International Financial System” (London, 4<sup>th</sup>-5<sup>th</sup> September 2009), [http://www.g20.org/Documents/FM\\_CBG\\_Comm\\_-\\_Final.pdf](http://www.g20.org/Documents/FM_CBG_Comm_-_Final.pdf)

<sup>6</sup> FSB is a policy arm of the G20 comprised of central bankers and financial regulators, and was formerly known as the Financial Stability Forum (FSF).

times but converts to loss-absorbing capital, i.e., equity during financial stress, thus acting as a shock absorber for the capital position.”<sup>7</sup>

### 3. UK FSA’s approach to capital, liquidity and leverage

Where possible, the FSA has taken unilateral steps to introduce amendments to its rules on capital and liquidity, ahead of the EU and BCBS, to address the problems highlighted by the banking crisis. Some of the new FSA rules may have to be re-examined and recalibrated in due course as the UK is bound by the amendments to the EU amendments to the CRD as well as the BCBS revisions to the Basel II framework, and the FSA will need to comply with the guidelines of the CEBS, when finalised.

On 19<sup>th</sup> January 2009, as the UK Government launched successive bank recapitalisation and other support (or rescue) measures, the FSA issued a statement<sup>8</sup> clarifying its regulatory approach to bank capital requirements. It would allow banks, as a way to counteract the ‘procyclical’ effects of Basel II capital framework, to measure the credit risks on their loan portfolios on a ‘through the cycle’ basis rather than a ‘point in time’ basis and to reduce their Tier 1 capital and Core Tier 1 capital during an economic downturn to 6-7% and 4%, respectively, of their risk-adjusted assets.

In October 2009, the FSA also finalised its overhaul of the UK liquidity regime and introduced new requirements with which firms must comply by January 2010. These included “lengthening their wholesale funding profile, shrinking their balance sheets and/or increasing their buffers of liquid assets”.<sup>9</sup>

On 18<sup>th</sup> March 2009 the FSA’s Turner Review and DP09/2: A Regulatory response to the Global Banking Crisis” (both dated 18<sup>th</sup> March 2009) included the following proposals relating to capital and liquidity requirements of banks.

- Capital adequacy: The Basel II capital framework should be reviewed and enhanced in light of the “severe systemic financial crisis”. The revised rules should include:
  - an internationally agreed minimum capital ratio;
  - a requirement for firms using the internal ratings based (IRB) approach to use the supervisory formula approach to derive an ‘effective’ risk weight for unrated exposures and/or supervisory review of the risk weights attached to credit rating agencies’ ratings;
  - for systemically important banks, (i) a greater “going concern” approach and (ii) stronger capital standards (in both quantity and quality) with loss-absorbing ability;
  - (similar to existing EU state aid rules) the imposition of “(income statement) net loss coupon deferral triggers” (a “burden sharing” concept) to banks receiving government support, which prevents them

<sup>7</sup> FSB Report to G20 Leaders: “Overview of progress on implementing London Summit recommendations on strengthening financial stability” (25<sup>th</sup> September 2009), [http://www.financialstabilityboard.org/publications/r\\_090925a.pdf](http://www.financialstabilityboard.org/publications/r_090925a.pdf). See also FSB press release (25<sup>th</sup> September 2009), [http://www.financialstabilityboard.org/press/pr\\_090925a.pdf](http://www.financialstabilityboard.org/press/pr_090925a.pdf); FSB Report to G20 Leaders: “Policy measures for improving financial regulation” (25<sup>th</sup> September 2009), [http://www.financialstabilityboard.org/publications/r\\_090925b.pdf?noframes=1](http://www.financialstabilityboard.org/publications/r_090925b.pdf?noframes=1).

<sup>8</sup> FSA Statement on Regulatory Approach to Bank Capital dated 19<sup>th</sup> January 2009, [http://www.hm-treasury.gov.uk/press\\_05\\_09.htm](http://www.hm-treasury.gov.uk/press_05_09.htm). See also, FSA Statement on Capital Approach Utilised in UK Bank Recapitalisation Package (14<sup>th</sup> November 2008), <http://www.fsa.gov.uk/pages/Library/Communication/Statements/2008/capapp.shtml>

<sup>9</sup> FSA Policy Statement PS09/16: “Strengthening Liquidity Standards, including feedback on CP08/22, CP09/13, CP09/14” (5<sup>th</sup> October 2009), [http://www.fsa.gov.uk/pubs/policy/ps09\\_16.pdf](http://www.fsa.gov.uk/pubs/policy/ps09_16.pdf). See also, CP08/22: Strengthening Liquidity Standards (4<sup>th</sup> Dec. 2008), [http://www.fsa.gov.uk/pubs/cp/cp08\\_22.pdf](http://www.fsa.gov.uk/pubs/cp/cp08_22.pdf); CP09/13: Strengthening Liquidity Standards 2: Liquidity reporting (15<sup>th</sup> April 2009), [http://www.fsa.gov.uk/pubs/cp/cp09\\_13.pdf](http://www.fsa.gov.uk/pubs/cp/cp09_13.pdf); CP09/14: Strengthening Liquidity Standards 3: Liquidity transitional measures (5<sup>th</sup> June 2009), [http://www.fsa.gov.uk/pubs/cp/cp09\\_14.pdf](http://www.fsa.gov.uk/pubs/cp/cp09_14.pdf).

from making any coupons or dividends payment and any share buy-backs where net profits are insufficient to pay them on *pari passu* securities;

- a requirement of capital buffers (or reserves) to mitigate pro-cyclicality, e.g., 2-3% of risk weighted assets, on top of minimum capital requirements; and
  - increased capital requirements for trading book assets “to capture the credit risk of complex trading activities” and a related reassessment of the Value at Risk (VaR) model.
- Hybrids: Regulatory treatment should be re-examined in the context of CRD amendments – e.g., mechanisms such as step-ups and stock cumulative coupons are considered to weaken permanence and loss absorbency.
  - Liquidity: FSA’s new liquidity rules should be implemented from January 2010, consisting of easily disposable assets (e.g., cash, deposits, govt. bonds, covered bonds).
  - Leverage and funding: There should be a maximum Gross Leverage Ratio (GLR) to complement Basel II, as well as a minimum Core Funding Ratio (CFR) to ensure that banks’ assets are supported by stable funding sources (such as retail deposits and long-term borrowings).

According to the FSA’s recent Feedback Statement (FS09/3) dated 30<sup>th</sup> September 2009<sup>10</sup> on The Turner Review and DP09/2, hybrids (‘innovative’/ non-Core Tier 1 capital) must be “capable of supporting Core Tier 1 capital by means of a conversion or write-down mechanism at an appropriate trigger” and that such instruments could be regarded as a form of “contingent Core Tier 1 capital.” However, the FSA indicated that further international work must be undertaken on the potential role of “contingent capital” before reaching any conclusion.

The FSA also states in FS09/3 that it intends to devote its immediate attention to the following wider regulatory undertakings with a view to re-examining its own rules on capital adequacy:

- the BCBS’s ongoing revision of the definition of “capital,” including their proposals on the “quality, consistency and transparency of the Tier 1 capital base,” which are expected to be issued by the end of 2009 and followed by an impact assessment in 2010; and
- the EU’s amendments to the CRD on the regulatory treatment of “hybrid capital instruments,” with a view to publicly consulting later this year.

A key conclusion of The Turner Review had been that, once economic recovery is assured, the banking sector should be subjected to stronger capital and liquidity requirements. FSA supports the ongoing work of the BCBS, being the “main forum for agreeing global capital standards” leading to concrete proposals which are anticipated before the end of 2009 to:

- strengthen the quality of bank capital;
- build-up counter-cyclical buffers that can be drawn down in periods of stress; and

<sup>10</sup> FSA Feedback Statement FS09/3: The Turner Review and DP09/2 (30<sup>th</sup> September 2009), [http://www.fsa.gov.uk/pubs/discussion/fs09\\_03.pdf](http://www.fsa.gov.uk/pubs/discussion/fs09_03.pdf). See also, Turner Review: A regulatory response to the global banking crisis (18<sup>th</sup> March 2009), [http://www.fsa.gov.uk/pubs/other/turner\\_review.pdf](http://www.fsa.gov.uk/pubs/other/turner_review.pdf); FSA Discussion Paper 09/2: “A regulatory response to the global banking crisis” (18<sup>th</sup> March 2009), [http://www.fsa.gov.uk/pubs/discussion/dp09\\_02.pdf](http://www.fsa.gov.uk/pubs/discussion/dp09_02.pdf)

- introduce a leverage ratio as a backstop to Basel II.”<sup>11</sup>

On 3<sup>rd</sup> November 2009, the HM Treasury announced<sup>12</sup> that Royal Bank of Scotland (RBS) and Lloyds Banking Group (“Lloyds”), both recipients of substantial capital injections from the UK government in the form of preference shares, will be offering to holders of subordinated debt, contingent convertibles (“CoCos”)/mandatory convertible notes (MCNs), to raise capital in the private sector and reduce their exposure to the UK Government’s Asset Protection Scheme (APS).<sup>13</sup>

The day before the Treaty announcement, the FSA Chairman Lord Turner had said in a speech at the Turner Review Conference on the problem of ‘too-big-to-fail’ banks, banks may have “to accept that debt capital has little or no role in the required capital of large systemically important banks.” Alternatively, they may “create a role for contingent capital, debt capital which will without doubt convert to equity if the equity ratio falls below a predefined level – effectively defining in advance the terms of a debt-to-equity swap.”<sup>14</sup>

### Next Stop, Harmonisation

Europe has taken great steps towards its goal of defining the quality and quantity of bank capital, but the world awaits the proposals of the BCBS flowing from the latest G20 Summit. Harmonisation is essential to ensure a level playing field across the globe for the capital raising efforts of banks. Therefore, further amendments to the Capital Requirements Directive are likely in the future in the push towards harmonisation of global adequacy capital standards. Given the likely scale of the new capital needed by the world’s banks over the coming years, such harmonisation cannot arrive too soon.

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*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*

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<sup>11</sup> Id.

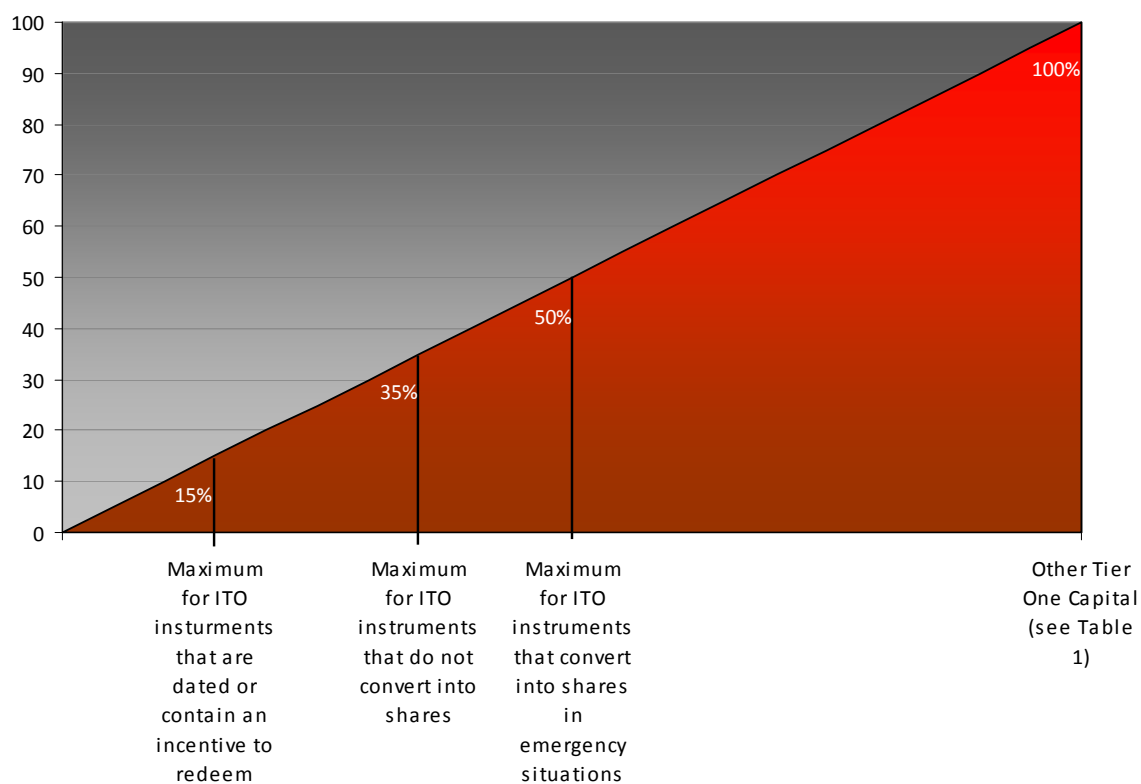
<sup>12</sup> HM Treasury press notice: Implementation of Financial Stability Measures for Lloyds Banking Group and Royal Bank of Scotland (3<sup>rd</sup> November 2009), [http://www.hm-treasury.gov.uk/press\\_99\\_09.htm](http://www.hm-treasury.gov.uk/press_99_09.htm)

<sup>13</sup> Under EU state aid rules the European Commission has granted approval to national support schemes on condition of the banks not paying dividends or coupons on Core Tier 1 capital instruments.

<sup>14</sup> Speech by Adair Turner, FSA Chairman, “Large systemically important banks: addressing the too-big-to-fail problem” at the Turner Review Conference: Progress towards global regulatory reform (2<sup>nd</sup> November 2009), [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/1102\\_at.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/1102_at.shtml)

**Appendix A**

**CRD Limitations on Proportions of Innovative Tier One Instruments**



**Appendix B****CRD Requirements as to Properties of Innovative Tier One Instruments (“ITO’s”)**

<b>Redemption/ Maturity</b>	Perpetual, or with maturity of at least 30 years. May be redeemed only with consent of relevant regulator. Competent authority may permit earlier redemption in ease of an unforeseen change of regulatory classification.
<b>Call Option Permitted</b>	Yes, but may not be exercised earlier than 5 years after issuance (or if the terms provide for a step-up or other incentive to redeem, incentive may not become effective before 10 years after issuance). Call can only be exercised with consent of relevant regulator.
<b>Coupons</b>	Non-cumulative only and able to be cancelled, on a non-cumulative basis, by issuer at any time
<b>Alternative Coupon Settlement</b>	Coupon may be satisfied by distribution of common stock in lieu (question whether or not the in-kind distribution can be monetised prior to distribution to holder of ITO’s)
<b>Incentives to Redeem Permitted</b>	Incentives such as interest rate step-up are permitted for perpetual securities if they are “moderate”, (which according to the CEBS means they do not exceed 100 basis points <sup>15</sup> or 50% of the initial credit spread <sup>15</sup> and only one step-up is permitted during the life of the ITO’s), and may not become effective earlier than 10 years after the ITO issuance. A principal stock settlement mechanism is also permitted if the conversion ratio does not exceed 150% of the conversion ratio at the issue date of the ITO’s.
<b>Ranking on Bankruptcy or Liquidation</b>	Subordinate to all non-subordinated creditors
<b>Other Material Features</b>	The terms of the ITO’s must provide for principal, interest and dividends to be such as to absorb losses and not hinder re-capitalisation of the ITO issuer

<sup>15</sup> Less the swap spread between the initial index basis and the stepped up index basis.

**Appendix C****Regulatory Capital: Timeline of Anticipated Developments**

	<b>Anticipated Development</b>
By end of 2011	<ul style="list-style-type: none"> <li>▪ European Commission to report to European Parliament &amp; Council on proposals to further enhance quality of “original own funds”</li> <li>▪ US to implement the Basel II capital framework in full</li> </ul>
By end of 2010	<ul style="list-style-type: none"> <li>▪ EU member states to implement the amending directives of the Capital Requirements Directive</li> <li>▪ CEBS to develop joint risk assessment process for Pillar II (supervisory review) of the Basel II capital framework</li> <li>▪ Planned implementation date of revised Basel II rules</li> </ul>
1 <sup>st</sup> Feb. 2010	Feedback deadline for FSA DP09/4: Turner Review Conference Discussion Paper: “Systemically important banks and assessing the cumulative impact” (22 <sup>nd</sup> Oct. 2009)
1 <sup>st</sup> Jan. 2010	UK FSA’s new liquidity rules to be implemented by FSA-regulated firms
Late 2009/ early 2010	<ul style="list-style-type: none"> <li>▪ Possible announcements by the European Commission on further proposed amendments to CRD relating to: <ul style="list-style-type: none"> <li>(i) capital requirements for the trading book &amp; re-securitisations, disclosure of securitisation exposures and remuneration policies;</li> <li>(ii) through-the-cycle expected loss provisioning; specific incremental capital requirements for residential mortgages denominated in a foreign currency; and the removal of national options and discretions</li> </ul> </li> <li>▪ Possible implementation guidelines by CEBS on (i) hybrid capital instruments and (ii) large exposures under the amended CRD</li> </ul>
By end of 2009	<ul style="list-style-type: none"> <li>▪ BCBS to publish concrete proposals on enhancements to Basel II, with impact assessment in early 2010 &amp; finalisation of new rules by end of 2010</li> <li>▪ European Commission (in consultation with the CEBS) to announce further proposed amendments to CRD, including potential increase of the minimum retention requirement for securitisations [CRD Art.122a]</li> </ul>