Contingent Capital Transactions: Will They Work Here?

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Panelists

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Background

- Because raising equity capital is expensive, banks search for funding alternatives to raise capital-equivalent securities.

- Typically these capital-equivalent securities have been subordinated, long-term debt, sometimes involving a conversion feature, that give rise to Tier 1 Capital for regulatory purposes.

- Ideally, such securities can be treated as debt for tax purposes.

Trust Preferred

- In a typical trust preferred arrangement, a bank raises cash by issuing debt to a trust or partnership, which in turn issues preferred securities to investors. *See* Notices 94-47 & 94-48; CCA 200932049 (March 10, 2009); TAM 199910046 (November 16, 1998).

- In 1992, regulatory changes were announced which allowed certain non-bank entities to use trust preferred securities as Tier 1 Capital.

- In 1996, further regulatory changes allowed trust preferred securities to be counted as Tier 1 Capital for banks.

Trust Preferred Securities – Common Terms

- Long maturities – 49 to 80 yrs.

- Optional deferral of interest – 5 to 12 yrs.

- Mandatory deferral of interest – 10 to 12 yrs.

- Replacement Covenants

- Interest Caps

Trust Preferred Securities – Historic Advantages

- Debt treatment for Federal income tax purposes – interest deduction

- Tier 1 Capital treatment for banks

- Equity credit for rating agency purposes (50% - 75% equity credit)

CCA 200932049

- In a 2009 memorandum, the IRS addressed the debt/equity characterization of trust preferred securities with strong equity characteristics, including a distant maturity date and the ability to defer payments for prolonged periods of time.

CCA 200932049 (cont'd)

- A well-capitalized company with a longstanding business and lengthy history of paying dividends created a trust to issue preferred securities.
- All the proceeds from the sale of the preferred securities were invested in notes issued by the company.
- The trust is a grantor trust and the holders of the notes are treated as holding undivided interests in the notes.
- The notes have a long maturity date, and the company has the right to redeem the notes before maturity.
- The company can defer payments of interest on the notes and there are limitations on the sources from which deferred payments can be made.

CCA 200932049 (cont'd)

- The IRS analyzed the rights provided under the notes as supplemented by the preferred securities to determine if they were debt or equity.

- In considering the terms of the notes and preferred securities, the IRS took into account the sound capitalization and past practices of the company.

- Given the financial strength of the company, the IRS did not find the long maturity date to be a decisive factor.

- The IRS found the risks of deferral of interest payments to be remote.

- Based on these conclusions, the IRS recommended that the company's debt characterization should not be challenged.

Dodd-Frank Legislation –

Impact on Trust Preferred Securities

Background

- The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") was signed into law on July 21, 2010.

- The Act makes significant changes to the ability of bank and thrift holding companies to issue trust preferred securities and to treat them as Tier 1 Capital.

Section 171 of the Act

- Trust preferred securities issued on or after May 19, 2010, will not be eligible for Tier 1 Capital treatment.

- Trust preferred securities issued before May 19, 2010, will be phased out as Tier 1 Capital incrementally over a 3-year period, starting on January 1, 2013.

- Grandfather provision for securities that were issued by smaller institutions before May 19, 2010

  - Bank and thrift holding companies with total consolidated assets of less than $15 billion as of December 31, 2009, will be permitted to include trust preferred securities in Tier 1 Capital for the life of the securities.

Summary

- Various effective dates and exemptions exist, including others not discussed today.

- The Act requires the Financial Stability Oversight Council to study the feasibility of contingent capital and to report to the Federal Reserve Board within a few years of the Act.

- If Congress acts to authorize contingent capital securities, practitioners hope it will also address the tax consequences applicable to them at that time.

Basel Committee on Banking Supervision –
Basel III Proposals

Basel III Proposals – Minimum Capital Requirements

- Tier 1 Capital must be at least 6% of risk-weighted assets.
- Tier 1 Capital consists of Common Equity Tier 1 and Additional Tier 1.
- Common Equity Tier 1 must be at least 4.5% of risk-weighted assets. Additional Tier 1 can include up to 1.5% of risk-weighted assets.
- Criteria for inclusion as Additional Tier 1 include CoCo-like loss absorption features in a perpetual, subordinated instrument.
- Certain global banks (G-SIFIs) will be required to maintain an additional 1% to 2.5% of Common Equity Tier 1.
- See also Capital Conservation and Counter-cyclical Buffers.

Contingent Capital Securities (CoCos)

Background

- Issued in recent years in Europe by Lloyds Banking Group, Rabobank Group, Yorkshire Building Society, Credit Suisse, and Bank of Cyprus.

- Structured as relatively short-term corporate bonds, paying coupon interest .

- Convertible into equity of the issuer when certain triggers are breached. Conversion could be mandatory or at the option of the issuer.

- The triggers are tied to the sufficiency of the issuer's equity capital ratio.

- CoCos have the downside of equities and the upside of bonds.

Advantages of CoCos

- Automatically increases capital and reduces debt of a distressed financial institution. Raises capital in conditions when other sources of funds are unavailable because shareholders will not agree to dilute their equity by share issuance or by fire sales. This could limit contagion during systemic stress.

- Would prevent market failure by providing another buffer before a bank default.

- The threat of losses from conversion and dilution would limit risk taking by managers, shareholders, and bondholders.

- Requiring bondholders to partner in a future recapitalization would motivate them to encourage managers to exercise financial discipline.

- Paying manager bonuses in CoCos would internalize externalities in some risky behavior.

CoCo Triggers

The triggers that would require conversion of the CoCos into equity are the key to the new financial structure.

- "High"-level triggers would require conversion of notes if a bank's financial condition deteriorated but was not close to collapse, as a form of crisis prevention.

- "Low"-level triggers would require conversion of notes if a bank is in true distress. Both carry the same risk as hybrid capital – forcing an institution into a humiliating cliff-fall which would be expected to spiral into a market crisis. The cliff effect of the trigger would be counter-productive in a culture driven by panics and a herd mentality.

- Triggers could be based on national financial criteria as well as on an individual institution's condition.

- How objective should the triggers be? The Basel committee proposed that the triggers should be within the regulator's discretion. But such subjectivity would make it difficult to price and sell CoCos.

Lloyds Bank Issuance

Enhanced Capital Notes

Issue date	November 2009 (various tranches)
Form	Debt, some registered and some in bearer form
Term	Various tranches, most with fixed maturity dates, though the Prospectus contemplates "Undated ECNs" that are perpetual
Interest rate	Various
Conversion	Automatic
Conversion Trigger	Consolidated Core Tier 1 Ratio < 5%
Conversion Amount	Convertible into stock equal to approx. 65% of ECN principal amount (thus, hypothetical conversion after issuance would have yielded approx. 150% of principal amount)
U.S. Tax Characterization	Issuer "believes" ECNs "should" be characterized as equity – disclosure for general informational only because ECNs not registered in the U.S.

Rabobank Issuance

	Senior Contingent Notes
Issue date	March 17, 2010
Form	Debt
Term	10 years
Interest rate	6.875% p.a.
Write -down	Automatic
Trigger Event	Equity Capital Ratio < 7% (ECR was 12.5% as of 12/31/2009)
Write-down Amount	Principal permanently reduced to 25% of original principal amount
U.S. Tax Characterization	No U.S. tax disclosure provided

Yorkshire Building Society Issuance

	Convertible Tier 2 Capital Notes
Issue date	April 1, 2010
Form	Debt
Term	15 years
Interest rate	13.35% p.a.
Conversion	Automatic
Conversion Trigger	Consolidated Core Tier 1 Ratio < 5%
Conversion Amount	Convertible into Profit Participating Deferred Shares with a nominal amount equal to the principal amount of the Notes
U.S. Tax Characterization	No U.S. tax disclosure provided

Credit Suisse Issuance

<u>Tier 2 Buffer Capital Notes</u>

Issue date	February 22, 2011
Form	Debt
Term	30 years
Interest rate	7.875% p.a. reset every 5 years
Conversion	Automatic
Conversion Trigger	Common Equity Tier 1 Ratio < 7% or a viability event
Conversion Amount	Convertible into ordinary shares
U.S. Tax Characterization	No U.S. tax disclosure provided

Bank of Cyprus Issuance

	Convertible Enhanced Capital Securities
Issue date	April 5, 2011
Form	Debt
Term	Perpetual
Interest rate	6.5% p.a. for 5 yrs., at a floating rate thereafter
Conversion	Automatic
Conversion Trigger	Common Equity Tier 1 Ratio < 5% or a viability event
Conversion Amount	Convertible into ordinary shares
U.S. Tax Characterization	No U.S. tax disclosure provided

U.S. Tax Issues

Debt vs. Equity

– No fixed right to a sum certain if conversion is into a fixed number of shares, but is this fatal?

- Remote contingencies generally disregarded, but this contingency deprives investors of creditor's rights when they would most want to have them.

- High likelihood of repayment can result in nominally contingent amount owed being treated as a fixed right to a sum (virtually) certain. *Schering-Plough Corp. v. United* States, 651 F. Supp.2d 219 (D. N.J. 2009), *aff'd sub nom., Merck & Co. Inc. v. United States,* 652 F.3d 475 (3rd Cir. 2011).

Debt vs. Equity (cont'd)

- Surplus notes issued by life insurance companies have been approved as debt.

  - *Harlan v. United States,* 409 F.2d 904 (5th Cir. 1969); *Jones v. United States,* 659 F.2d 618 (5th Cir. 1981); *Anchor National Life Insurance Co. v. Commissioner,* 93 T.C. 34 (1989); 1996 FSA LEXIS 583.

Section 163(l)

- No deduction for interest allowed with respect to a "disqualified debt instrument."

- A disqualified debt instrument is any debt of a corporation that is payable in equity of the issuer or a related party or equity held by the issuer (or any related party) in any other person.

Section 163(l) (cont'd)

- Debt is payable in equity for purposes of section 163(l) if:
    - A substantial amount of the principal or interest is required to be paid or converted ,or at the option of the issuer or a related party is payable in, or converted into, such equity;
    - A substantial amount of the principal or interest is required to be determined, or at the option of the issuer or a related party, is determined, by reference to the value of such equity; <u>or</u>
    - The debt is part of an arrangement that is reasonably expected to result in a transaction described above.
- Section 163(l) generally does not apply to conventional convertible debt provided that the holder's right to convert is not substantially certain to be exercised.
- Are contingent capital securities "reasonably expected" to be paid in equity? It would seem they are not.

Section108(e)(8)

- For COD purposes, debt paid with stock is treated as having been satisfied for cash equal to the fair market value of the stock.

- This may result in COD income to the debtor when a trigger event occurs because the contingent capital security will be converted into equity (whether automatic or optional).

Possible Contingent Capital Variation

- If and when a trigger event occurs, the debt could convert into stock having a value equal to the principal amount of the debt.
- Would this result in the holder having an unconditional right to a "sum certain?" *See* Rev. Rul. 85-119.
- This would avoid the COD issue.
- Not clear issuers would have a high enough degree of tax certainty unless the IRS rules favorably or legislation is passed.
- Would banks accept the dilutive effect on their stock?

Contingent Re-Convertibles

- Another variety of contingent capital securities reportedly being considered in the market
- These instruments, sometimes called Re-CoCos, involve step-up and step-down features
- Bond steps down in the event the issuer's equity capital ratio falls below a predetermined level
- Bond steps up if issuer's equity capital ratio recovers to a predetermined level
- Unlike CoCos, Re-CoCos have the upside and downside of equity

Tax Treatment of CoCos Worldwide

- UK
- Canada
- Netherlands
- Germany
- France
- Italy
- Switzerland
- Luxembourg