Contingent Capital:
The Development of a New Asset Class

The Credit Crunch for 2007-09 has had a devastating effect on banks throughout the world, much to the chagrin of the regulators who were entrusted with the task of ensuring that bankers' exuberance in good times did not lead them to over-reach. The response of governments has been unprecedented, with direct investments[1] [2] and guarantees being required to stave off financial collapse.

There is broad agreement that the proportion of common equity in bank capitalization should increase - the Group of Central Bank Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, announced on September 7[3] that they had agreed to "raise the quality, consistency and transparency of the Tier 1 capital base. The predominant form of Tier 1 capital must be common shares and retained earnings." The IMF estimates[4] that approximately $670-billion in share capital will be required if the leverage ratio (Tangible Common Equity / Tangible Assets) is to meet its targets.

Non-equity Capital

A growing regulatory distaste for non-equity forms of capital (preferred shares, Innovative Tier 1 Capital and Subordinated Debt) led S&P to downgrade a wide swath of European banks' hybrid capital on March 31, 2009[5], with Moody's[6] and DBRS[7] applying the rationale to Canadian banks' hybrid capital at the end of June.

The regulatory distaste took concrete form at the European Commission in July 2009, when they stated[8] "*the discretionary offset of losses (for example by releasing reserves or reducing equity) by beneficiary banks in order to guarantee the payment of dividends and*

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[1] US Treasury, *Troubled Assets Relief Program, Transactions Report for Period Ending October 30, 2009,* available on-line at http://www.financialstability.gov/docs/transaction-reports/11-3-09%20Transactions%20Report%20as%20of%2010-30-09.pdf (accessed 2009-11-6) Quoted figure includes $70-billion to AIG under "SYSTEMICALLY SIGNIFICANT FAILING INSTITUTIONS"

[2] The Chancellor of the Exchequer, *Reforming Financial Markets,* July 2009, available on-line at http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf (accessed 2009-11-6)

[3] Bank for International Settlements, *Comprehensive response to the global banking crisis,* 2009-9-7, available on-line at http://www.bis.org/press/p090907.htm (accessed 2009-11-6)

[4] International Monetary Fund, *Global Financial Stability Report, October 2009,* "GSFR-0910" available on-line at http://www.imf.org/External/Pubs/FT/GFSR/2009/02/pdf/text.pdf (accessed 2009-11-6)

[5] Standard & Poor's press release, 2009-3-31, no longer available on-line, discussed at http://www.prefblog.com/?p=6104 (accessed 2009-11-6)

[6] Moody's, *Comment on Canadian Bank Subordinated Capital,* 2009-6-30, available on-line at http://www.moodys.com/cust/loadhighlight.asp?documentid=1506900000008431&original=1&redir_url=/cust/loadhighlight.asp&bhcp=1 (accessed 2009-11-6)

[7] Dominion Bond Rating Service, *DBRS Downgrades Canadian Banks' Preferred Shares and Tier 1 Innovative Instrument Ratings,* 2009-6-29, available on-line at http://www.dbrs.com/research/229439/dbrs-downgrades-canadian-banks-preferred-shares-and-tier-1-innovative-instrument-ratings.pdf (accessed 2009-11-6)

[8] Commission Communication, 2009-7-22, available on-line at http://ec.europa.eu/competition/state_aid/legislation/restructuring_paper_en.pdf (accessed 2009-11-6)

coupons on outstanding subordinated debt, is in principle not compatible with the objective of burden sharing" and were given force when Northern Rock[9] and KBC[10], among others, were forced to impose a coupon deferral to the greatest extent possible as a condition of their bail-outs.

Burden-sharing may also be accomplished by issuer repurchases at sub-par prices. Over one-hundred issues have been repurchased or exchanged in this manner, with the total gain to the issuers being in excess of €11-billion.[11] However, regulators have not failed to notice that although the book profit from these transactions is incorporated into retained earnings, there is still cash leaving the firm, and are urging that there be greater use of exchange offers into more junior forms of bank capital.[12]

A highly successful instance of such an exchange was the Citigroup exchange of its preferred shares and some subordinated debt into common shares. For example, the 6.875% E-TruPS were issued on June 30, 2006[13] and later listed on the NYSE under the symbol CPRO. These were 60-year notes, callable at par after 5 years, issued at $25 when Citigroup common was trading[14] at about $48. CPRO set a low of $2.60 – about one-tenth of issue price – in the first quarter of 2009. Under the terms of Citigroup's exchange offer[15], each CPRO could be exchanged for 7.30769 shares of Citigroup, implying an effective conversion price of $3.42, less than one-tenth of the common's price on the issue date of the sub-debt. Citigroup closed at $3.02 on the date of the exchange offering, implying that holders of these subordinated notes had lost approximately 12% of the principal invested – but common shareholders had lost about 94%.

This is the type of burden sharing that regulators are seeking to encourage; but the process should be formalized in order to reduce the uncertainty that has proved so destructive to the capital markets over the past few years.

Contingent Capital

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[9] Neil Unmack, Reuters, *Reality arrives at The Rock,* 2009-8-18, available on-line at http://blogs.reuters.com/commentaries/2009/08/18/reality-arrives-at-the-rock/ (accessed 2009-11-6)

[10] KBC, Press Release, *KBC to clarify suspension of coupon payment on outstanding KBC Bank 525 million GBP hybrid Tier-1 issue,* 2009-8-11, available on-line at https://multimediafiles.kbcgroup.eu/ng/published/KBCCOM/PDF/COM_RVG_pdf_KBC_to_clarify_suspension_of_coupon_payment_11_08_2009.pdf (accessed 2009-11-6)

[11] Ben Katz, Barclays Capital, presentation at the London Financial Regulation Conference, 2009-7-2, *How to revitalize the Financial System – Raising additional Capital,* available on-line at http://fmg.lse.ac.uk/upload_file/1268_Ben%20Katz.pdf (accessed 2009-11-6)

[12] See GFSR-0910, above.

[13] SEC Document, available on-line at http://www.sec.gov/Archives/edgar/data/1366727/000095012306008128/y22500fpfwp.txt (accessed 2009-11-6)

[14] Citigroup *Historical Price Lookup* available on-line at http://www.citigroup.com/citi/fin/index.htm (accessed 2009-11-6)

[15] Citigroup, *Offers to Exchange,* 2009-7-17 available on-line at http://www.citigroup.com/citi/fin/data/prosp090717.pdf?ieNocache=906 (accessed 2009-11-6)

Elements of a corporation's capitalization that have some degree of seniority but which may be converted into more junior elements, are referred to as Contingent Capital. Regulatory impetus for the formalization of contingent capital has been growing in recent months, with the US Treasury musing[16] about the possibility of "requiring some banking firms … to issue, appropriately designed contingent capital instruments – including (i) long-term debt instruments that convert to equity capital in stressed conditions" They were quick to note the problems, however: "The feasibility of contingent capital instruments, however, remains uncertain. The challenges of contingent capital include, among others, devising the right trigger event for conversion and designing an instrument that will be marketable by banking firms at a reasonable cost."

HM Treasury suggests[17] "One solution would be to make some of the debt (perhaps the subordinated debt tranche only) convertible into equity in the event of a systemic crisis and on the authority of the financial regulator"; the idea also received support from Canada's Office of the Superintendent of Financial Institutions in a speech by Julie Dickson.[18]

Advisors will be interested in new types of investments, but two important structural issues must be addressed

- The Trigger: under what circumstances will the conversion of the more senior instrument into common equity become mandatory?
- The Price: what will be the terms of the conversion?

The Conversion Trigger

There are various proposals for the trigger. The original conception[19] by Prof. Mark J. Flannery of the University of Florida proposes that banks be required to finance 5% of their assets with contingent capital and that the market value of their common equity be a minimum of 8% of their assets. The conversion trigger is a decline in the market value of their equity to below 8%, at which point sufficient contingent capital is converted in order to top it up, with replacement contingent capital to be issued shortly thereafter.

The major problem with the proposal trigger is regulatory dependence upon market values. Events of the past two years have provided ample evidence that market values can decline in a manner virtually unrelated to any calculation of intrinsic value, and that healthy institutions can see their equity price decline precipitously for no other reason

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[16] US Treasury, *Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms,* 2009-9-3, available on-line at http://www.treas.gov/press/releases/docs/capital-statement_090309.pdf (accessed 2009-11-6)

[17] HM Treasury, *Reforming financial markets,* July 2009, available on-line at http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf (accessed 2009-11-6)

[18] OFSI, *Remarks by Superintendent Julie Dickson to the C.D.Howe Institute Policy Roundtable Luncheon,* 2009-10-28, available on-line at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/speeches/JD_CDHI_e.pdf (accessed 2009-11-6)

[19] Mark J. Flannery, *No Pain, No Gain? Effecting Market Discipline via "Reverse Convertible Debentures",* November, 2002, available on-line at http://bear.cba.ufl.edu/flannery/No%20Pain,%20No%20Gain.pdf (accessed 2009-11-9)

than the existence of, shall we say, less healthy institutions. Additionally, the ability of management to make cosmetic adjustments to the stated balance sheet, together with the problems inherent in comparing book values to market values, provides a measure of uncertainty for investors with respect to the potential for conversion – and uncertainty, as we have seen, may rapidly become crippling in a crisis. As well, it is possible that the conversion may reinforce an equity market decline and make it harder for the institution to issue share capital directly.

The Squam Lake Working Group (SLWG), a highly distinguished collection of academics, has proposed[20] a double trigger for conversion, the first being a declaration by regulators that a systemic crisis exists, the second being determined by the covenants of the particular issue (one possibility being the breaching of extant regulatory ratios). The first of these triggers, the declaration by regulators, will introduce even more uncertainty amongst investors in crisis conditions, as the value of the investment in its initial state may be wildly different from its converted value. This increases the potential for regulatory capture and even corruption as well as harming the values of the bank's capital instruments on the markets, making it more difficult to refinance.

The SLWG's purpose in specifying such a double trigger was to maintain the current protections of subordinated debenture holders in normal times, when a bank may fail without endangering the world financial system, but the additional uncertainty introduced by the requirement for regulatory declaration will make such securities difficult to price, limiting the potential for systemic improvements in market discipline.

The use of regulatory ratios as a trigger is a feature of the Lloyd's Banking Group exchange offer[21] and two extant Australian issues, Commonwealth Bank PERLS III and Westpac TPS. Such triggers have a superficial appeal, as they address directly the problem of potential regulatory action, but are flawed in that they may be adversely affected by future changes in the regulatory regime. Not only may the calculation of Tier 1 ratios change in the future, but the regulatory requirements may also change. Canada, for example, has established[22] a target of 7% for Tier 1 Capital ratios, well in excess of the Basel II floor of 4%. With such a trigger, investors are being asked to provide capital that is not simply contingent upon an analysis of the issuer, but is also subject to regulatory whims.

The Conversion Price

Two basic models for the conversion price have been subjected to discussion: first, that the conversion price be equal to the market price at the time the conversion is triggered,

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[20] Squam Lake Working Group, *An Expedited Resolution Mechanism for Distressed Financial Firms: Regulatory Hybrid Securities,* available on-line at http://www.cfr.org/publication/19002/expedited_resolution_mechanism_for_distressed_financial_firms.html?breadcrumb=%2Fthinktank%2Fcgs%2Fsquamlakepapers (accessed 2009-11-9)

[21] Lloyds Banking Group, *Offer to Exchange,* 2009-11-3, available on-line at http://webcasts.lloydsbankinggroup.com/capitalraising/files/Non-US_EOM.pdf (accessed 2009-11-9)

[22] OSFI, *Memorandum, 1999-1-28,* available on-line at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/capital/advisories/99-01-28_e.html (accessed 2009-11-9)

and second, used for the new Lloyds Banking Group notes, that the conversion price is equal to the market price at the time the notes are issued.

The first option can lead to massive – and difficult to forecast - dilution in times of stress which may well make it more difficult for a bank to issue replacement equity capital in a normal arm's-length transaction.

The Lloyds Bank model, in which is exchange price is equal to the common's price at times of issue, is disastrous and, probably, makes such notes impossible to issue in a non-coercive manner. The use of the current market price implies that the noteholders have no first-loss protection – such an issue cannot even be considered a bond.

A Market-Friendly Trigger & Price Model

The currently proposed triggers and conversion price calculations are not good enough in times of stress, at which time certainty is at a premium. Ideally, the non-equity components of capital will be required to meet tests of certainty before being granted regulatory status as "loss absorbing" securities.

Thus, I propose that the conversion trigger be based on the price of the common stock. If, for example, a Tier 1 instrument is issued at a time when the common stock is trading at $50, conversion to common should occur when the volume-weighted average price of the common taken over any period of twenty consecutive trading days is less than half the issue-date price, or $25.00. The conversion price should be fixed at the same price as the trigger price.

Tier 2 instruments could have the same conversion pattern but with a greater degree of first loss protection; the trigger and conversion price could be one-quarter the issue date price of the common, rather than the one-half I propose for Tier 1 instruments.

Such a regime will

- allow the potential for dilution to be analyzed properly by prospective purchasers of equity new issues
- allow certainty as to the degree of this potential dilution
- allow holders of the Tier 1 instruments to hedge their potential exposure to equity via the options market; and provide purchasers of the Tier 1 instruments with substantial first-loss protection

In effect, the proposal formalizes such exchange offers as the Citigroup offer described earlier in this essay, but makes the conditions known in advance.

Some may object that a mandated conversion to common may make it impossible for bond funds to invest in such securities: this must be counted as a feature, not a bug. The surprising effects of the Primary Reserve money market fund "breaking the buck" due to the Lehman default should serve as an object lesson to regulators: the pretense that risky instruments are risk-free is destabilizing.