

FREQUENTLY ASKED QUESTIONS ABOUT CONTINGENT CAPITAL AND RELATED DEVELOPMENTS

Understanding Contingent Capital

What is 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 regulatory 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. 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 generally 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 were 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 trust (“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 by the issuer.

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

Regulators have 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 set higher regulatory capital requirements and established 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 regulators and rating agencies concluded that certain hybrid capital securities, such as trust preferred 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).

Regulatory Developments

How have recent regulatory developments addressed loss absorbing capital?

Recent regulatory developments in both the United States and the European Union (the “EU”) 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.

Basel III (also referred to herein as the Basel III framework) is a comprehensive set of international reform measures for strengthening the regulation, supervision and risk management of the banking sector, which includes enhanced capital requirements. Individual countries, however, are responsible for their own implementation of the Basel III framework. In the United States, the implementation of the Basel III framework differs in certain respects, as discussed in more detail below, from the implementation in the EU.

Similarly, in the EU, the implementation of the Basel III framework, as reflected in CRD4 (as defined below), differs in certain respects, as discussed in more detail below.

International Reforms (Basel III)

What are the minimum capital requirements under Basel III?

The Basel III framework was published by the Basel Committee on Banking Supervision (the “Basel Committee”) in December 2010 and later revised in July 2011. 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 were to be phased in between January 1, 2013 and January 1, 2015, and regulatory adjustments were to 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 were to 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.

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 loss absorption. 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 also has published a set of FAQs on the Basel III definition of capital, most recently updated in September 2017 (Basel III definition of capital – Frequently asked questions, <http://www.bis.org/bcbs/publ/d417.pdf>).

In November 2011, the Basel Committee published final rules setting out a framework on the assessment methodology for global systemically important banks ("G-SIBs"), the magnitude of additional loss absorbency that G-SIBs should have and the arrangements by which the requirement will be phased in. The assessment methodology for G-SIBs 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 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 have been 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).

U.S. Reforms

What are the minimum capital requirements under the Dodd-Frank Act and U.S. Federal Reserve Board rules?

In many respects consistent with the proposed Basel III framework, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "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 provision (Section 171) of the Dodd-Frank Act, which is applicable to all financial institutions, requires 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 provision limits regulatory discretion in adopting Basel III requirements in the United States and permits 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 (“BHCs”), certain hybrid securities, including trust preferred securities, will no longer be included in Tier 1 capital. The legislation applies retroactively to trust preferred securities issued after May 19, 2010. BHCs and systemically important non-bank financial companies were required to phase-in these requirements from January 2013 to January 2016. Mutual holding companies and thrift and BHCs with less than U.S.\$15 billion in total consolidated assets are not subject to this prohibition.

Led by the U.S. Federal Reserve Board (the “FRB”) on July 2, 2013, the three U.S. federal banking agencies approved a broad and comprehensive revision of the regulatory capital rules applicable to all U.S. banks and BHCs (except those with less than U.S.\$500 million in total consolidated assets). The new rules 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 provision 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 capital requirements under the new rules are more onerous than the requirements under the Basel III framework. In addition, in the United States, a security that is treated as debt for accounting purposes will not receive Tier 1 capital treatment.

The effectiveness of the new rules was phased in according to different start dates, ranging from January 1, 2014 to January 1, 2019, and different phase-in periods, ranging from two years to nine years. The new rules will not be fully implemented until January 1, 2022. The new rules consist of the following:

- The Basel III Capital Rule 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 Rule, among other things:
 - subjects U.S. banks and BHCs 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), a Tier 1 leverage ratio of 4%, and, for those U.S. banks and BHCs subject to the Advanced Approaches Rule (those with U.S.\$250 billion or more in total consolidated assets or U.S.\$10 billion or more in foreign exposures), an additional leverage ratio of Tier 1 capital to total leverage exposure of 3%; and

- o 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 BHCs subject to the Advanced Approaches Rule, 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 Rule 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 Rule, become the new Collins Amendment “floor” for certain U.S. banks and BHCs.
- The Advanced Approaches Rule 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 (along with 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 BHCs that have significant trading activity and became effective on January 1, 2013.

Have any U.S. studies on contingent capital been completed?

Yes. 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 completed a study of a contingent capital requirement for certain non-bank financial companies and BHCs. Additional regulatory guidance will be required in the United States regarding the types of hybrid securities (in addition to non-cumulative perpetual preferred securities) that will benefit from favorable regulatory capital treatment.

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 BHCs in the United States.

EU Reforms

What are CRR and CRD4?

In the EU, the majority of the Basel III proposals have been implemented by the Capital Requirements Regulation (Regulation (EU) No. 575/2013) ("CRR") which, together with the directive (Directive 2013/36/EU) recasting the previous Capital Requirements Directive, form the package of legislation known as "CRD4." CRR already has direct effect in all EU member states, whereas the new directive was required to be separately implemented by each EU member state into its own laws by December 31, 2013.

Whereas the Basel III proposals apply only to internationally active bank groups, CRD4 applies to certain EU investment firms, as well as to EU banks and building societies.

CRR 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 CRR, instruments do not have to be common 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. This is relevant in particular to non-joint stock companies, such as mutuals, co-operative banks and savings institutions.

In relation to instruments that previously qualified for regulatory capital treatment, but cease to be recognized as Tier 1 or Tier 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. CRR states that any instrument issued before December 31, 2011, that previously qualified as regulatory capital, will continue to qualify as regulatory capital until December 31, 2021, but only as to a specified percentage of its amount, such percentage gradually decreasing each year until December 31, 2021. Some limited discretion is given to national regulators as to the exact percentage to apply for any particular period, so as 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, CRR 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%, or any higher percentage specified in the terms governing the relevant instrument.

The European Banking Authority (the "EBA") was mandated to draft technical standards in respect of procedures and timing for the determination of trigger points. Since the write-down of principal on a going concern basis can be temporary, the EBA was also mandated to specify the nature of any subsequent write-up of principal and the procedures and timing of such write-up. The European Commission's delegated regulation (Regulation (EU) No. 241/2014), has now enacted these EBA technical standards in a binding form.

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. CRR went further and stated that

dividend stoppers will also not be permitted in Tier 1 instruments.

Contingent capital instruments currently can qualify as additional Tier 1 or Tier 2 capital under CRD4. However, the CRD4 package did not contain the EU's proposed legislation for the Basel Committee's proposal for all Tier 1 and Tier 2 instruments to be able to absorb losses at the instigation of a competent authority, at the point of an entity's non-viability (see "*International Reforms (Basel III)*" above). These provisions though are now included in the EU Bank Recovery and Resolution Directive, and were required to be implemented into the laws of each EU member state by December 31, 2014.

Relationship to Total Loss Absorbing Capacity ("TLAC")

Will contingent capital instruments replace hybrid securities? What is TLAC?

It remains to be seen whether contingent capital instruments will completely replace hybrid securities. 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 G-SIBs, 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 G-SIBs 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.

Having said that, the Basel Committee stated that it would continue to review contingent capital and would support its use in meeting any higher national loss absorbency requirements than the global requirement, because the Basel Committee recognizes that contingent capital instruments with a high trigger point can help absorb losses on a going concern basis.

However, it seems that contingent capital instruments will still have a role to play outside the Basel III requirements themselves. In November 2015, the Financial Stability Board (the "FSB"), an international body that monitors and makes recommendations about the global financial system, finalized its principles on the adequacy of the loss-absorbing capacity of G-SIBs in a resolution situation. These principles included a recommendation that G-SIBs, including EU and U.S. G-SIBs, should be required by regulators to hold minimum TLAC, including Basel III minimum capital requirements (but not the capital buffers) and certain other instruments that can be "bailed-in" in a bank resolution.¹ The FSB also proposed that the TLAC requirements for a G-SIB should be at least 6% of the Basel III leverage ratio denominator ("LRD") as of January 1, 2019 and 6.75% of the LRD as of January 1, 2022.²

The FSB has stated that it expects at least 33% of a G-SIB's minimum TLAC requirement to be met in the form of debt regulatory capital instruments and other TLAC-eligible liabilities that are not regulatory capital. Contingent capital instruments that qualify as

¹ From January 1, 2019, TLAC must equal 16% of a G-SIB's risk-weighted assets, and from January 1, 2022, TLAC must equal 18% of a G-SIB's risk-weighted assets.

² The Basel III leverage ratio measures a bank's Tier 1 capital as a percentage of its total (non-weighted) assets and off-balance sheet exposures, and as currently proposed by the Basel Committee would be at least equal to 3%.

additional Tier 1 and Tier 2 capital can satisfy this category of TLAC so long as they are subordinated to all those liabilities that the FSB expressly excludes from TLAC eligibility. This subordination may be achieved by way of contractual subordination or statutory subordination, or alternatively by being issued by an entity that has no excluded liabilities on its balance sheet that rank *pari passu* or junior to TLAC-eligible instruments on its balance sheet. This “structural” type of subordination is expected to be mandated for both U.S. and UK G-SIBs by their respective resolution authorities or regulators.

What are the implications of the Final TLAC Rule in the United States?

On December 15, 2016, the FRB approved final rules (the “Final TLAC Rule”) that impose on U.S. BHCs that are G-SIBs a minimum TLAC requirement, a minimum external long-term debt (“LTD”) requirement, and a clean holding company requirement. Intermediate holding companies (“IHCs”) of foreign banking organizations that are G-SIBs and subject to a U.S. IHC requirement are subject to a TLAC, LTD and clean holding company requirement. Eligible external LTD includes debt that is issued directly by the covered BHC that is, among other things, unsecured, plain vanilla, and governed by U.S. law. Only 50% of the amount of eligible external LTD (due to be paid between one and two years) can be utilized to satisfy external LTD requirements. The Final TLAC Rule distinguishes between resolution covered IHCs and non-resolution covered IHCs. The Final TLAC Rule will apply as of January 1, 2019, but there is a grandfather provision for certain outstanding external LTD issued prior to December 31, 2016.

What is MREL and what are its implications in the EU?

In the EU, the resolution authority of each EU member state was required from January 1, 2016, under the Bank Recovery and Resolution Directive, to set, on a bank-by-bank basis, a minimum level of own funds and bail-inable liabilities (“MREL”) to be maintained by banks in its jurisdiction. Like the TLAC requirement described in the FSB’s final principles, the MREL obligations can be satisfied with contingent capital instruments. However, unlike the TLAC requirement described in the FSB’s final principles, the MREL obligations only apply to EU banks and investment firms, including EU G-SIBs.

The European Banking Authority’s regulatory technical standards, as to the assessment criteria for each EU member state’s determination of MREL, were heavily influenced by the TLAC requirement for G-SIBs described in the FSB’s final principles. The European Commission published its legislative proposals in November 2016.

Each EU national resolution authority will set MREL for each bank under its jurisdiction, and the levels and methodology used will need to comply with standards prescribed by the European Banking Authority. These standards provide that a bank’s MREL must consist of both an amount necessary for loss absorption prior to, and during, resolution, as well as an amount necessary for the subsequent recapitalization of the bank. The loss absorption amount will have to at least equal the minimum capital requirements prescribed by the Capital Requirements Regulation, together with any applicable leverage ratio requirement set by the relevant national competent authority.

The Bank of England has stated that for the biggest/most complex UK banks it intends to set MREL at a level equivalent to twice the bank's current minimum capital requirements – once for the loss absorption portion and once for the recapitalization portion. Although not strictly required by the European Bank Recovery and Resolution Directive, the Bank of England also proposes that MREL liabilities for UK G-SIBs, and other UK banks whose resolution strategy would involve bail-in, should be subordinated to senior operating liabilities of the relevant bank, which is broadly consistent with the TLAC requirement described in the FSB's final principles.

On November 23, 2016, the European Commission released draft legislative proposals that, if enacted following consideration by the European Parliament and the Council of the EU, would integrate into the EU law the TLAC requirement described in the FSB's final principles. It proposes to do this by altering the MREL requirements for EU G-SIBs, so that they reflect the TLAC requirement described in the FSB's final principles and, in particular, specify a minimum floor for the amount of MREL to be held by such banks, in line with the TLAC requirement. EU non-G-SIBs would not be subject to such a MREL floor and would also be subject to less stringent criteria in terms of the required features of their MREL instruments.

Under the proposals, MREL should be set, for all EU banks, as a percentage of risk-weighted assets and also of the Basel III leverage ratio denominator. Instruments will not qualify for MREL to the extent that they are already counted towards regulatory capital, and where there is a shortfall in a bank's MREL, any common equity Tier 1 capital contained in a capital buffer will be treated as counting towards the bank's MREL

requirement, potentially giving rise to a capital buffer shortfall and consequent restrictions on distributions and bonuses. Unlike the TLAC requirement described in the FSB's final principles, only bonds that contain contractual bail-in language will be eligible for MREL. Structured notes will not be eligible for a G-SIB's MREL, but will be eligible for the MREL of a non-G-SIB to the extent that the amount of the liability is fixed, is not affected by a derivative feature and is not subject to a netting agreement. For a liability to be eligible for an EU G-SIB's TLAC, it must be subordinated to all liabilities excluded from MREL-eligibility. The subordination must be achieved by contractual language, by the laws of the jurisdiction of the issuer's member state or structurally, by virtue of being issued by an entity (such as a holding company) that has no liabilities on its balance sheet that are excluded from MREL-eligibility and that rank *pari passu* or junior to MREL liabilities on its balance sheet. Such subordination is not mandated for non-G-SIBs, but may be specified by a resolution authority for a particular bank. The draft legislation also proposes to permit some *de minimis* levels of non-subordinated MREL, as an exception to the general rule for G-SIBs.

The MREL provisions for G-SIBs are intended to apply from January 1, 2019, though the revised MREL provisions for non-G-SIBs are intended to apply from the date falling 18 months after the legislation comes into force.

Are contingent convertible instruments suitable for all types of investors?

Many jurisdictions will require, as part of their regulations regarding conduct of business, that authorized entities selling financial instruments to an investor in their jurisdiction must perform an assessment of whether those instruments are suitable or appropriate for that particular investor. This is generally the case in the United Kingdom, for example. However, the Financial Conduct Authority (“FCA”) in the United Kingdom has, in addition, determined that contingent convertible instruments are not appropriate instruments to be offered or sold to ordinary retail investors in the United Kingdom. The FCA’s stated rationale for this policy is that it regards contingent convertible instruments as highly complex and as having unusual loss absorbency features which together create the risk that these instruments will be inappropriately sold to ordinary retail investors. Therefore, since October 1, 2015, contingent convertible instruments may not be offered or sold to ordinary UK retail investors by UK authorized persons. “Ordinary retail investors” in this context will not include high net worth individuals or sophisticated individuals who, along with institutional investors, may still be sold contingent convertible instruments.

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 that certain regulatory actions are taken with respect to the issuer (“triggers”).

What types of loss absorption features are possible?

There are two possible types of loss absorption 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.

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, unless the conversion ratio is based on the current market price of the issuer’s common shares and subject to a floor, in which case the extent of any dilution would depend on the timing of the conversion. If the conversion to equity is paired with an early trigger (*i.e.*, the capital ratio or market metric is set at 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, depending on how much senior debt of the issuer is outstanding.

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, and some would not be able to invest in securities with a conversion feature that could result in their holding equity securities. 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 loss absorption triggers and are some preferable to others?

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

A trigger based on capital ratios would force mandatory loss absorption 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 loss absorption 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 mandatory loss absorption, 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 produced 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.

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 ratio level so that it is 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 loss absorption 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 loss absorption 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.

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 likely the securities are to have a favorable 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.

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.

What is the tax treatment of contingent capital 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.

In December 2016, the IRS issued a revenue procedure stating that the IRS would treat certain debt instruments issued by G-SIBs to related parties as indebtedness for federal income tax purposes. In particular, the revenue procedure applies to debt instruments issued by a foreign G-SIB to its domestic intermediate holding company that qualify under FRB regulations as internal total loss-absorbing capacity instruments ("internal TLAC"). The revenue procedure acknowledges that internal TLAC instruments lack several elements that are generally required for an instrument to be treated as indebtedness for federal income tax purposes. For example, internal TLAC may be converted into equity if required by regulators. Despite such features, the revenue procedure provides a safe harbor for these instruments "in the interest of sound tax administration."

The scope of the revenue procedure is narrowly tailored to internal TLAC issued on or after December 15, 2016. As a result, the U.S. federal income tax treatment of other contingent capital instruments will depend on existing law (see "What is the relevance of Section 163(l) of the Internal Revenue Code of 1986?" and

“What is the tax position where the conversion generates cancellation of debt income?” below). At least as far as TLAC (other than internal TLAC which is directly covered), the revenue procedure can be read to indicate that the IRS will give deference to FRB regulations in determining whether such an instrument is debt or equity for U.S. federal income tax purposes.

What is the tax treatment of contingent capital in the United Kingdom?

On January 1, 2014, the Taxation of Regulatory Capital Securities Regulations 2013 came into effect. The key effect of these regulations is that instruments that are, or were previously, additional Tier 1 or Tier 2 instruments will be taxed in the United Kingdom as loan relationships and that where a principal amount is written down, or the instrument is converted to a common equity Tier 1 instrument, no debit or credit will be brought into account for corporation tax purposes, by the issuer or by a connected holder, in respect of the conversion or the writing-up or writing-down. However, an unconnected holder of such an instrument can still bring into account for corporation tax purposes the debit incurred on the writing-down or conversion of the instrument. The regulations also have the effect that coupons will be deductible as interest and will not be viewed as distributions, and that no income tax will be withheld from payments on such instruments. For capital gains tax purposes, such instruments will be exempt as they will represent a “normal commercial loan.” Transfers of the instruments also will be exempt from all stamp duties.

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, as amended (“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 indebtedness 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 was 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 (a different class of) equity. 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 was 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.

Rating 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 had 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 loss absorption 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 loss absorption triggers are not clearly defined or if the regulators have significant discretion to force loss absorption, which makes it difficult to predict the likelihood of loss absorption. The rating agencies have issued statements and/or methodologies regarding the treatment of contingent capital instruments.

Moody's

The rating methodology of Moody's Investors Service ("Moody's") for rating bank hybrids and contingent capital instruments includes a framework for rating "high trigger" contingent capital securities and non-viability contingent capital securities. Previously, Moody's would rate contractual non-viability securities and junior securities that may be subject to bail-in, but not "high trigger" contingent capital securities. Moody's defines non-viability securities generally as junior securities, with or without coupon suspension mechanisms, that absorb losses either through conversion to equity or a principal write-down at the point of non-viability or upon the breach of a trigger that is set very close to the point of non-viability.

Moody's rating methodology for bank hybrids and contingent capital instruments also includes the following components: (i) a loss given failure ("LGF") analysis; (ii) the introduction of a macro profile into the elements that Moody's considers when it assigns a bank's baseline credit assessment ("BCA"); (iii) a scorecard which now incorporates not only financial ratios but also a broader range of metrics and qualitative considerations; and (iv) a counterparty risk assessment ("CR assessment"). Moody's employs both a basic and an advanced LGF analysis. The basic LGF analysis applies to banks that are not subject to operational resolution regimes. The advanced LGF analysis applies to banks that are subject to operational resolution regimes, whereby losses can be imposed selectively on creditors outside of a liquidation, and through which specific legislation provides a reasonable degree of clarity on how the bank's failure could affect depositors and other creditors. Moody's framework for assigning BCAs is structured around a scorecard that

more comprehensively integrates Moody's analytical judgments. The scorecard begins by focusing on five core ratios that Moody's has found to be predictive of bank failure covering five main financial factors (asset risk, capital, profitability, funding structure and liquid resources), and analysts and rating committees may consider supplementary ratios, as relevant, for each institution. Moody's macro profile complements the bank-specific analysis reflected in the scorecard and is expressed on a scale ranging from Very Strong+ to Very Weak- and comprises six elements (economic strength, institutional strength, susceptibility to event risk, credit conditions, funding conditions and industry structure). The CR assessment is not a rating, but an assessment of an issuer's ability to avoid defaulting on certain senior bank operating obligations and other contractual commitments.

Although Moody's will rate bank hybrids and contingent capital instruments where loss absorption is tied to triggers that are credit-linked, objective and measurable, there have been no such issuances to date. To date, Moody's has rated only issuances where loss absorption is subject to regulatory discretion and/or the breach of regulatory capital triggers. Moody's will continue to not rate instruments where loss absorption occurs: (1) at the bank's option or (2) where the loss absorption is tied to triggers unrelated to the bank's financial health such as the bank's share price.

In July 2015, Moody's proposed a rating approach for insurance contingent capital securities that include an equity conversion or principal write-down trigger (which is designed to be triggered prior to the insurer failing). The ratings approach incorporates three components: (i) the difference between the insurer's current local insolvency ratio and the trigger; (ii) the

probability of the insurer's solvency ratio reaching a certain threshold that Moody's perceives as failing; and (iii) the loss severity if either or both of these events occur.

Fitch

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"). 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.

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. 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.

Fitch's rating methodology currently includes the following:

- The ability to reflect incremental non-performance risk relative to a bank's VR for securities that are supposed to absorb losses on a "gone-concern" basis, but where there is an elevated risk that non-performance could occur ahead of the risk captured in VR.
- Explicit flexibility to widen incremental non-performance risk notching of securities with fully discretionary coupons, including additional Tier 1 securities, by more than three notches.
- Loss severity notching is one or two notches for all subordinated debt and legacy hybrid securities.
- Equity credit does not require a permanent and full write-down, and write-back features are not a barrier to equity credit.

S&P

Under the methodology of Standard & Poor's Rating Services ("S&P") for rating bank hybrid capital, instruments that qualify as Tier 1 capital and meet all other applicable S&P criteria are eligible for intermediate equity content, even without a contingent capital feature. Going concern contingent capital instruments are eligible for intermediate equity content if they are classified as Tier 1 or Tier 2 capital and meet all other applicable S&P criteria. Such instruments are viewed as having a strong capacity to absorb losses on a going concern basis via principal write-down or conversion into common equity. If the instrument is

classified as Tier 2, the principal write-down must be at least 25%. Tier 2 instruments that do not have a contingent capital feature and only absorb losses on a non-viability basis (gone-concern contingent capital or bail-in capital) will receive minimal equity content.

Additional loss-absorbing capacity (“ALAC”), which can come in the form of certain hybrid capital instruments and other liabilities, is part of S&P’s framework for rating banks globally. ALAC can come in the form of certain hybrid capital instruments and other liabilities. S&P evaluates a bank’s ALAC using the following criteria: (i) whether, based on legislative and regulatory features, it is expected that ALAC will reduce default risk on a bank’s senior unsecured obligations, supporting its issuer credit rating; (ii) the features of instruments that are eligible for inclusion in ALAC; (iii) the quality and quantity of ALAC liabilities as a proportion of risk-weighted assets that will uplift a bank issuer credit rating above its stand-alone credit profile; and (iv) how support based on ALAC interacts with other forms of positive and negative external intervention recognized in S&P’s criteria, including other forms of external support (*e.g.*, government support, group support, guarantees and other short-term support). For a contingent capital instrument to be included in ALAC, it must either (i) have a mandatory contingent capital clause leading to common-equity conversion or a principal write-down, or both, that satisfies certain conditions,³ or (ii) be

³ S&P lists several conditions that a contingent capital principal write-down or common-equity feature must meet in order to be included in ALAC: (a) the instrument must be subject to conversion or write-down at or before a regulatory determination of a bank’s “nonviability,” or at the bank’s entry into resolution; (b) the instrument must not cause a default of the operating bank or trigger a revision of the operating bank issuer credit rating to “selective default” or “D” (nor have cross-default or guarantee provisions relating to the operating

subject to a regulatory or legal framework that creates the equivalent of such a clause.

In July 2016, S&P requested comments on proposed revisions to its criteria for evaluating the capital adequacy of bank and certain nonbank financial institutions worldwide. The proposed criteria update is intended to capture enhanced bank disclosures subject to Basel III capital standards globally and to incorporate the experience of financial institutions as they navigated the aftermath of the financial crisis. S&P specifically proposed: (i) modifying some charges in light of the losses banks experienced since the criteria were published in 2010; (ii) adding some exposure categories to account for increased disclosure by financial institutions, and particularly banks, as a result of the Basel III framework; and (iii) changing certain weights used to calculate S&P Global Ratings RWAs to account for the recent default and transition studies and other published criteria, as well as the stress scenarios in Appendix IV of “Understanding Standard & Poor’s Rating Definitions.”

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bank and its senior unsecured debt obligations); and (c) the instrument must be exercised at the discretion of the supervisors or responsible authorities under a resolution regime.