

Box A

Recent Trends in the Issuance of Basel III Compliant Contingent Capital Instruments

Changes to the Basel framework for bank capital and liquidity requirements, collectively referred to as Basel III, have encouraged banks to issue capital instruments that are classified as debt, but which can be written down or converted to equity. These instruments are a subset of both the wider class of securities called contingent convertible capital instruments, and non-common equity (NCE) regulatory capital.

The increased supply of Basel III compliant NCE capital instruments with contingent convertible features has coincided with a period of strong investor demand for high-yielding debt, creating buoyant market conditions in recent years. This box describes recent trends and drivers of issuance of these capital instruments, their potential benefits and some risks surrounding them.

Definitions

Bank capital, in its simplest form, is equal to the portion of the value of a bank's assets that is not matched by liabilities owing to other parties, such as deposits or debt. It represents a bank's ability to absorb losses on its assets. The Basel III capital framework, which was finalised in June 2011, introduced a minimum level of common equity – called Common Equity Tier 1 (CET1) capital – which is the most loss-absorbing form of bank capital. Banks are not obliged to repay the principal of common equity outside of liquidation or make distributions such as dividend payments. In liquidation, common equity represents the most subordinated type of claim.

Non-common equity regulatory capital instruments are sometimes called hybrid securities because they

have characteristics of both equity and debt – some are also referred to as CoCos given their contingent convertible nature. Hybrid capital instruments with characteristics that are most similar to common equity are classified as Additional Tier 1 (AT1) capital under Basel III and are designed to absorb losses while the bank is still a going concern. Like common equity, AT1 capital instruments do not have a maturity date and distributions such as dividends and coupon payments are fully discretionary; in liquidation, AT1 capital instruments are senior only to common equity. AT1 capital includes preferred shares and debt instruments that have loss-absorption triggers which allow the principal to be written down or converted to common equity during times of stress.¹ This has the effect of strengthening the banks' capital position at a time when raising additional equity would otherwise be difficult. Allowing the issuer to miss coupon payments can also reduce pressure on liquidity.

Tier 2 (T2) capital is a lower-quality form of regulatory capital that is designed to absorb losses when a bank fails (that is, becomes a 'gone concern'). T2 capital instruments must have an original maturity of at least five years and, like AT1 capital instruments, have no 'step-up' clauses or other incentives to redeem;² in liquidation, T2 capital is senior only to CET1 and AT1.

- 1 The Basel III framework only requires AT1 to contain a numerical trigger when considered a liability for accounting purposes. A numerical loss-absorption trigger is activated when the CET1 capital ratio of the bank falls below a certain level (e.g. below 5.125 per cent of risk-weighted assets). This is in addition to the non-viability trigger.
- 2 Basel III no longer recognises hybrid instruments which provide an incentive for the issuer to redeem through features such as 'step-up' clauses, where coupon payments can increase ('step-up') from one period to another.

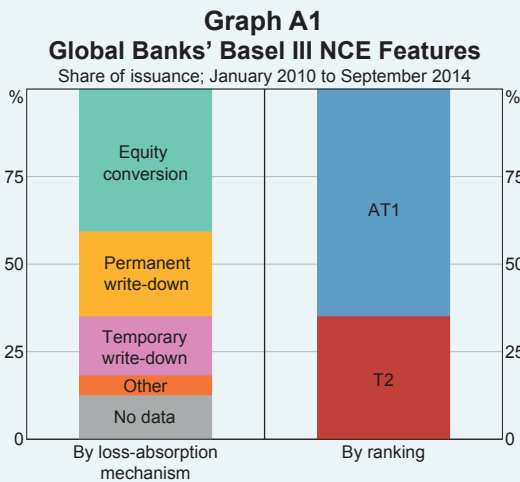
To facilitate loss absorption on a gone-concern basis, both AT1 and T2 capital instruments must, where not enforced by legislation, incorporate a contractual feature allowing the principal to be written down or converted to common equity if the relevant regulator determines that the bank is no longer able to support itself in the private market. This feature, which is often called the point of non-viability trigger, is designed to ensure losses can be imposed on all capital holders before other resolution actions are taken, including those that may involve taxpayers being exposed through government intervention.

Issuance

Within the class of Basel III compliant NCE, losses can be attributed to capital holders in different ways when a trigger event occurs (Graph A1). For example, full principal write-down yields an absolute loss for the individual investor. In contrast, equity conversion may allow investors to recoup losses should share prices recover, while diluting the stake of existing shareholders. Temporary write-down/write-up mechanisms would write down principal by the amount necessary to return the bank's capital ratio to the trigger level; these mechanisms also allow the issuer to write up principal should the bank return to profitability.

The designs of triggers also vary. Most AT1 triggers are tied to a CET1 ratio of 5.125 per cent of risk-weighted assets, consistent with the Basel III requirement for instruments intended as going-concern capital, though some are higher. Numerical triggers are typically not required for T2 instruments, which tend to rely only on the point of non-viability trigger (triggered at the discretion of the national authority), though Swiss gone-concern capital instruments require numerical triggers at 5 per cent of risk-weighted assets (Table A1). At least one recent issue has included multiple triggers (based on the capital ratios of either the bank or its holding company) and some issuance in Asia can be triggered by either the home or host regulators. Regulatory call options (allowing the issuer to buy back the instrument if regulatory requirements change) are a very common feature across different issuers.

Issuance has increased strongly in recent years (Graph A2), as banks have moved to raise capital to meet the stricter Basel III capital requirements and to replace maturing instruments issued under the Basel II framework. Meanwhile, the low interest rate environment has supported investor demand; these securities offer higher yields than senior debt or term deposits, reflecting their higher risk.



Sources: Bloomberg; Dealogic; RBA

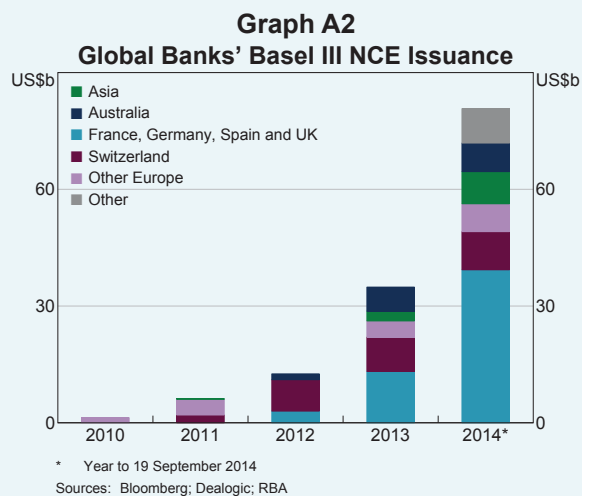


Table A1: Recent Examples of Basel III Compliant Contingent Convertible Bond Issuance

Issuing Bank	Issue Date	Coupon Per cent	Amount Billions	Country	CET1 ^(c) Ranking ^(b)	trigger	Loss-absorption Mechanism
Banco Popular Español	Oct 13	11.5	EUR 0.5	Spain	AT1	5.125%	Principal write-down
Barclays	Nov 13	8.25	USD 2.0	UK	AT1	7%	Equity conversion
Crédit Agricole	Apr 14	6.5	EUR 1.0	France	AT1	5.125% and 7% ^(d)	Temp write-down/write-up
Deutsche Bank	May 14	7.125	GBP 0.65	Germany	AT1	5.125%	Temp write-down/write-up
UBS	May 14	5.125	USD 2.5	Switzerland	T2	5%	Principal write-down (full)
Shengjing Bank	May 14	6.18	CNY 2.2	China	T2	No (PoNV)	Principal write-down (full)

(a) Sample selected to emphasise the variety of unique features across and within regions

(b) AT1 or T2 capital ranking as identified by the issuer

(c) CET1 ratio to risk-weighted assets trigger specified where applicable; discretionary point of non-viability (PoNV) trigger identified where CET1 triggers are not required

(d) CET1 trigger tied to both the parent (7 per cent) and the issuing bank level (5.125 per cent) CET1 ratio

Sources: Bloomberg; Dealogic; RBA

Issuance has been strong in Europe where regulators require all AT1 capital instruments to contain a trigger tied to regulatory capital ratios. For some countries within Europe, issuance has been attractive because coupon payments are tax deductible for the issuer. European issuers of Basel III compliant NCE have tended to offer loss-absorption mechanisms with the potential to recoup losses after a trigger event.

Issuance by Swiss banks has been encouraged by regulations requiring systemically important banks to hold up to 9 per cent of risk-weighted assets as NCE with both numerical and discretionary regulatory triggers. In contrast, regulators in the United States have opted to rely entirely on statute at resolution to comply with Basel III loss-absorption requirements, and have indicated they will continue to study the advantages and disadvantages of banks issuing instruments with contingent convertible triggers as regulatory capital. Issuance of these instruments in the United States has therefore been negligible.

Australian banks have issued some AT1 and T2 instruments consistent with APRA's implementation of the Basel III framework (see 'The Australian Financial System' chapter); while in Asia, some T2 instruments with the required discretionary triggers have been issued.

In line with buoyant market conditions, the spread to benchmark for contingent convertible instruments, as well as the spread between high trigger and low trigger instruments narrowed over 2013 and early 2014, before ticking up in July (Graph A3). One particular deal was postponed when the scale of problems at the failed Portuguese lender Banco Espírito Santo first became evident as the market demanded a higher yield than the issuer was prepared to offer. In early September, another issuer reported under-subscription. These incidents suggest that growth in demand for this class of instrument might be significantly reduced if the price of risk was to increase.

Graph A3

European USD Contingent Convertible Index



* The benchmark security, representing the risk-free rate, is matched to the term of each individual security

** High CET1 ratio triggers are at or above 7 per cent; low CET1 ratio triggers are at or below 5.125 per cent

Sources: Bloomberg; Credit Suisse

Potential Risks

As a general proposition, if banks have more loss-absorbing capital on their balance sheets, the resilience of the banking sector improves; this is a positive development for financial stability. That said, some regulators have raised concerns that some investors could be underestimating the probability of a trigger event, implying that some NCE issues may be mispriced. A significant reassessment of the risks could impose heavy losses on investors and substantially increase banks' funding costs, especially as this could coincide with increased stress in the banking system.

In addition, contingent convertible instruments may distort incentives in stressful situations. Bank share prices could come under pressure if holders of these instruments, anticipating losses, short-sell bank shares, aiming to close their positions with the shares generated at conversion. Shareholders may also sell before the conversion of these instruments if they anticipate losses due to the subsequent dilution of their holdings.

Regulators' incentive to trigger conversion, and therefore the capacity of these instruments to absorb losses, might also be affected by the type of investor facing those losses. Ideally, NCE regulatory capital should not be held by systemically important institutions, lest they provide another mechanism for contagion to spread.³

A sample of European AT1 issuance indicates that asset managers and hedge funds in continental Europe and the United Kingdom have purchased the majority of NCE (Table A2). Some purchases by asset managers are likely to be on behalf of retail clients. Several regulators globally, including the Australian Securities and Investments Commission, the European Securities and Market Authority, and the United Kingdom's Financial Conduct Authority (FCA) have expressed concerns that some retail investors may not fully understand the risk associated with these highly complex capital instruments, particularly given the market's early stage of development and the lack of experience with contingent triggers. The FCA has also imposed a temporary restriction on the distribution of contingent convertible instruments to certain types of retail investors, effective from 1 October 2014. ✎

Table A2: European AT1 Investors^(a)
Share of issuance, per cent

Investor Type	2013	2014
Asset managers	63	59
Hedge funds	12	21
Insurance/pension funds	6	9
Banks/private banks	16	10
Other	3	1

(a) From a sample of 11 AT1 European contingent convertible instruments with data available on investor distribution
Sources: Dealogic; RBA

³ For this reason, Basel III requires that cross-holdings of any capital instruments are deducted from regulatory capital of the same kind.