5 More and Better Bank Capital, But Will It Really Absorb Losses ?

Andrew A. BERNSTEIN [1],
Senior Counsel at Cleary Gottlieb Steen & Hamilton LLP,
Member of the Haut Comité Juridique de la Place Financière de Paris

1 - In December 2008, representatives of major French banking groups appeared one-by-one in the halls of the Ministry of Economy and Finance, ready to receive injections of capital from a new French Government bank rescue entity, the *Société de Prise de Participation de l'État* (SPPE). Most of the banks did not need to be rescued, but they all received fresh capital to reinforce their perceived financial strength in the highly uncertain circumstances following the September 2008 bankruptcy of Lehman Brothers.

The SPPE did not subscribe for new shares of the French banks. Instead, it invested in « hybrid » instruments that looked like bonds, but with terms that would automatically recapitalize the banks if their capital fell below regulatory minimum levels. Other governments around the world invested in similar instruments issued by their banks, providing much-needed temporary capital that helped the banks survive the financial crisis.

Banks had issued similar « hybrid » instruments to investors for years. When the financial crisis hit, regulators wanted the existing hybrid instruments to serve their purpose of absorbing losses before their governments injected new capital. But this turned out to be difficult or impossible in practice, both because the terms of the instruments did not allow them to absorb losses in a timely manner, and because of fears that the market reaction triggered by the use of loss absorption clauses could have triggered an implosion that would have worsened the already dramatic financial crisis. As a result, the new government capital supported returns to investors who supposedly had signed up to be second in line (after ordinary shares) to bear losses.

Many retrospective reviews of regulatory reforms since the 2008 financial crisis point to increased and higher quality bank capital as a pillar of the stronger financial system that has emerged, reducing the likelihood of banks requiring government support such as that provided by the SPPE. [2] Less prominent is the question of whether, in the new environment, the additional capital will actually serve its purpose of absorbing losses before a bank tumbles into insolvency, preventing a systemic crisis and minimizing the need for public financial support. Yet this question was a key factor in the design of new rules governing the terms of capital instruments adopted after the crisis.

This article analyzes the impact of post-crisis reforms on the terms and loss absorbing capacity of hybrid capital instruments. It begins by recalling the purpose and history of these instruments, and why they were less effective than expected in the 2008 crisis. It then discusses the main post-crisis regulatory changes and how they make hybrid instruments more likely to absorb losses. Finally, it examines the first few cases where some new features of these instruments have been used, concluding that markets seem to have accepted the limited implementation of some of these features, and they anticipate that other features might be used in the future. Yet it remains to be seen whether the new and improved hybrid instruments will effectively cushion the impact of a future crisis, avoiding a death spiral that would require a new round of taxpayer support for the financial system.

1. What are Hybrid Capital Instruments and why do they exist ?

2 - Hybrid capital instruments are part of the mix of capital that banks are required to maintain under applicable banking regulations. They are referred to as « hybrid » because they behave like debt instruments when times are good, but they automatically (at least in theory) convert into or reinforce capital when times are bad.

Banks are required to maintain amounts of capital designed to ensure that any losses will be absorbed before they affect higher-ranking instruments such as ordinary bonds and, especially, deposits. So long as a bank has sufficient capital, investors should be willing to subscribe for a bank's bonds, and depositors should be willing to keep their money in the bank (even above amounts that are guaranteed by government insurance schemes), allowing the bank to provide financing for economic activity.

Under rules originally adopted by the Basel Committee on Banking Supervision in 1988 and reinforced several times, most recently as part of the Basel III package that is still in the process of being implemented, banks must maintain an amount of capital equal to a specified percentage of their risk exposures, calculated primarily by applying various risk-weightings to the different types of assets they hold, plus additional capital to account for other risks, such as market and operational risk.

The most basic type of capital (known today as « common equity Tier 1 » or CET1 capital) is composed of ordinary shares and other items belonging to holders of ordinary shares, such as reserves and retained earnings. If a bank incurs losses, they reduce the amount of CET1 capital, but they do not affect other instruments in the bank's capital structure so long as some CET1 capital remains available.

The problem with ordinary shares is that they can be difficult, expensive, and time-consuming for a bank to issue, or impossible to issue in a crisis situation. An investor will only subscribe for new shares if it believes it will earn a return consistent with the risk it bears as a shareholder. The return is partially received in the form of dividends, which are not tax deductible for the bank. In addition, issuing new shares can be complicated – it usually requires the approval of a bank's shareholders, who may be reluctant to see their economic and voting rights diluted by a new issuance. In some jurisdictions new shares are issued in rights offerings, usually priced at a significant discount to trading prices. Moreover, some

1. The views expressed in this article are those of the author alone, and do not necessarily represent the views of Cleary Gottlieb or the *Haut Comité*.
2. See, *e.g.*, Working Group established by the Committee on the Global Financial System, *Structural changes in banking after the crisis*, Bank for International Settlements (CGFS Papers) No. 60 (January 2018), at 2, 6, 8-9, 22 (2018) ; The Group of Thirty, *Managing the Next Financial Crisis : An Assessment of Emergency Arrangements in the Major Economies* 7-8 (2018) ; *Bank Regulation and Supervision Ten Years after the Global Financial Crisis*, World Bank Policy Research Working Paper 9044 (2019).

banks do not have publicly listed shares, limiting their access to new share capital.

To address these problems, banks have developed hybrid instruments that are intended to serve the same loss-absorption objectives as ordinary shares, but can be issued more easily, and to a broader investor base. The instruments take the form of subordinated debt or preferred shares, with interest or dividends paid at a fixed or variable rate. When a bank incurs losses, the hybrid instruments absorb any losses that exceed CET1 capital. Some of the instruments (known today as « Additional Tier 1 » or AT1) are designed to absorb losses while the bank remains a going concern, either through the conversion of the hybrid instrument to shares or through a write-down or cancellation. Other instruments (known as « Tier 2 ») absorb losses solely through subordination to protect investors in higher-ranking instruments from losses at the time of liquidation (referred to as « gone concern » instruments).

It is much easier for a bank to issue hybrid instruments than it is to issue new shares. Hybrid instruments that that absorb losses through write-downs rather than conversion to new shares can typically be issued without shareholder approval. They do not dilute voting rights of existing shareholders. The interest or dividend rate is well below the return sought by share investors, and it can sometimes be structured to be tax deductible. Hybrid instruments can be marketed to a fixed income investor base that is substantially larger than the base of investors willing to subscribe for bank shares. They can also be issued in any currency, providing a natural hedge against foreign exchange rate risk for banks with global operations.

For all these reasons, it is attractive for banks to issue hybrid instruments as part of their capital planning. Hybrid instruments can also be attractive for regulators seeking to ensure that banks have the broadest access to fresh capital, as hybrid instruments represent a significant source of potential capital that would not be available if banks were limited to issuing ordinary shares. [3] At the same time, regulators seek to be vigilant to ensure that, in case of financial difficulty, hybrid capital instruments can actually recapitalize the bank.

2. Historical Regulation of Hybrid Capital Instruments

3 - The main question for regulators is whether hybrid instruments will effectively absorb losses as and when needed. This is generally not a difficult question for Tier 2 instruments, which are only required to absorb losses at the stage of liquidation, when subordination by itself is sufficient to protect higher-ranking creditors. The story is more complex for AT1 instruments, which are designed to absorb losses before the bank becomes insolvent, but for which market pressures can make the loss absorption features more difficult to use.

Hybrid instruments of the type referred to today as AT1 have taken on various names over the years – OpCo preferred, Trust preferred, Super-Subordinated Notes, Contingent Capital (or CoCos) to name just a few. The common features are that these instruments are the lowest ranking instruments other than ordinary shares, that interest or dividend payments can be cancelled when needed to support the bank, and that these instruments are converted to ordinary shares or written off if certain triggering events occur (generally the failure of the bank to maintain its required level of CET1 capital).

These instruments were initially conceived shortly after the first Basel capital requirements were adopted in 1988. While their terms provided that they could act like shares if needed – with optional dividends or interest and no maturity dates – they also included features designed to provide assurances to investors that they would behave more like bonds. In the most common structure, interest or dividends became mandatory for a year after the issuing bank paid dividends on ordinary shares. In addition, the hybrid instruments generally could be redeemed (or « called ») at the issuer's option after a period of time. Some hybrid instruments (referred to as « innovative ») provided for the interest or dividend rate to increase (or « step up ») if they were not called on the first possible date. These features provided an issuer with an incentive to redeem, and the instruments were generally marketed on the basis that they would be redeemed on the first possible date unless the issuing bank fell into dire financial difficulty.

In 1998, the Basel Committee published a press release containing the first set of international standards applicable to innovative Tier 1 instruments. [4] The press release laid out what it referred to as « stringent conditions » for innovative Tier 1 capital instruments, including a requirement that interest or dividends be optional unless dividends were paid on ordinary shares, that they were non-cumulative (meaning any unpaid interest or dividends were cancelled and not just deferred), that they could not be redeemed before the fifth anniversary of issuance (and then only with regulatory approval) and that the interest or dividend rate could not step-up before the tenth anniversary of issuance, and then only in limited amounts. The press release provided that innovative instruments could account for no more than 15% of total Tier 1 capital (although no limit was placed on « non-innovative » hybrid instruments, meaning instruments without any interest or dividend step-up).

National regulators adopted some or all of the Basel Committee's recommendations, and some went even further. For example, the French Banking Commission's rules on calculating capital ratios provided that, in addition to satisfying the requirements of the Basel Committee 1998 Press Release, French banks could include hybrid instruments (innovative and non-innovative) in an amount limited to 35% of total Tier 1 capital (the remainder of Tier 1 capital had to be in the form of ordinary shares or the equivalent). [5]

3. Hybrid Capital Instruments in the 2008 Financial Crisis

4 - The 2008 financial crisis presented the first great test of the standards applicable to hybrid Tier 1 instruments under the 1998 Basel Committee press release. By almost any measure, these instruments failed the test.

In theory, hybrid capital instruments should have absorbed losses triggered by the 2008 financial crisis, through the cancellation of interest and dividend payments, and the write-down of principal (or conversion to ordinary shares). But there were a number of obstacles that prevented this from happening.

First, the terms of the instruments proved to be insufficiently robust. Many banks had paid dividends on ordinary shares in 2008, making interest and dividend payments on hybrid Tier 1 instruments mandatory for a year. It was also impossible to use the write-down mechanisms in the terms of the instruments, which were triggered by the failure of banks to maintain required capital ratios. Substantially all banks kept their capital ratios above regulatory minimum levels despite the crisis, [6] and in any event they could not calculate new ratios in time to trigger the write-down mechanisms

3. Basel Committee on Banking Supervision, *Instruments eligible for inclusion in Tier 1 capital*, Basel Committee 1998 Innovative Instrument Press Release (1998) : « [S]ome banks have issued a range of innovative capital instruments, such as instruments with step-ups, with the aim of generating Tier 1 regulatory capital that is both cost-efficient and can be denominated, if necessary, in non-local currency. »

4. Op. Cit. Basel Committee on Banking Supervision. These standards were by their terms applicable to innovative instruments issued through special purpose vehicles, although through market practice and standards adopted by national regulators, they also became applicable to instruments issued directly by banks.

5. French Banking Commission (applying Regulation no. 90-02 dated February 23, 1990, as amended, of the Comité de la Réglementation Bancaire et Financière), *Methods for Calculating the Capital Ratio*, §2.1 (2009).

6. Stan Maes and Wim Schoutens, *Contingent Capital : An In-Depth Discussion*, 41 Banca Monte dei Paschi di Siena Economic Notes, No. 1/2 – 59, 71-72 (2012).

(which in some cases provided for such calculations only on a quarterly basis). Even if the capital ratio triggers had been tripped, many hybrid instruments provided for a period of three months or more before a write-down, during which the bank was required to seek other measures (such as the issuance of new ordinary shares) to raise capital.

Second, there was a widespread fear that the use of the loss absorbing mechanisms would trigger a panic that would have worsened the financial crisis and driven even healthy banks into insolvency. As an example, it would have been economically rational for a regulator to have prohibited a bank from calling its hybrid instruments, because doing so would require the bank to raise new capital in a disrupted market at a much higher cost. Yet when Deutsche Bank suggested in December 2008 that it might not call a series of Tier 2 securities on its call date in January 2009, the Financial Times reported that this « seriously spooked fixed income markets. » [7]

The failure of banks (and their regulators) to use the capital-like features of hybrid instruments presented a significant issue for governments that provided financial support to the banking sector. As the Basel Committee wrote in August 2010, « During the [2008] financial crisis a number of distressed banks were rescued by the public sector injecting funds in the form of common equity and other forms of Tier 1 capital. This had the effect of supporting not only depositors but also the investors in regulatory capital instruments. Consequently, Tier 2 capital instruments (mainly subordinated debt), and in some cases non-common Tier 1 instruments, did not absorb losses incurred by certain large internationally-active banks that would have failed had the public sector not provided support. » [8]

4. Post-Financial Crisis Reforms Affecting Hybrid Capital Instruments

5 - The regulatory reaction was « never again. » In the United States, the so-called Collins Amendment to the Dodd-Frank Act eliminated the regulatory capital qualification of trust-preferred securities (a commonly used type of hybrid Tier 1 instrument) for large bank holding companies. [9] Globally, regulators working under the aegis of the Basel III standards imposed new requirements, much more stringent than the « stringent conditions » in the 1998 press release, on all hybrid instruments, requiring in particular that Additional Tier 1 instruments (the new name coined under Basel III) contain features requiring them to effectively absorb losses on a « going concern » basis. The purpose, as expressed by the Basel Committee, was that « a public sector injection of capital needed to avoid the failure of a bank should not protect investors in regulatory capital instruments from absorbing the loss that they would have incurred had the public sector not chosen to rescue the bank. » [10]

In Europe, the new requirements were embodied in a legislative package that included a capital requirements directive (CRD IV/V) [11] and a capital requirements regulation (CRR). [12] The new standards applicable to Additional Tier 1 instruments included a requirement that issuing banks have the option to cancel interest and dividend payments at any time (regardless of whether dividends are paid on ordinary shares), a limitation requiring interest and dividends to be paid only to the extent of distributable items available to pay dividends on ordinary shares, an obligation to cancel interest and dividend payments if required capital ratios are not maintained or if the supervisory regulator otherwise requires cancellation, a mandatory and immediate write-down feature triggered by the failure to maintain required capital ratios, which the regulator could require the bank to calculate at any time (and not just quarterly), and a prohibition on interest and dividend step-ups or any « incentives to redeem » (which included statements made in the marketing process to lead investors to believe the instruments would be called). [13] Moreover, CRR provided explicitly that regulators could not approve redemptions unless the bank replaced the called instruments with equal or better capital, or demonstrated to the regulator that it had sufficient capital without the called instruments. [14] CRR also mandated the European Banking Authority to monitor the quality of Additional Tier 1 instruments, which it has done through reports published on four occasions. [15]

CRD IV also required Member States to adopt a new standard restricting a bank from paying Additional Tier 1 coupons (as well as dividends on ordinary shares and certain employee bonuses) if it fails to maintain additional capital (known as « buffers ») above required capital ratios. The purpose is to require banks to conserve capital above the regulatory minimum levels, and to maintain additional capital to cover certain macroeconomic and systemic risks. If a bank fails to maintain its buffers, Additional Tier 1 coupons, dividends and the relevant employee bonuses can only be paid to the extent of the « Maximum Distributable Amount » (MDA), comprising essentially the current year's net income not already used for these purposes.

These new requirements, alone, did not solve the main issue that presented a problem for governments that provided support for banks during the financial crisis. So long as the capital ratios of banks remained above regulatory minimum levels, the AT1 instruments would not be written down, and any public financial support would benefit investors in those instruments. One of the recitals in CRR specifically addressed this, providing that all AT1 and Tier 2 instruments should be capable of being written down at the point of non-viability (defined to include the point at which extraordinary public support is needed), and stating that if legislation was not adopted to address this by the end of 2015, revisions to CRR to address this should be considered. [16]

Such legislation was adopted in 2014, in the form of the Bank Recovery and Resolution Directive (BRRD). [17] Under Article 59 of the BRRD, Member States must ensure that resolution authorities exercise « without delay » a new power to require capital instruments to be written-down or converted to equity in a number of circumstances, including where « extraordinary public financial support is required. » [18] If the bank subsequently enters into reso-

7. Paul Murphy, *Deutsche Rattles the Bond Market*, FT Alphaville (17 December 2008).
8. *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability*, Basel Committee on Banking Supervision Consultative Document (BCBS 2010 Loss Absorbency Proposal) (August 2010).
9. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (codified at 15 U.S.C. § 78o), § 171 (2010).
10. BCBS 2010 Loss Absorbency Proposal, at 3.
11. Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, as amended (« CRD IV/V »).
12. Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, as amended (« CRR »).
13. *See* CRR, Arts. 52-54 ; Commission Delegated Regulation (EU) No 241/2014 of 7 January 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for Own Funds requirements for institutions, Art. 20(f).
14. CRR, Art. 78, paragraph 1.
15. CRR. Art. 80, paragraph 1 ; *see, e.g.*, EBA Report on the Monitoring of Additional Tier 1 (AT1) Instruments of European Union (EU) Institutions – Update, EBA/Rep/2021/19 (June 2021).
16. CRR, Recital 65.
17. Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, as amended (« BRRD »).
18. For certain banks, including larger banks subject to supervision by the European Central Bank, the write-down and conversion power is exercised by the Single Resolution Board pursuant to Article 21 of Regulation (EU) 806/2014 of the

lution, any capital instruments that remain can be further written-down or converted to equity through the use of the « bail-in » tool by resolution authorities.

5. Experience With New Capital Instruments (So Far)

6 - The package of new requirements adopted under the CRD IV, the CRR and the BRRD (and reinforced in amendments adopted in 2016) have provided significant new tools that should make it more likely that AT1 instruments will effectively absorb losses if a future crisis were to raise the specter of another infusion of public funds into banks. Whether these tools will actually be effective, however, remains uncertain. The evidence so far is inconclusive.

It is clear that the market takes the coupon restrictions in the new regulatory regime quite seriously. In 2013, just after the CRD IV and the CRR were adopted (although they were not yet effective), the Italian bank Monte dei Paschi de Siena cancelled coupons on three hybrid instruments as a condition for obtaining the State's financial support. [19] Then in 2016, there were market rumors that Deutsche Bank might have difficulty making AT1 coupon payments due to the MDA, [20] followed by statements to the same effect regarding UniCredit in 2017 [21] (although it turned out that neither bank actually became subject to MDA restrictions). Because of the risk of mandatory coupon restrictions, all major banks communicate their « distance to MDA trigger, » providing investors with the amount of losses the banks would need to incur before AT1 coupons would be limited by the MDA. Communication has become even more robust in 2021 and 2022, as the MDA concept was extended to cover additional buffers that banks must now maintain above a large basket of instruments subject to potential loss-absorption or bail-in (the « minimum ratio of eligible liabilities, » or MREL), and it will be extended further in 2023 when a leverage-related buffer requirement becomes applicable.

In addition, the market seems to have accepted the fact that banks will not automatically call AT1 securities on the first possible redemption date, although this has taken some time. When Deutsche Bank decided in 2013 not to call a series of Tier 1 securities issued before the new regime came into effect, Reuters reported that this « tarnished its reputation » and recalled the specter of the December 2008 decision not to call its Tier 2 bond. [22] Yet the Financial Times reported in 2019 that the trading price of the Tier 2 Deutsche Bank bond had substantially rebounded within months of the decision not to call, and it was fully repaid at maturity in 2014. [23] The Financial Times report was published in the context of a decision by Santander not to call an AT1 bond for purely economic reasons (as Santander was not in financial difficulty), which the Financial Times said violated a « gentleman's agreement » with investors that such bonds would be called at the first possible date. [24] Yet as the COVID-19 pandemic hit, several banks decided not to call AT1 securities in the second quarter of 2020, leading a market commentator writing in March 2022 to refer to decisions not to call AT1 bonds as « quite a non-event. » [25] In November 2022, following announcements by two banks of their decisions not to call AT1 securities and a rumor of a possible third non-call, an analyst for a prominent investment manager was quoted as saying that « non-calls are not a pre-occupation » for the market. [26]

The restrictions on coupon payments on AT1 securities were not tested in the COVID-19 pandemic. Regulators such as the European Central Bank, the US Federal Reserve System and the Bank of England restricted or recommended limitations on banks paying dividends on or repurchasing ordinary shares, without recommending the cancellation of AT1 coupons. [27] As a consequence, the pandemic did not constitute a test of the effectiveness of the new AT1 regime in crisis conditions.

Conclusion

7 - There is an inherent tension, in any instrument designed to allow banks to raise fresh capital, between the need to reassure the market and attract investors, on the one hand, and the need to ensure that the loss absorption features of such instruments can effectively serve their purpose, on the other hand. This is true for CET1 instruments such as ordinary shares, and it is particularly true for AT1 instruments that are marketed as bonds.

It seems clear that the original design of the predecessors of AT1 instruments tilted too much in favor of market reassurance, with the consequence that the loss absorption features did not work adequately in the 2008 financial crisis, resulting in governments providing support not just for essential banking activities that finance the economy, but also for the hybrid instruments that should have absorbed some of the losses that were ultimately borne by taxpayers.

It is unclear whether the situation will be different in a future crisis. While the more robust AT1 terms required by the new regulations include features that must be triggered automatically in crisis conditions, the new regime also gives regulators crisis management and early intervention powers that may reduce the likelihood of the triggers ever being reached. In addition, because the new regime requires banks to maintain more capital than before the 2008 financial crisis, with a greater share of that capital in the form of CET1 instruments, it is possible that the need to test the new AT1 triggers will never arise. If so, that would be a positive outcome for banks, regulators, investors and taxpayers, as it would mean that the « more and better capital » maintained by banks would have served its purpose.■

European Union and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation 2010/1093, as amended.

19. Valentina Za, Silvia Aloisi, *Monte Paschi freezes coupon payments on hybrid debt*, Reuters (23 September 2013).
20. Pierluigi Bologna, Ariana Miglietta and Anatoli Segura, *Contagion in the CoCo Market ? A Tale of Two Stress Events*, 16 International Journal of Central Banking 137, 144-148 (December 2020).
21. Helen Durand, *UniCredit AT1 coupon payments hang on swift capital raise*, Reuters (12 January 2017).
22. Aimee Donnellan, *Investors tire of Deutsche Bank non-call trend*, Reuters (21 August 2013).
23. Thomas Hale, *Revisiting a Deutsche Bank controversy*, Financial Times (13 February 2019).
24. Robert Smith, *Santander Shocks Market With Bond Decision*, Financial Times (12 February 2019).
25. Jérôme Boudinet, *Learning to live with CoCo non-calls*, La Française Group Technical Report (15 March 2022).
26. Fabrice Anselmi, *Le marché des dettes bancaires CoCo frémit à nouveau*, L'AGEFI Quotidien (23 November 2022).
27. *See, e.g., ECB asks banks not to pay dividends until at least October 2020*, ECB Press Release (27 March 2020).