Contingent Convertible Bonds in the European Union: Structuring Considerations and Current Legal Issues

In December 2011, the Basel Committee on Banking Supervision (the Basel Committee) published its final rules, known as Basel III, modifying the Basel II regulatory capital accord for internationally active financial institutions. One of the primary objectives of Basel III is to increase the quantity and quality of capital required to be held by such institutions.

This Alert discusses the key legal and structuring issues to be considered by European Union (EU) financial institutions proposing to issue contingent convertible (CoCo) capital instruments under the Basel III rules as amended by guidance and recommendations from the European Banking Authority (EBA).

Introduction

Prior to the adoption of Basel III, financial institutions had issued at least US$157 billion in aggregate face value of so-called “hybrid” capital instruments containing features allowing such instruments to function like equity in certain respects and like debt in other respects. Basel III changed that regulatory capital landscape dramatically by requiring non-equity bank instruments to function much more like equity and less like debt.

Generally, Basel III restructures the required capital structuring of banks along the following lines:

• **Tier 1 (T1):** T1 capital includes subcategories CET and AT1 (as defined below). The EBA Recommendation (described below) required that CET and AT1 capital collectively comprise 9 percent of risk-weighted assets of the relevant bank. The EBA indicated in a preliminary assessment in July 2012 that the 27 European banks which submitted recapitalization plans following the EBA Recommendation had met or were on track to reach the 9 percent T1 target, including through the issuance of CoCos which represented a principal aggregate amount equivalent to 15 percent of the €76 billion T1 shortfall.

• **Core Equity Tier 1 (CET):** The CET capital definition is narrowed to include only common equity capital, retained earnings and comparable items. Under Basel III, banks must meet much higher T1 requirements as a percentage of risk-weighted assets — Basel III requires CET capital to constitute at least 4.5 percent of risk-weighted assets. However the EBA Recommendation (described below) required that banks hold 5.125 percent of CET capital by July 2012.

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• **Additional Tier 1 (AT1):** AT1 capital includes hybrid instruments, stock surplus and instruments issued by consolidated bank subsidiaries held by third parties. The potential contribution of AT1 to regulatory capital has been reduced to 1.5 percent from 2 percent. Under Basel III, additional loss absorption features are required in order for any non-perpetual instrument, including CoCos, to be treated as AT1 capital. With respect to the EBA Recommendation, AT1 capital can comprise up to 3.875 percent of risk-weighted assets and instruments compliant with the EBA term sheet called Buffer Convertible Capital Securities (BCCS) will be recognized as AT1.

• **Tier 2 (T2):** The subcategories of upper and lower T2 are eliminated under Basel III and a bank's ability to treat this type of instrument as regulatory capital has been reduced. The EBA has not yet taken a view with respect to T2 instruments.

• **Tier 3:** This category of bank regulatory capital has been eliminated entirely under Basel III.

• **Capital Conservation Buffer:** Basel III introduces this new capital requirement, which effectively raises the total capital requirement for banks because those banks that fall below the sum of the T1, T2 and capital conservation buffer levels are subject to restrictions regarding the payment of dividends and bonuses until the required levels are once again met.

• **Deductions:** Basel III introduces mandatory regulatory deductions from common equity capital for, among other items, certain investments in non-consolidated financial institutions, mortgage servicing rights and deferred tax assets.

CoCos are a type of hybrid capital instrument that have been issued by financial institutions since approximately December 2009. CoCos are designed to help a bank meet its capital adequacy and funding requirements while at the same time achieving favorable tax deductibility treatment for coupon payments and “equity” credit from rating agencies. The main premise behind CoCos is that during periods when banks are facing liquidity pressures or other market stresses, they can reduce their coupon payments and/or gain an extra cushion of equity capital.\(^4\)

CoCos are typically structured either as contingent notes or as contingent convertible notes. Contingent notes feature a write-down of the principal amount of the notes upon the occurrence of a specific trigger event. In some cases, the principal can be written down to zero and the note is effectively cancelled; in other cases, the principal write-down is temporary and can be written back up as the bank returns to fiscal health. Contingent convertible notes feature a conversion into the equity of the relevant bank or the relevant bank holding company either at a pre-determined conversion price or at a conversion ratio determined at the time on the basis of certain variable inputs. In the case where a CoCo issuer is an affiliate of the relevant bank, the notes are generally exchangeable into the common equity of the bank or the bank holding company. At the bank's discretion or upon request of the regulator, coupon payments can be suspended. Unpaid coupon payments are extinguished and cannot be repaid at a later point, even with approval of the relevant regulator.

**Basel III and the EBA Recommendation**

**Basel III**

While hybrid instruments have been a part of bank regulatory capital for decades, the Basel III framework contains specific and more stringent requirements for those instruments, including CoCos.

Under the Basel III framework, CoCos can qualify as AT1 capital if they have, *inter alia*, the following features:

• They are fully paid-in\(^5\).
• They are subordinated to depositors, general creditors and subordinated debt.
• They are perpetual and without incentives to redeem or expectation of redemption.
• They are callable by the issuer only after a minimum of five years, only with prior supervisory approval, and without features hindering the recapitalization of the bank.
• They have dividends or coupons payable only out of distributable income, with full discretion on the part of the bank to cancel the dividend or coupon without triggering an event of default or other restriction, and with full access by the bank to any cancelled dividend or coupon.
• They have no credit-sensitive dividend or coupon feature.
• They are unsecured.
• Upon the occurrence of a stress event, they either convert to common shares at a pre-set conversion ratio or suffer a principal write-down to a pre-set trigger point (the aggregate amount to be written-down or converted upon the occurrence of the stress event must be at least sufficient to return the bank’s CET ratio to the pre-trigger level or the full principal value of the instrument, whichever is lower).

Under the Basel III framework, CoCos can qualify as T2 capital if they have, **inter alia**, the following features:

• They are fully paid-in.
• They are subordinated to depositors and general creditors of the bank.
• They have a maturity of at least five years.
• They are callable by the issuer only after a minimum of five years, only with prior supervisory approval, there are no structural features which would create the impression that the issuer will call the securities at such time, and the bank must not exercise the call unless the instrument is concurrently replaced with one of the same or better quality or the bank demonstrates that its regulatory capital exceeds the Basel III requirements.
• The instruments do not contain any incentives to redeem or step-ups.
• They have no credit-sensitive dividend or coupon feature.
• They are not secured or covered by a guarantee of the issuer or related entity or other arrangement that functions as a credit enhancement with respect to claims by depositors and general creditors of the bank.
• The issuer is either the bank, the bank holding company or a special purpose vehicle which makes the proceeds of the issuance immediately available to an entity which conducts the bank's business.

**EU Capital Requirements Directive**

Basel III implementation within the EU is underway in the form of proposed changes to the existing EU Capital Requirements Directive (CRD). The draft legislative package (collectively referred to as CRD IV) includes both a regulation directly applicable within the Member States and a directive requiring Member States to transpose the directive into national law. An initial CRD IV proposal was published by the European Commission in July 2011. Although the European Commission aims for CRD IV to become effective by January 1, 2013, following the review of the draft directive and regulation, the Committee on Economic and Monetary Affairs of the European Parliament proposed a number of changes to each text which have been tabled for debate in plenary sessions of the European Parliament provisionally scheduled for late October. Pursuant to European law, the European Council must also approve of the CRD IV package.

The existing draft CRD IV proposal as presented to the EU Parliament faithfully implements Basel III within the EU, with some variations not generally relevant to this client alert. Whereas Basel III applies only to “internationally active banks”, CRD IV and the EU’s other capital requirement rules for financial institutions will apply to all banks and certain investment firms in every Member State.
EBA Recommendation

In July 2011, the EBA published the results of a stress test conducted on 71 European banks designed to assess the capital adequacy and resiliency of large European banks in a scenario of negative gross domestic product in the EU and further deterioration in the market value of certain European sovereign debt securities (the EBA Stress Test). The results of the EBA Stress Test revealed a €25 billion deficit in T1 capital for approximately 20 banks; however, since the EBA Stress Test excluded certain European banks, and given further deterioration in the market for certain European sovereign debt securities, the EBA clarified that the total T1 shortfall was approximately €76 billion for 27 banks. Following the EBA Stress Test, the EBA published a recommendation (the EBA Recommendation) in December 2011 pursuant to its authority granted in the Regulation 1093/2010. The EBA required that each bank with a capital shortfall to prepare and submit a recapitalization plan by January 20, 2012 for review both by the bank’s competent supervisory authority and the EBA itself.

Pursuant to Regulation 1093/2010, regulators in the EU Member States must make every effort to comply with the EBA’s recommendations. The EBA emphasized that banks needing recapitalization should use private sector sources of funding to strengthen their capital position rather than engaging in “excessive deleveraging” to reach the 9 percent minimum required capital threshold. As a result, the EBA published an annex to the EBA Recommendation a term sheet for BCCS, CoCo-like instruments structured to convert to common equity under certain circumstances. According to the EBA, the recapitalization plans submitted to it by the relevant banks as measured by the percentage of the recapitalization amount included measures for new capital raising and retaining of reserves (26 percent), conversion to equity of existing hybrid debt (22 percent), capital impact of risk-weighted asset measures (including disposal of assets, deleveraging measures and new advanced models of risk management)(23 percent) and issuance of private CoCos (6 percent).

The key features of BCCS are as follows:

• BCCS are direct, unsecured, undated and subordinated securities of the relevant bank issuer (entirely consistent with the Basel III framework).

• The required trigger events for conversion are:
  
  – In the event that the (i) the CET ratio of the bank falls below 5.125 percent after January 1, 2013, consistent with the Basel III phase-in and the assumed effectiveness of CRD IV and (ii) the T1 ratio (net of certain deductions) falls below 7 percent, provided the EBA Recommendation is still in force (in each case, a Contingency Event), or
  
  – if either (x) the national banking regulator determines that conversion is necessary for the bank to remain solvent or (y) the relevant bank has received public sector support from the relevant Member State, without which the bank would be insolvent as determined by the national banking regulator (in each case, a Viability Event).

The BCCS term sheet states that conversion rate will be established on a case-by-case basis, either within a predetermined range or at a set rate of conversion with a limit on the permitted amount of conversion.

• In order to ensure loss absorbency, the bank issuer must have sole discretion at all times to definitively cancel coupon payments on a non-cumulative basis without triggering an event of default.

• Upon certain breaches of minimum solvency requirements related to distributable income, the EBA or the relevant national banking regulatory will require the bank issuer to cancel coupon payments.

• Finally, the national banking regulator will have the authority at all times, in its sole discretion, to cancel coupon payments on the BCCS.
According to the EBA, European banks have issued BCCS instruments with €11.5 billion in aggregate principal amount, representing approximately 12 percent of the recapitalization amount required under the EBA Recommendation. In addition, several European financial institutions issued CoCos in the form of T2 instruments prior to and following the EBA Recommendation.

In April 2012, the EBA launched a consultation process regarding, *inter alia*, bank regulatory capital and the structuring of CoCos (the Technical Standards Consultation Paper). Pursuant to the draft CRD IV regulation Article 49(2), the EBA is tasked with developing regulatory technical standards with respect to several key points for the structuring of CoCos. Among the open issues for which the Technical Standards Consultation Paper solicits input are the following:

- **Form, nature and definitions of “incentives to redeem”:** The Technical Standards Consultation Paper suggests that the EBA will consider the following types of call options as “incentives to redeem” all call options which include increase cost of interest or ability for the investor to convert the instrument into common equity if the call option is not exercised;

- **Write-up provisions for CoCos:** The Technical Standards Consultation Paper suggests that the EBA will allow write-ups that are based on actual profits of the institution, within the full discretion of the institution, *provided* that such write-ups are extended on a pro rata basis to similar AT1 instruments that have been subjected to such a write-down and that the maximum amount of the write-up be based on the bank’s profit multiplied by the sum of the nominal of all AT1 instruments before the write-down that have been so written-down divided by the total T1 capital of the relevant bank *further provided* that the write-up will trigger a reduction of CET, after such time that the institution must remain in full compliance with the CRD IV requirements.

- **Procedure and timing for determining if a trigger event has occurred:** The Technical Standards Consultation Paper suggests a maximum of one month for the amount to be written-down or converted.

While the Technical Standards Consultation Paper should not be considered indicative of the EBA’s final views on the topics covered, it suggests that the EBA is open to the possibility of introducing both principal write-downs and write-ups with respect to AT1-compliant CoCos whereas the BCCS term sheet had permitted only CoCos which feature a conversion to common equity. The consultation process closes in August 2012, at which time the EBA will consider the responses in producing draft technical standards as mandated by the draft CRD IV.

**Structuring Considerations**

The following are some of the important structuring considerations for issuers in connection with the issuance of any CoCo instrument:

- **Conversion to common equity or principal write-down:** An issuer should consider whether to structure the loss absorption feature of the instrument as a conversion of the instrument into common equity or as a principal write-down without conversion. For CoCos with principal write-downs, the issuer must consider the extent of the required write-down and whether to incorporate a principal write-up as the bank returns to fiscal health. Most of the recent CoCo issuances by European banks have incorporated principal write-downs. However, there is less public guidance from the regulators on write-ups, and indeed the EBA has commenced a consultation process about this feature of CoCos. For CoCos that convert to common equity, the issuer must consider and resolve outstanding antidilution and conversion ratio issues at the time of issuance.

- **New issuance, warrants to purchase or exchange offer for outstanding debt:** An issuer should consider whether it is advantageous for it to call existing T2 and/
or other subordinated debt and offer CoCos in exchange to existing holders as part of its liability management exercises to reach the 9 percent T1 threshold. The Bank of Cyprus and Credit Suisse offered the right to purchase CoCos to certain existing common equity holders in April 2011 and July 2012, respectively. In addition, Lloyds TSB and Yorkshire Building Society undertook exchange offers in December 2009 for existing regulatory capital as part of a restructuring (and in the latter case, as part of its takeover of Chelsea Building Society).

- **Capital structure treatment:** An issuer should consider whether a CoCo should be structured as an AT1 instrument or as a T2 instrument. Market precedents exist for both, even though the EBA clearly has expressed its preference for AT1 treatment through its BCCS term sheet. In addition, the risk discount price associated with CoCos must be compared to the cost of issuing new common equity (e.g., via a rights offering). In addition, an issuer should take into consideration which of its outstanding instruments could benefit from grandfathering (and for how long) and those that will not, in order to structure a robust and fully-compliant bank regulatory capital structure for the long term.

- **Trigger issues:** An issuer should consider whether the trigger for conversion or principal write-down should be set at the regulatory minimum, or whether the trigger should reflect an additional Capital Conservation Buffer. In addition, an issuer should consider the frequency of reporting its risk weighted capital ratio in light of the fact that during the financial crisis banks often failed due to a crisis of confidence rather than a classic liquidity crisis; although the Viability Event trigger was conceived by the Basel Committee to reduce such risks.

- **Additional rights for CoCo holders:** An issuer should consider whether to include additional rights for holders of CoCos, such as springing voting rights or dividend stoppers blocking dividend or coupon payments on other instruments (e.g., common equity or other AT1 instruments). According to the Basel Committee, dividend stoppers are permissible if they (a) only block payments on instruments for which the issuer retains full discretion, (b) cease once payments have resumed on the relevant CoCo, and (c) do not impede the normal operation of the bank. However, these features have yet to be seen in the nascent Basel III-compliant CoCo market, and the EBA term sheet is silent with respect to such additional rights.

- **Tax Considerations:** The tax treatment of CoCos varies by jurisdiction. Given the current market environment, coupon costs for issuers are likely to be high. Thus, the tax treatment of CoCos may determine whether CoCos are cost-effective compared to common equity. The tax analysis is largely driven by the terms and conditions of the CoCo, including, *inter alia*, the maturity of the CoCo (perpetual instruments face unique problems) and the write-down or worst case scenario situations (CoCos incorporating principal write-downs may generate more uncertainty than those with conversion to common equity). In addition, issuers that are US tax payers should consider:
  - **Interest deductibility.** If the CoCos are treated as debt instruments for US federal taxation purposes, interest payments can generally be deducted (if not disallowed under special rules) by the issuer for federal income tax purposes.
  - **Cancellation of indebtedness income.** To the extent the conversion of the CoCos into equity occurs and the fair market value of the equity instrument which is received is lower than the amounts treated as due under the CoCos, or to the extent a write-down of principal occurs, the issuer could recognize cancellation of indebtedness income. If the CoCos are treated as equity, there would be no need to record cancellation of indebtedness income upon a conversion or write-down of the CoCo, but there would also be no favorable tax deductibility for coupon payments.
Issuing or exchanging CoCos in the United States

To date, few CoCo issuances have been extended into the United States or included disclosure which would allow the sale of the securities to US persons. The majority of CoCo issuances have been issued solely outside the US and marketed and sold to only non-US persons in offshore transactions in reliance on Regulation S of the Securities Act of 1933, as amended (the Securities Act).

For issuers that may be considering an offering and sale of CoCos into the US, the securities must either be registered with the Securities and Exchange Commission (SEC) under the Securities Act or issued pursuant to an exemption from registration. We regularly advise issuers on the principal methods by which a European bank could issue CoCos within the US and refer you to our publication on this topic.

Conclusions/Lessons Learned from Recent CoCo Issuances by European Banks

To date, several European banking institutions from jurisdictions such as Cyprus, Portugal, Switzerland and the United Kingdom have issued CoCos totalling approximately US$20 billion in aggregate principal amount. The terms and circumstances of such issuances varied greatly:

• First, the majority of private issuances and exchange offers of CoCos by European banks have been conducted in reliance on Regulation S of the Securities Act.

• Second, a number of issuances occurred in the context of an economic restructuring of a distressed bank group, while other issuances were by institutions in positions of relative economic strength.

• Third, certain issuances were structured to qualify as AT1 whereas others were explicitly structured to qualify as T2.

• Fourth, certain CoCos were issued in connection with exchange offers for existing subordinated debt instruments, whereas others were new issuances unconnected with liability management exercises.

• Fifth, many CoCos, especially those in response to the EBA Recommendation and compliant with the EBA term sheet, were exclusively subscribed by governments or government funds, in certain cases with assistance from the EU.

The EBA consultation and CRD IV legislative approval process will likely provide further guidance from regulators regarding the terms and conditions of CoCos. With the CRD IV package expected to come into force in 2013, CoCos will likely continue to play a role in bank regulatory capital raising. Based upon experience to date, the specific circumstances and the interplay with the national regulatory environment of each bank dictate the terms and structure of a CoCo issuance that will be most attractive to an issuing bank.
Endnotes

1. The term CoCo as used in this Alert refers solely to contingent convertible bonds issued by banks for regulatory capital purposes.


3. European Banking Authority, Update on the implementation of Capital Plans following the EBA’s 2011 Recommendation on the creation of temporary capital buffers to restore market confidence. July 2012.

4. It should be noted that several European banks have considered issuing CoCos as a means of providing executive compensation to their staff as a means to link compensation with long-term performance. Private issuances of CoCos as executive compensation raises other legal questions that are outside the scope of this alert and accordingly, not discussed here.

5. The Basel Committee clarified that paid-in does not have to be with cash, although it indicated that it is likely to be the case for most of the applicable AT1 and T2 instruments. Prior supervisory approval is required when a bank proposes to issue AT1 or T2 instruments that have been paid in by some means other than cash, for example, via exchange of other outstanding instruments. The Basel Committee, Basel III definition of capital – Frequently asked questions, December 2011, pg. 2.

6. The Basel Committee clarified that incentives to redeem include, inter alia: (i) call options at a pre-set date after which time the credit spread of an instrument increases if such call option is not exercised, (ii) a call option combined with a requirement that the CoCo holder convert the instrument into common equity if the call option is not exercised and (iii) a call option combined with underlying changes to the reference rate by which the coupon is calculated which effectively increases the coupon. Id.

7. The Basel Committee clarified that under certain circumstances which were not foreseeable the time of the issuance, the issuer can call AT1 and T2 instruments within the first five years for regulatory or tax reasons. Id., pg. 6.

8. The Basel Committee clarified that the trigger level for write-down/conversion must be at least 5.125 percent CET. See infra Contingency Event (as defined below). In addition, the write-down/conversion must generate CET under the relevant accounting standards. Id.

9. Supra at Note 5.


13. Supra at Note 3, pg. 3.


17. European Banking Authority, Overview of the Capital Plans following the EBA Recommendation on the creation and supervisory oversight of temporary capital buffers to restore market confidence (EBA December 2011 Recommendation).

18. Supra at Note 16.

19. Supra at Note 3, pg. 7.

20. European Banking Authority, Consultation Paper on Draft Regulatory Technical Standards on Own Funds. EBA/CP/2012/02.

It is not clear what the EBA's view is with respect to the so-called CoCoCo structure which was utilized in the recapitalization of the Bank of Cyprus. In that structure, the perpetual AT1 securities featured a conversion right at the option of the holders during specified conversion periods in addition to a Contingency Event and Viability Event triggers in which the securities would be mandatorily converted into the bank’s common equity upon designated stress events or regulatory intervention, as the case may be.

22 Supra at Note 20.
23 Supra at Note 5, pg. 3.

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