Perpetual Bonds: Lessons for Regulatory Capital Hierarchies

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Agenda

I. **Credit Swiss/UBS Merger**

II. Innovative/hybrid instruments

III. Basel III: ATIC Standard

IV. Legal/regulatory constraints

V. Concluding insight

UBS/CS
A formal resolution proceeding??

- 19 March 2023 Announcement: UBS & CS would merge

- Swiss minister of finance: "commercial transaction"!!!

- 2 elements of the transaction:

  – (i) A write-down of all CS AT1 Perpetual Bonds for CHF 16 billion; and

  – (ii) A share swap for CS shareholders: 1 UBS share for 22.48 CS shares

Impact on AT1 market

- ATI write-down & retention of shareholders equity
- Yields on AT1 instruments increased substantially
- Scheduled issuances were postponed
- Authorities issued statements reiterating that:
  - AT1 instruments rank ahead of CET1 in the hierarchy of claims

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Basel II:
Innovative or Hybrid Instruments

- Debt/Equity instruments

- They achieve the following objectives :

Increased ROE & EPS

- Tax effective instrument that can be treated:

1. as debt by tax authorities
2. as equity by accountants
3. as regulatory capital by supervisors

Basel II: Int. Convergence

Regulatory Capital **Economic Capital**

Innovative Instruments

Other Examples include: VAR, FIRB, AIRB, ICAAP

Reasons for using T1 innovative instruments

- Cheaper Source of capital/Common equity

- Non-dilutive (ROE, EPS ratios):
  - Common equity are calculated in the denominator of these ratios

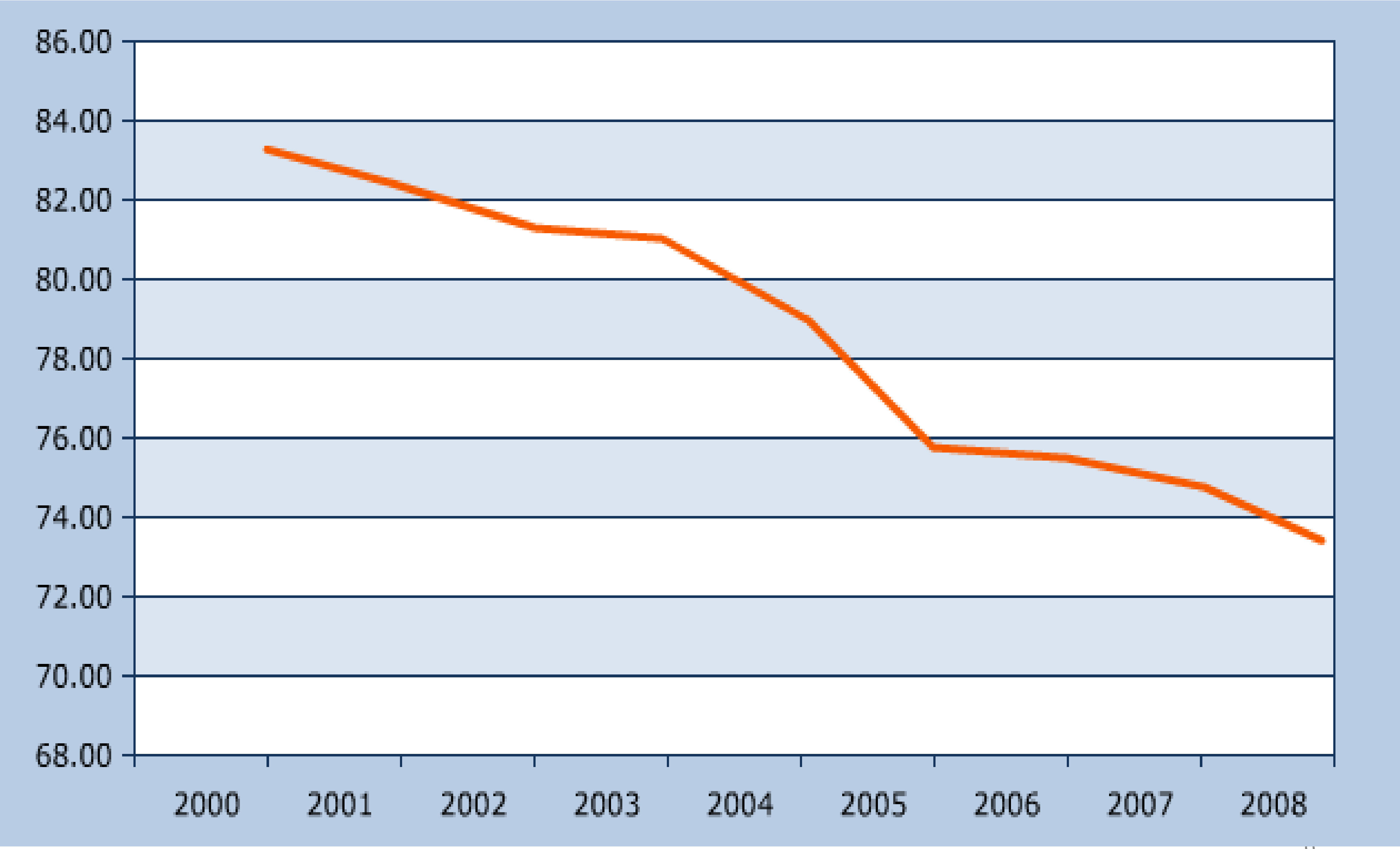
- Quantity of capital :

  can be issued in larger amounts (attractive to investors)

- Raising capital in difficult times *(not easy to issue common shares)*

- Hedging the bank Core Capital

Decline in the Quality of Bank Capital :
Major UK Banks' Core Tier 1 Capital as a % of Total Tier 1 Capital



(Source: Bank of England Financial Stability Report June 2009)

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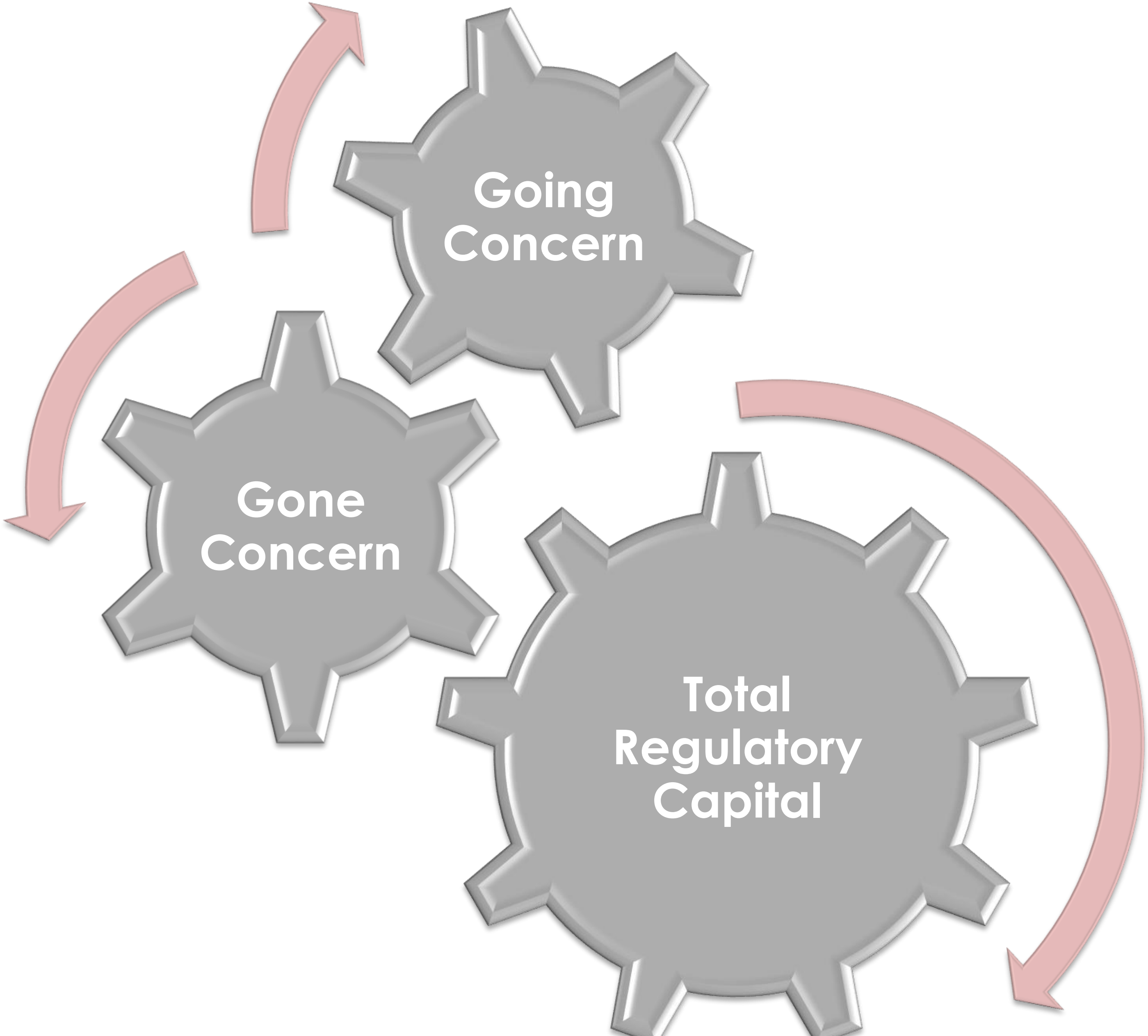
The Quality and Quantity of Capital

- Basel III: RC/Acc. Capital
- Basel III: areas of changes
  - a tightening of the previous definitions
  - the inclusion of very specific classification criteria &
  - the clarification of the roles of Tier 1 and Tier 2


Going Concern
Gone Concern
Total Regulatory Capital

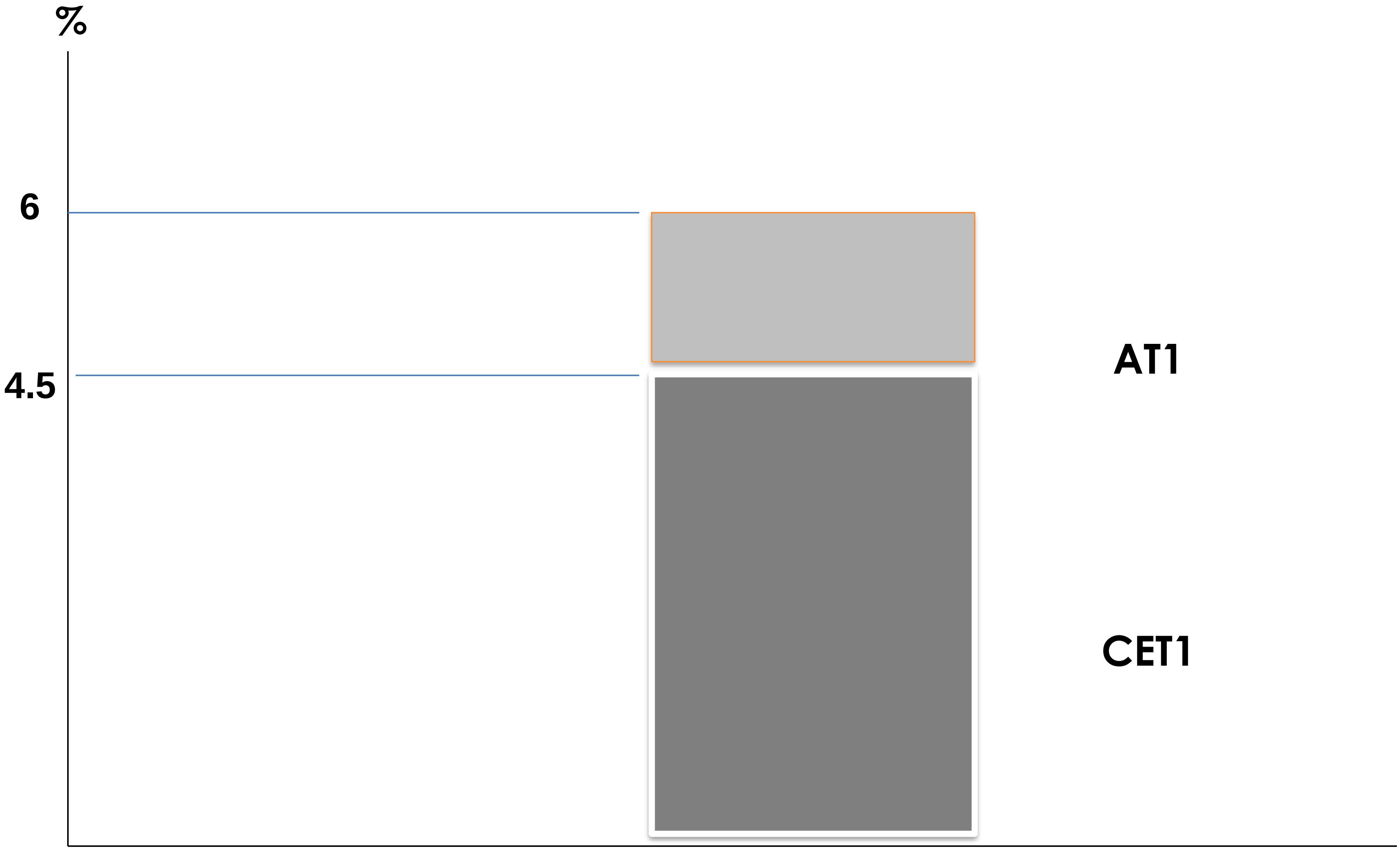
Going-concern Capital

- Have the capacity to unconditionally absorb losses
- Allowing the bank to remain in business
- Payments are fully discretionary

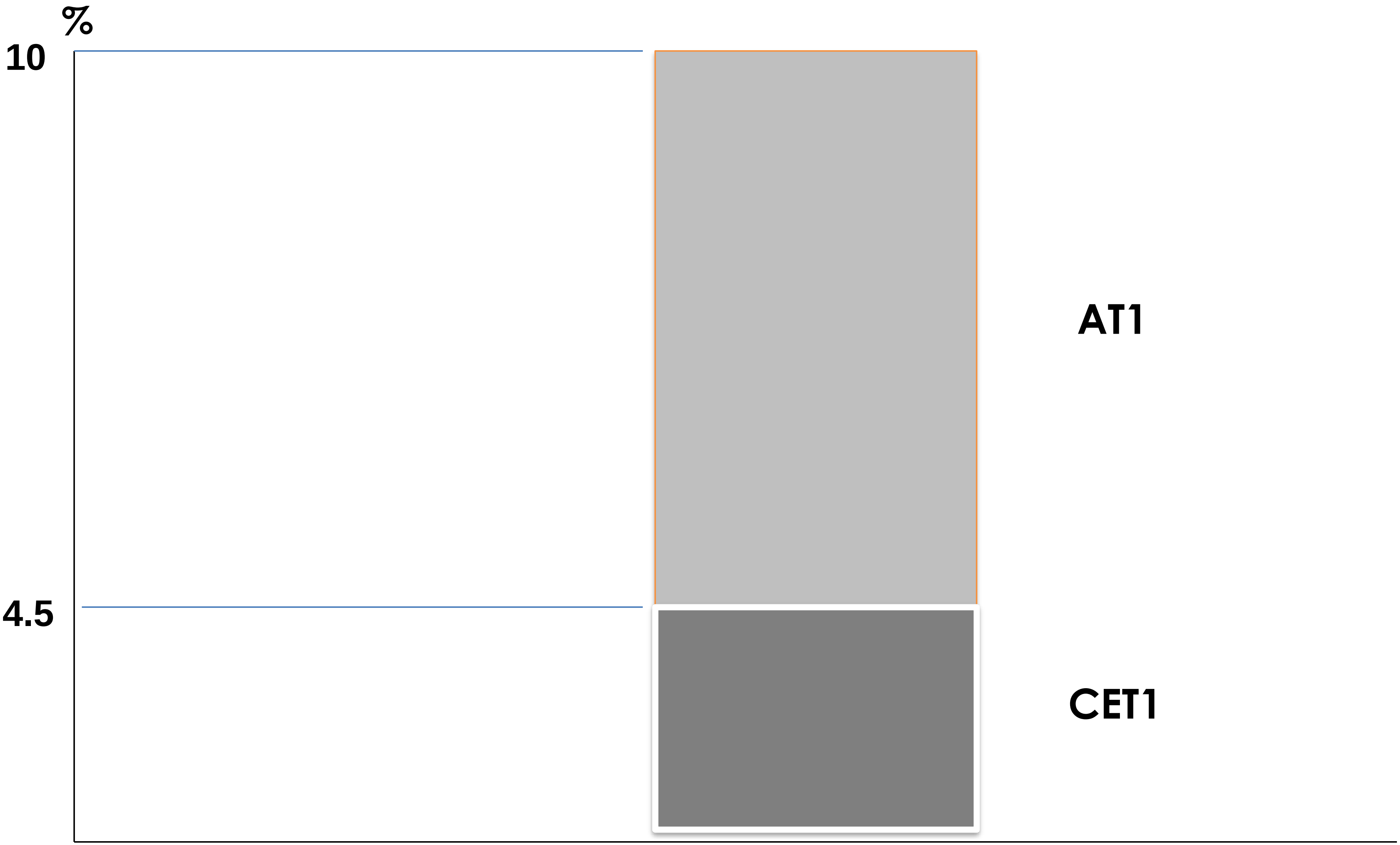
Gone-concern Capital

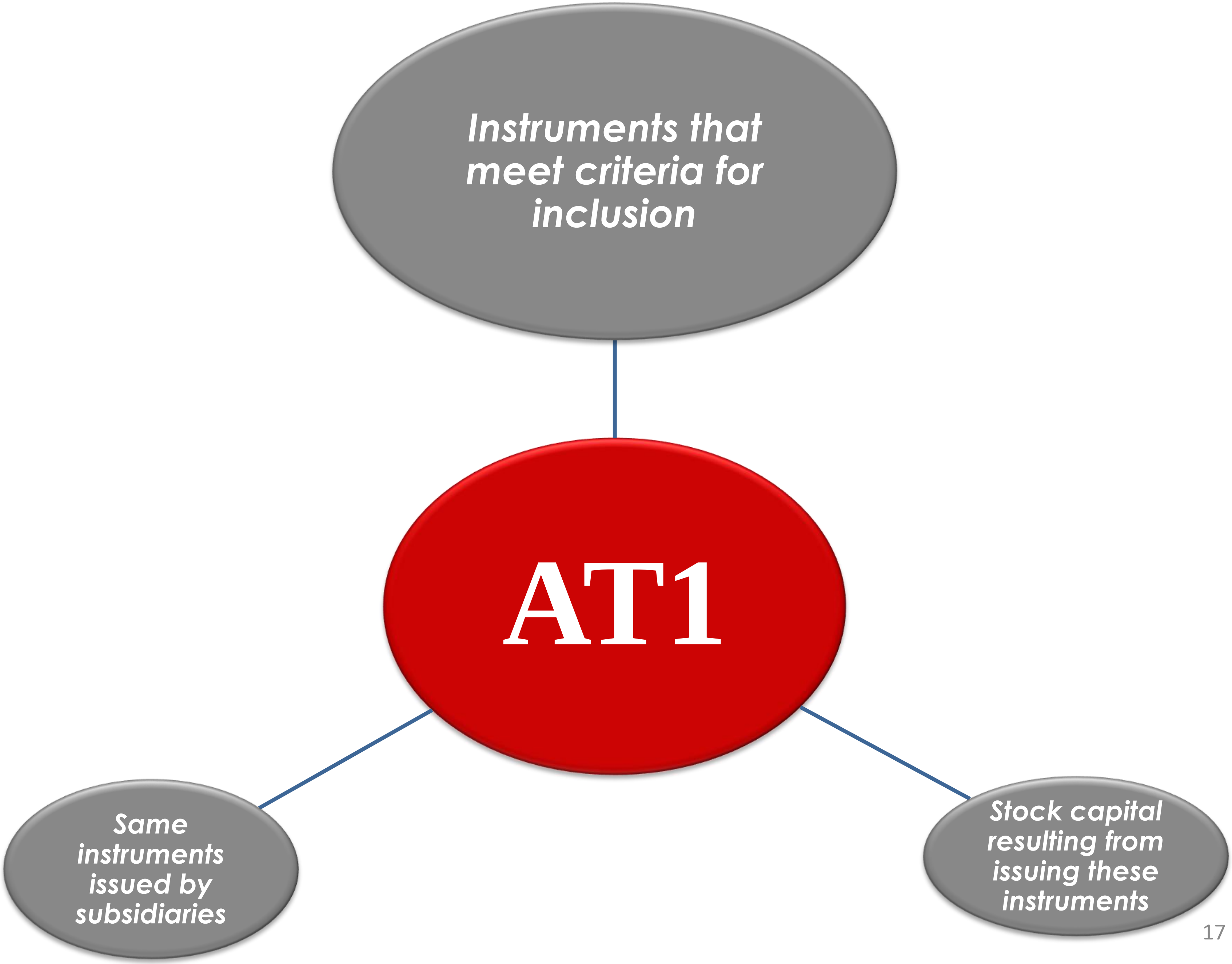
- Instruments must:
  - absorb losses only in liquidation
  - written-off or converted into common equity at the point of non-viability.
- No upper & lower
- No limits

Tier 1 Structure



Is this a good Capital Structure?




Instruments that meet criteria for inclusion
AT1
Same instruments issued by subsidiaries
Stock capital resulting from issuing these instruments

Criteria for inclusion in Tier 1 capital

- Issued & fully paid-in
- Subordinated to:
  - depositors, general creditors, &
  - subordinated debts of the bank
- Neither secured nor covered by guarantees by the issuer
- Perpetual (no maturity, no step up, no incentive to redeem)
- Issuer can't purchase it nor fund its purchase

Criteria for inclusion in Tier 1 capital

- May be callable at the order of the issuer after 5 years:
  - **Sup. approval** before any exercise of the call option
  - Issuer ***must*** not create any expectation that the call will be exercised
  - Banks must not exercise a call unless:
    - They ***replace*** … with similar or better quality; or
    - ***Issuer demonstrates*** that its capital position is ***well above MCR***

Criteria for inclusion in Tier 1 capital

Non-Cumulative, dividend/coupon discretion

a) ***Bank must have full:***
   - discretion at all times to cancel distributions
   - access to cancelled payments

b) ***Cancellation of discretionary payments must not:***
   - be an event of default
   - impose restrictions on the bank

c) ***Credit sensitive dividend feature:***
   - Periodic reset based on the issuer's credit standing

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CS/UBS Case: add. questions

1. Can AT1 instruments be written down “in isolation”? ie regardless of a writedown on CET1 capital?

2. Are isolated writedowns idiosyncratic to CS and the specific circumstances of that bank’s failure

3. Will other AT1 instruments, might behave similarly?

AT1 Standard?

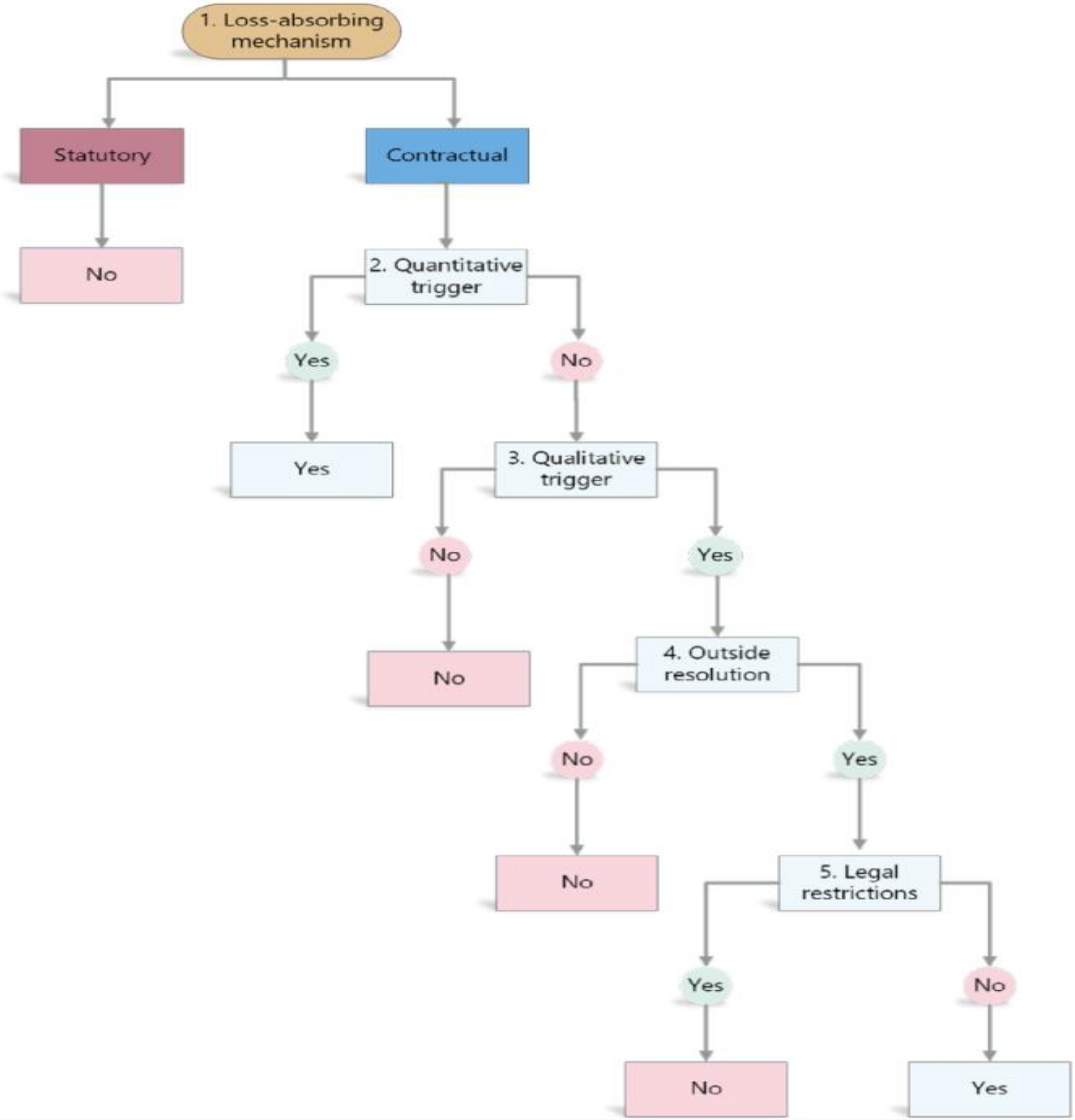
- **Contractual** principal loss absorption mechanism

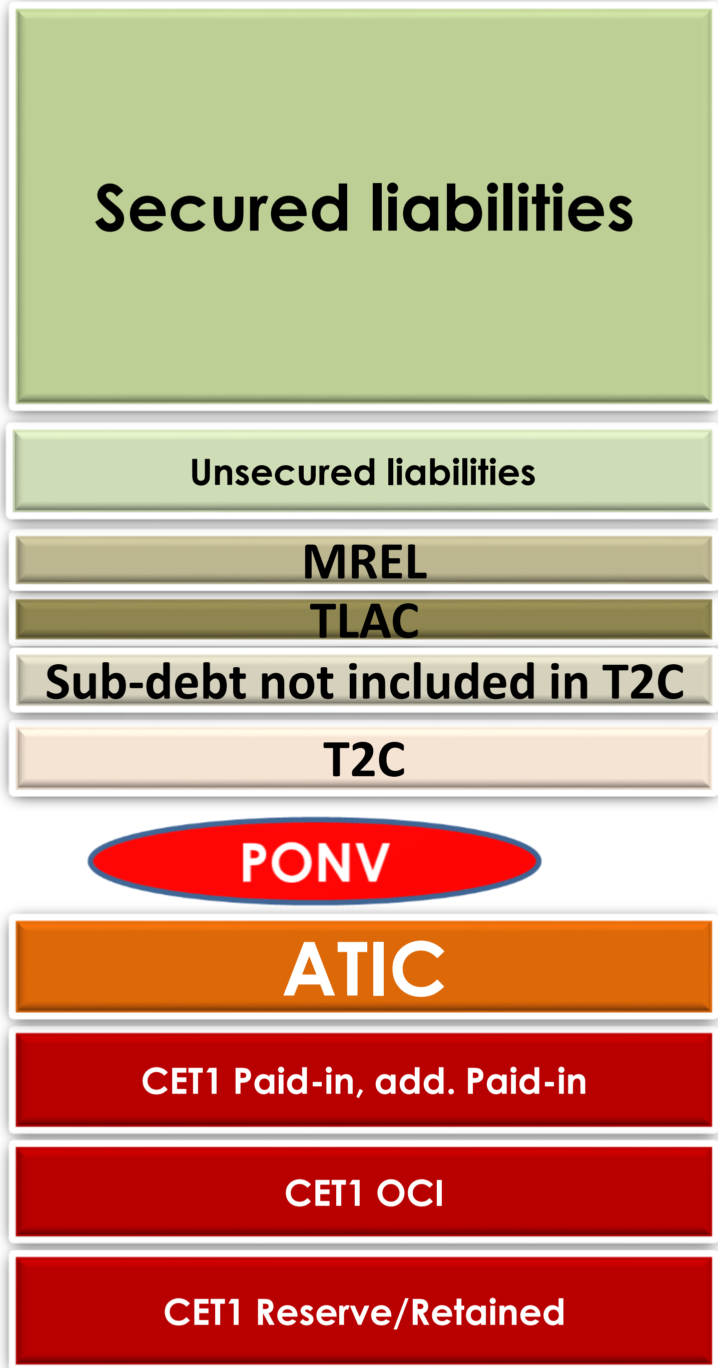
- Some jurisdictions have a “Statutory Approach”:
  - Writedown irrespective of terms and conditions

AT1 Standard: Contractual triggers:

- **Quantitative trigger:**
  - Instruments must contain a trigger calibrated to ≥ 5.125% CET1

- **Qualitative trigger:**
  - Decision of sup/Reg. that a writedown is needed to restore viability or
  - Decision by the public sector to provide support to restore the viability


1. Loss-absorbing mechanism
Statutory
Contractual
No
2. Quantitative trigger
Yes
No
Yes
3. Qualitative trigger
No
Yes
No
4. Outside resolution
No
Yes
No
5. Legal restrictions
Yes
No
No
Yes


Secured liabilities
Unsecured liabilities
MREL
TLAC
Sub-debt not included in T2C
T2C
PONV
ATIC
CET1 Paid-in, add. Paid-in
CET1 OCI
CET1 Reserve/Retained

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Concluding insight

- FINMA relied on emergency ordinance powers not AT1 standard

- Isolated write-down of AT1 insts. is possible:

  EU, Japan, Switzerland and the UK

- If trigger event was to take place outside resolution

- To avoid isolated write down, authorities have to take a Resolution Action

Concluding insight

- AT1 standard: absorb losses on a going-concern basis
- Transparency & disclosure in ATIC markets
- Capital hierarchy is essential to preserve confidence
- Regulatory credibility and legal certainty
- Is the standard remains fit?
  - Adjustments needed?
  - Possible move to simpler, more transparent capital instruments

Questions

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