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BASEL III: DEHYBRIDIZATION OF CAPITAL

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ABSTRACT

One of the core problems in the credit crisis of 2007-08, which continued in an attenuated form through 2011, is the risk of national banking failure stemming from inadequate banking capital. Basel II, whose main purpose was to set out standards for the regulation of capital of internationally active banks, had encouraged a hybridization of capital which was dramatically reversed by the announcement of Basel III in December 2009. This paper explores the rationale for the new capital standard under Basel III. We focus on the link between excessive hybridization of tier 1 capital as a result of implementing Basel II, and the subsequent need for government sponsored bailouts during periods of high liquidity risk. This linkage indicates that Basel II had failed to mitigate liquidity risk, and perversely, amplified it by allowing hybrid financial instruments to be treated with equity-like certainty. Basel III in effect represents a failure of the financial economic models of Basel II. To allay these failures, we propose that substantive legal distinctions replace financial risk metrics in drawing distinctions between equity, hybrid capital and debt with regards to core capital. These distinctions will provide a sense of certainty and financial stability to banking capital.

I.
INTRODUCTION

In this paper, we examine the new capital adequacy regime under Basel III[1] by asking why did Basel II, after twelve

1. *See generally* BANK FOR INT'L SETTLEMENTS BASEL COMM. ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS (2010) [hereinafter BASEL III], *available at* http://www.bis.org/publ/bcbs189.pdf. For the liquidity portion of the Basel Committee on Banking Supervision's reforms, *see generally* BANK FOR INT'L SETTLEMENTS BASEL COMM. ON BANKING SUPERVISION, BASEL III: INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS AND MONITORING (2010), *available at* http://www.bis.org/publ/bcbs188.pdf.

years of technical consultations with the international banking community,[2] need to be amended so radically and quickly after the credit crisis? The general consensus is the 2007-08

2. Basel I set out an agreement to apply common minimum capital standards in the banking industry. The standards address mainly credit risk. Assets of banks were classified and grouped in five categories according to credit risk, carrying risk weights of zero, ten, twenty, fifty, and one hundred percent. The target standard ratio of capital to weighted risk assets was set at 8% of which the tier 1 capital element would be at least 4%. Tier 1 capital included only *permanent shareholders' equity* (issued and fully paid ordinary shares and common stock and perpetual non-cumulative preference shares) and *disclosed reserves* (created or increased by appropriations of retained earnings or other surplus, e.g. share premiums, retained profit, general reserves and legal reserves) while deducting goodwill. BANK FOR INT'L SETTLEMENTS BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988) [hereinafter International Convergence 1988], *available at* http://www.bis.org/publ/bcbs04a.pdf. In a press release later that year, the Basel Committee on Banking Supervision introduced the definition of operational risk, management oversight, measurement, monitoring and management information systems, policies and procedures and internal controls. Press Release, Bank for Int'l Settlements Basel Comm. on Banking Supervision, Operational Risk Management (Sept. 22, 1998), http://www.bis.org/publ/bcbs42.pdf. Shortly thereafter, in another press release, the committee introduced innovative capital instruments for inclusion in tier 1 capital. Such instruments were limited to a maximum of 15% of tier 1 capital. Press Release, Bank for Int'l Settlements Basel Comm. on Banking Supervision, Instruments Eligible for Inclusion in Tier 1 Capital (Oct. 27, 1998), http://www.bis.org/press/p981027.htm. Basel II has three pillars: minimum capital, supervisor review and market discipline. With regard to minimum capital, Basel II maintained both the definition of the numerator of the capital ratio (i.e. the definition of regulatory capital) and the minimum requirement of 8% of capital to risk-weighted assets as set out in the 1988 together with the tier 1 eligibility as announced in its October 1998 press release, "Instruments eligible for inclusion in Tier 1 capital". The second pillar is the so-called referee system: the process whereby internal auditors and national regulators ensure their country banks are following the rules. The third pillar looks to enhanced disclosure of risk. With respect to measures of risk exposure, there are three broad categories that risks run by banks fall into: credit risk, market risk and operational risk instead of the focus on credit risk under 1988 Accord. Consequently, a bank must hold adequate capital against all three types of risks. *See* BANK FOR INT'L SETTLEMENTS BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK – COMPREHENSIVE VERSION (2006) [hereinafter INTERNATIONAL CONVERGENCE 2006], *available at* http://www.bis.org/publ/bcbs128.pdf (This document is the final edition of the Basel II framework and is a compilation of the June 2004 Basel II Framework, the elements of the Basel I that were not revised during the Basel II process, the *1996 Amendment to*

credit crisis disproved the efficacy of the financial economic model for tier 1 capital of Basel II, which by providing the standard language for legal and regulatory regimes did not discourage, limit or prohibit excessive hybridization but rather provided an imprimatur for the issuance and trade of hybrid capital structures to the detriment of the entire global banking system.

Basel III, in contrast to Basel II's broad definition of tier 1 capital,[3] includes relatively restrictive definitions of tier 1 capital,[4] a new leverage ratio,[5] a new capital surcharge for systemically important banks,[6] a framework for counter-cyclical capital buffers,[7] measures to limit counter-party credit risk[8] and short- and medium-term quantitative liquidity ratios.[9] These measures taken separately would each have a strong effect of dampening normal banking business, but taken together they announce a near draconian reform. The net effect of the reforms is that they increase the probability of banks suffering a reduction in profitability and return on equity, but to admit so much would be disastrous, so instead many market participants have complained that such reforms will decrease lending.[10]

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the Capital Accord to Incorporate Market Risks, and the November 2005 paper on Basel II. No new elements were introduced in this compilation.).

3. For the Basel II definition of tier 1 capital, INTERNATIONAL CONVERGENCE 2006, *supra* note 2, ¶ 49.

4. BASEL III, *supra* note 1, ¶¶ 49-56.

5. *Id.* at ¶¶ 151-67.

6. *Id.* at ¶ 32.

7. *Id.* at ¶¶136-51.

8. *Id.* at ¶¶ 97-121.

9. *Id.* at ¶¶ 34-47.

10. *See* Australian Baking Association, Submission on the Basel Committee's Strengthening the Resilience of the Banking Sector 10 (Apr. 16, 2010), http://www.bis.org/publ/bcbs165/aubac.pdf ("The ABA supports the Committee's objective of implementing an internationally harmonised capital and liquidity framework that is simple to understand and compare across jurisdictions. However, the ABA is concerned that the severity of the changes proposed in the Committee's Consultative Documents will ultimately present an impediment to economic recovery and to longer term economic growth."); Letter from Adam M Gilbert, Managing Dir., JP Morgan Chase, to Basel Comm. on Banking Supervision, Bank for Int'l Settlements (Apr. 16 2010), http://www.bis.org/publ /bcbs165/jpmorganchase.pdf; Letter from M.D. Linsz, Corp. Treasurer, Bank of America, to Basel Comm. on Banking Supervision, Bank for Int'l Settlements 3-4 (Apr. 16, 2010), http://www.bis.org/publ/bcbs165/boac.pdf; Letter from D.K. Wong, Treasurer, and K

It is not unexpected that Basel II should be amended in light of the financial crisis, but how far should the regulatory pendulum swing in forming Basel III? Will the Basel III capital regime work on the root causes of the financial crisis? What side-effects will consumers, investors and healthy banks suffer when the new capital regime takes effect?

This paper explores a similar but narrower range of questions. How does the new capital adequacy regime under Basel III differ from Basel II? How plausible is the argument that establishing and maintaining higher quality capital and thereby limiting excessive hybridization of tier 1 capital will lead to the lowering of the probability of government bail-outs and financial crises? To answer these questions, in section 2 the main features of Basel III are defined with a focus on the distinction between quality of capital and quantity of capital. In section 3, hybrid capital instruments are defined and analyzed in light of Basel III requirements. In section 4, we discuss how Basel III is likely to affect U.S. and EU regulations and speculate on the legal and social consequences of the adoption and adaptation of Basel III in the U.S. and EU. In section 5, we examine the correlation between excessive hybridization of tier 1 capital encouraged by Basel II and the subsequent government bail-outs of financial institutions in the U.S and Europe. Given this correlation it is not surprising that Basel III seeks to lower the volume of hybridization of tier 1 capital and thus, to reduce the need for government bail-outs during financial crises. An even stronger claim can be made that Basel III, unlike Basel II, will help reduce the probability of financial crises themselves by making it more difficult for banks to use hybrid capital as a source for cash.

II.
STRENGTHENING THE BANKING SECTOR

Banks and regulators have provided mixed comments on the upcoming implementation of Basel III on capital adequacy with some saying that such regulatory challenges are inevitable in response to the credit crisis and others complaining that

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Hosuki, Head of Market Risk Dept., Morgan Stanley, to Basel Comm. on Banking Supervision, Bank for Int'l Settlements 11-12 (Apr. 16, 2010), http://www.bis.org/publ/bcbs165/morganstanley.pdf.

Basel III will have a negative impact on business.[11] While the concept of 'capital' is traditionally defined as a mix of equity and debt that banks are required to hold in reserve to support their business[12] and may be considered a global or universal

11. *Compare* Selwyn Blair-Ford, *The Global Regulatory Response*, GLOBAL ASSOCIATION OF RISK PROFESSIONALS, Apr. 5, 2010, http://www.garp.org/news-and-publications/2010/april—/the-global-regulatory-responce.aspx, *and* Natasha Brereton and Laurence Norman, *BOE King: Concerned Basel III Won't Be Tough Enough*, DOW JONES NEWSWIRES, July 28, 2010, http://www.gfmag.com/ latestnews/latest-news-old.html?newsid=7670525.0, *and* Jaime Caruana, Gen. Manager, Bank for Int'l Settlements, Speech at the 3rd Santander Int'l Banking Conf.: Basel III: towards a safer financial system 2 (Sept. 15, 2010) (transcript available at http://www.bis.org/speeches/sp100921.pdf), *and* Hervé Hannoun, Deputy Gen. Manager, Bank for Int'l Settlements, Speech at BoJ-BIS High Level Seminar on Financial Regulatory Reform: Implications for Asia and the Pacific: Basel III Capital Framework: a decisive breakthrough 8 (Nov. 22, 2010) (transcript available at http://www.bis.org/speeches/sp101125a.pdf); *with* Australian Banking Association, Submission on the Basel Committee's Strengthening the resilience of the banking sector, 10 (Apr. 16, 2010), http://www.bis.org/publ/bcbs165/aubac.pdf, *and* Daniel Cotti, *Basel III and Global Trade: The Devil's in Details*, BAFT-IFSA GLOBAL VOICE 1, 3 December 2010, *available at* https://www.baft-ifsa.com/eWeb/docs/Newsletter/GlobalVoice DecIssue2.pdf, *and* EUR. BANKING FED'N INST. FOR INT'L FIN., INTERIM REPORT ON THE CUMULATIVE IMPACT ON THE GLOBAL ECONOMY OF PROPOSED CHANGES IN THE BANKING REGULATORY FRAMEWORK 5 (2010), *available at* http://www.ebf-fbe.eu/uploads/10-Interim%20NCI_June2010_Web.pdf, *and* Letter from Adam M Gilbert, Managing Dir., JP Morgan Chase, to Basel Comm. on Banking Supervision, Bank for Int'l Settlements (Apr. 16 2010), http://www.bis.org/publ /bcbs165/jpmorganchase.pdf, *and* Letter from M.D. Linsz, Corp. Treasurer, Bank of America, to Basel Comm. on Banking Supervision, Bank for Int'l Settlements (Apr. 16, 2010), http://www.bis.org/publ/bcbs165/boac.pdf, and Masayuki Oku, *A Cure That Could Do More Harm Than Good*, FINANCIAL TIMES, July 13, 2010, http://www.ft.com/cms/s/0/3ba83868-8eb1-11df-8a67-00144feab49a.html#axzz1 Apeyl1Cz, *and* Letter from D.K. Wong, Treasurer, and K Hosuki, Head of Market Risk Dept., Morgan Stanley, to Basel Comm. on Banking Supervision, Bank for Int'l Settlements (Apr. 16, 2010), http://www.bis.org/publ/bcbs165/morganstanley.pdf.

12. *Bank Capital*, FIN. TIMES LEXICON, http://lexicon.ft.com/Term?term=bank-capital; 12 C.F.R. pt. 225, App. A ("A banking organization's qualifying total capital consists of two types of capital components: 'core capital elements' (tier 1 capital elements) and 'supplementary capital elements' (tier 2 capital elements). . . To qualify as an element of tier 1 or tier 2 capital, an instrument must be fully paid up and effectively unsecured. Accordingly, if a banking organization has purchased, or has directly or indirectly funded the purchase of, its own capital instrument, that instrument generally is disqualified from inclusion in regulatory capital. A qualifying tier 1 or tier 2 capital instrument must be subordinated to all senior indebtedness of the organiza-

concept, the question is whether a set of regulatory requirements defining capital can be found that is (1) consistent across jurisdictions given the various combinations of capital and (2) compatible across national laws, notwithstanding local rules such as taxation and accounting. Indeed, the meaning of bank capital in terms of its proper calculation, supervision and oversight management within the international regulatory framework has been the subject of intense debate prior to, during and after the 2007-08 financial crisis.[13]

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tion. If issued by a bank, it also must be subordinated to claims of depositors. In addition, the instrument must not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices. . . . Tier 1 capital generally is defined as the sum of core capital elements less any amounts of goodwill, other intangible assets, interest-only strips receivables, deferred tax assets, nonfinancial equity investments, and other items that are required to be deducted in accordance with section II.B. . . . Tier 1 capital must represent at least 50 percent of qualifying total capital."). According to Art. 57(a) of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, capital is a component of own funds. 2006 O.J. (L 177) 57 ("Capital within the meaning of Article 22 of Directive 86/635/EEC, in so far as it has been paid up, plus share premium accounts but excluding cumulative preferential shares." 1986 O.J. (L 372) 22 ("Subscribed capital shall comprise all amounts, regardless of their actual designations, which, in accordance with the legal structure of the institution concerned, are regarded under national law as equity capital subscribed by the shareholders or other proprietors.")).

13. *See, e.g.*, Rafael Repullo, Jesus Saurina & Carolos Trucharte, *Mitigating the Pro-Cyclicality of Basel II* 9 (Banco de Espana, Working Paper No. 1028, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1697529; Martin F. Hellwig, *Capital Regulation after the Crisis: Business as Usual?* 14 (Max Planck Inst. For Research on Collective Goods, Working Paper 2010/31, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1645224; Rafael Repullo & Javier Suarez, *The Procyclical Effects of Basel II* 25-26 (Collegio Carlo Alberto, Working Paper, 2007), *available at* http://www.carloalberto.org/files/repullo-procyclicality.pdf; Paolo Angelini et al., *Propcyclicality of Capital Regulation: Is it a Problem? How to Fix it?* 13-19 (Bank of Italy, Occasional Paper No.74, 2010) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1721563; Frank Heid, *The Cyclical Effects of the Basel II Capital Requirements*, 31 J. BANKING & FIN. 3885, 3885-900 (2007); Charles Goodhart, *The Regulatory Response to the Financial Crisis* 12-15 (CESifo, Working Paper No. 2257, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1113002; Raphael Douady, *A Non-Cyclical Adequacy Rule and the Aversion of Systemic Risk* 1-2 (CES Univ Paris, Working Paper, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1617419; Adrian Blundell-Wignall & Paul Atkinson, *Thinking Beyond The Basel III: Necessary Solutions for Capital and Liquidity*, 2010 OECD J., no. 1, at 1, 4-14; Douglas J.

Despite these debates, it is generally acknowledged that Basel III strengthens capital adequacy by increasing the quantity and quality of capital held by banks.[14] It sets a risk-weighted common equity capital ratio of 4.5 per cent, more than double the current 2 per cent level, plus a new conservation buffer of 2.5 per cent.[15] Banks whose capital falls within the conservation buffer will face restrictions on paying dividends and discretionary bonuses.[16] Therefore, Basel III sets an effective floor of 7 per cent. Table 1 and Figure 1 plot the new minimum capital requirements according to the Basel III timeline.

Elliott, *A Primer on Bank Capital*, THE BROOKINGS INST. 8-12 (2010), *available at* http://www.brookings.edu/%7E/media/Files/rc/papers/2010/0129_capital_elliott/0129_capital_primer_elliott.pdf; Francesco Cannata & Mario Quagliariello, *The Role of Basel II in the Subprime Financial Crisis: Guilty or Not Guilty?* 5-7 (CAREFIN, Research Paper No. 3/09, 2009), *available at* http://ssrn.com/abstract=1330417; FINANCIAL SERVICES AUTHORITY, THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 59-61 (2009), *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf; Martin Wolf, *Basel: the mouse that did not roar*, FINANCIAL TIMES, Sept. 14, 2010, http://www.ft.com/cms/s/0/966b5e88-c034-11df-b77d-00144feab49a.html#axzz1AFt2UF9v; RUSTOM BARUA ET AL., ALGORITHMICS, *Basel III: What's New? Business and Technological Challenges*, 27-31 (Sept. 17, 2010), *available at* http://www.algorithmics.com/EN/media/pdfs/Algo-WP0910-LR-Basel3-Exd.pdf; PRICEWATERHOUSECOOPERS, RESPONSE TO BASEL COMMITTEE ON BANKING SUPERVISION, 16-17 (Apr. 16, 2010), *available at* http://www.pwc.com/en_GX/gx/banking-capital-markets/assets/basel-committee-banking-supervision-feedback.pdf.

14. BASEL III, *supra* note 1, ¶ 7. *See also* WALTER W. EUBANKS, CONG. RESEARCH SERV., R41467, THE STATUS OF BASEL III CAPITAL ADEQUACY ACCORD 3 (2010); Peter Went, *Basel III Accord: Where Do We Go From Here?* 3 (GARP Research Ctr., Working Paper, 2010), *available at* http://ssrn.com/abstract=1693622.

15. BASEL III, *supra* note 1, ¶¶ 50, 129.

16. *Id.* ¶ 129. *See also*, Brooke Masters, *Basel Rewrites Capital Rules for Banks*, FINANCIAL TIMES, Sept. 17, 2010, http://www.ft.com/cms/s/0/6c6b672a-be7e-11df-a755-00144feab49a.html#axzz1ACtOTgBH.

TABLE 1: BASEL III CAPITAL REQUIREMENTS[17]

Bank Capital	Info	Current	New
Common Equity	Banks have to be able to meet this level of capital to operate.	2%	4.5%
Conservation Buffer	Banks with ratios below 7% will be able to conduct business as normal; however, these banks will be constrained in terms of paying dividends and bonuses.[18]	-	2.5%
Counter-cyclical Buffers	"If the relevant national authority judges a period of excess credit growth to be leading to the build up of system-wide risk, they will consider putting in place a countercyclical buffer requirement. This will vary between zero and 2.5% of risk weighted assets, depending on their judgment as to the extent of the build up of system-wide risk."[19]	-	0 – 2.5%
Systemically Important Banks' Buffer	"Systemically important banks should have loss absorbing capacity beyond the minimum standards and the work on this issue is ongoing."[20]	-	Under Discussion

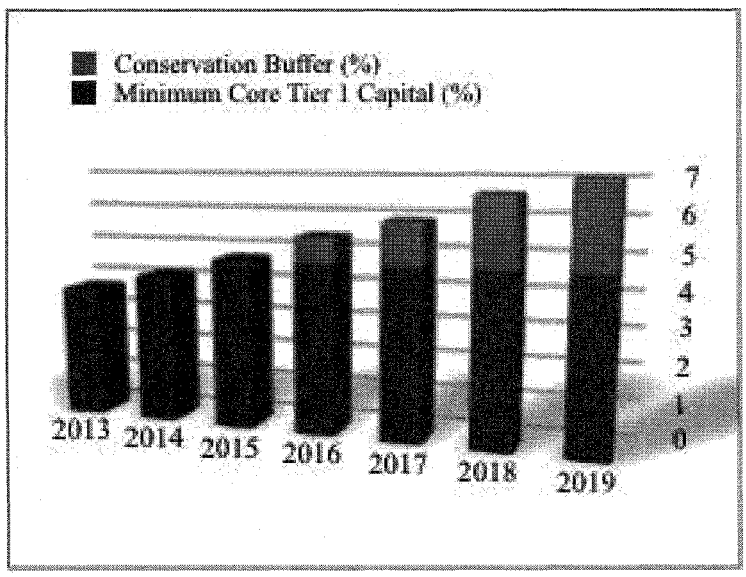
17. BASEL III, *supra* note 1, ¶¶ 29, 129, 132. *See also* Tom Braithwaite & Francesco Guerrera, *Regime Will Reshape Business Models*, FINANCIAL TIMES, Sept. 13, 2010, http://www.ft.com/cms/s/0/f649dd72-bf65-11df-965a-00144feab49a.html#axzz1WXT67Btc.

18. Basel III, *supra* note 1, ¶ 129.

19. *Id.* ¶ 139.

20. *Id.* ¶ 32.

FIGURE 1: BASEL III TIMELINE[21]



According to the transitional periods of Basel III, the minimum common equity (core tier 1 capital) and tier 1 requirements will come into effect between 1 January 2013 and 1 January 2015, and by 1 January 2013 the minimum common equity requirement will rise from the current 2% level to 3.5% and the tier 1 capital requirement will rise from 4% to 4.5%.[22] From 1 January 2014, banks will also be required to meet a 4% minimum common equity requirement and a tier 1 requirement of 5.5%. And from 1 January 2015, banks will have to meet the 4.5% common equity and the 6% tier 1 requirements. The capital conservation buffer will be phased in between 1 January 2016 and the end of 2018 with full effectiveness by 1 January 2019. The buffer will begin at 0.625% of Risk Weighted Assets ("RWAs") on 1 January 2016 and increase each subsequent year by an additional 0.625 percentage points, to finally a 2.5% of RWAs as of 1 January 2019.[23] Table 2 illustrates the calibration of Basel III capital framework across common equity, tier 1 capital and total capital.

21. *See id.* ¶¶ 94, 133-135; Braithwaite, *supra* note 17.
22. BASEL III, *supra* note 1, ¶ 94.
23. *Id.* ¶ 133.

TABLE 2: CALIBRATION OF BASEL III CAPITAL (%)[24]

	Common Equity	Tier 1 Capital	Total Capital
Minimum	4.5	6.0	8.0
Conservation Buffer	2.5	-	-
Minimum Plus Conservation Buffer	7.0	8.5	10.5

Basel III ratios are (at least nominally) significantly more onerous than the Basel II rules currently in place. In effect, Basel III more than triples the size of the capital reserves that the banks must hold against losses and sets a minimum tier 1 ratio of 8.5 per cent, compared with the current ratio of 4 per cent. However, one should take these heightened ratios with a grain of salt since at the margin, strengthening that which amounts to almost nothing does not in itself amount to much.[25] That is, many banks already operate with comparably high capital ratios.[26] On average, the "large U.S. banks have 8.79 per cent capital, which is more than the 7 per cent equity component that Basel III will require."[27] "The average tier 1 ratio for all banks hovered around the double-digit mark for the past two decades in the U.S, according to Federal Deposit Insurance Corporation data."[28] The tangible common equity

24. *Id.* Annex 1 at 64.

25. Martin Wolf, *Basel: The Mouse That Did Not Roar*, FINANCIAL TIMES, Sept. 14, 2010, http://www.ft.com/cms/s/0/966b5e88-c034-11df-b77d-00144feab49a.html.

26. *See* Patrick Jenkins, *Q&A: What Is Bank Capital?*, FINANCIAL TIMES, Sept. 13, 2010, www.ft.com/cms/s/. . ./f98164ba-bf65-11df-965a-00144feab49a.html ("The average bank today probably has a core tier one ratio of about 7 or 8 per cent, compared with a regulatory minimum of 2 per cent, and a tier one ratio of 9 or 10 per cent, compared with a 4 per cent minimum.").

27. Hannah Kuchler, *US Financials Boosted by New Bank Rules*, FINANCIAL TIMES, Sept. 13, 2010, http://www.ft.com/cms/s/0/44072dac-bf3f-11df-a789-00144feab49a.html ("At the end of March 2009, Tier 1 ratios of Bank of America, Citibank, JPMorgan Chase, Bank of New York Mellon, KeyCorp and Wells Fargo were 10.09%, 11.8%, 11.3%, 13.8%, 11.16% and 8.28, respectively.'").

28. *Basel III*, FINANCIAL TIMES, Sept. 12, 2010, http://www.ft.com/cms/s/3/131f4e30-bea5-11df-a755-00144feab49a.html; Thomas Bernauer & Vally Koubi, *Regulating Bank Capital: Can Market Discipline Facilitate or Replace Capital Adequacy Rules?* 19 (Ctr. for Int'l Studies, Working Paper No. 3, 2002).

measures fell steadily from 2002 as hybrid capital instruments[29] gained popularity and "intangibles jumped from nothing in the 1980's to 4 per cent of assets just before the meltdown in 2008."[30] The apparent quantum leap in the level of required capital is not a stochastic revolution so much as a hurried evolutionary adaptation.

The new ratios of Basel III are based on Basel II's concept of risk-weightings.[31] Under any reasonable interpretation of

29. The term "hybrid capital instruments," for purposes of this article, encompasses innovative instruments, non-innovative instruments and non-cumulative perpetual preference shares. Innovative instruments are financial instruments with incentives for redemption, such as step-ups, and non-innovative instruments are financial instruments which, as the term implies, do not have incentives to redeem. *See Proposal for a Common EU Definition of Tier 1 Hybrids*, COMM. OF EUROPEAN BANKING SUPERVISORS ¶ 9 (Mar. 26, 2008), http://www.c-ebs.org/getdoc/06e25083-2f37-4146-90f3-9e9a40365117/hybrids.a spx. "*Non-cumulative* means that should the bank decide not to make a dividend payment, the dividend is not deferred, but cancelled. This ensures that the capital has no fixed costs." *Interim Prudential Sourcebook: Banks*, FINANCIAL SERVICES AUTHORITY 2 (Apr. 2005), http://www.fsa.gov.uk/pubs/hb-releases/rel55/rel55ipru _bank.pdf. "By contrast, cumulative instruments allow the issuer to defer payment to a later date, therefore preserving cash, but the issuer is still committed to paying and therefore the hybrid instrument has not absorbed a loss." COMM. OF EUROPEAN BANKING SUPERVISORS, *supra* ¶ 87. "Perpetual preferred stock that provides for the accumulation or future payment of unpaid dividends is deemed to be cumulative, regardless of whether or not it is called noncumulative." Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure, 12 C.F.R. § 225 app. A (2011). "Hybrid securities (which include convertibles, adjustable-rate preferred securities, and trust-preferred stock) are either preferred stock with debt-like features or deeply subordinated debt with equity-like features." Christopher L. Culp et al., *Contingent Capital vs. Contingent Reverse Convertibles for Banks and Insurance Companies*, 21 J. APPLIED CORP. FIN. 17, 17 (2009).

30. FINANCIAL TIMES, *supra* note 28.

31. INTERNATIONAL CONVERGENCE 1988, *supra* note 2, ¶ 29 (". . . weighted risk ratio in which capital is related to different categories of asset or off-balance-sheet exposure, weighted according to broad categories of relative riskiness"); *Risk-Weighted Assets Definition*, OECD GLOSSARY OF STATISTICAL TERMS, http://stats.oecd.org/glossary/detail.asp?ID=6222 (last visited Sept. 9, 2011) ("Risk-weighted assets refer to a concept developed by the BCBS for the capital adequacy ratio. Assets are weighted by factors representing their riskiness and potential for default."). So a loan secured by property is less risky and given a lower multiplier than one that is unsecured. For example, under the Basel II, government bonds with ratings above AA- have a weight of 0 per cent, at the same time; corporate loans rated above AA- are weighted 20 per cent. INTERNATIONAL CONVERGENCE 2006, *supra* note 2, ¶¶ 53, 66.

risk weightings, questions of notional capital are intimately connected to the quality of capital. Are the regulatory risk weightings an accurate reflection of asset quality? Or, do different accounting treatments from various jurisdictions relating to special purpose vehicles, derivative netting and repos radically affect comparability?[32] Given the plethora of regulatory arbitrage opportunities,[33] the new 8.5 per cent tier 1 ratio may represent yet another opportunity for banks to game the system in the name of financial innovation.[34]

However Basel III may be gamed, crucial from a regulatory perspective are the facts that: (1) the global banking system suffered a near collapse in 2008,[35] and (2) governments

32. FINANCIAL TIMES, *supra* note 28.

33. Tyrone M. Carlin, Guy Ford & Nigel Finch, *Magic Pudding or Regulatory Arbitrageur's Friend? The Use of Hybrid Debt Equity Securities by Australian Listed Corporations* 10-18 (Macquarie Graduate Sch. of Mgmt., Working Paper No. 4, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm ?abstract_id=901122; Victor Fleischer, *Regulatory Arbitrage* 20 (Univ. of Colo. Law Sch., Working Paper No. 10-11, 2010), *available at* http://papers.ssrn.com / sol3/papers.cfm?abstract_id=1567212; Paul Tucker, Deputy Governor, Bank of England, Remarks at the FSB and Korean G20 Presidential Committee Conference: Financial Crisis and G20 Financial Regulatory Reform: An Overview, (Sept. 3, 2011); Ian H. Giddy, *Global Financial Markets: Understating and Using Hybrid Financial Instruments*, GIDDY.COM, http://giddy.org/dbs/ structured/gfmch17.htm (last visited Sept. 9, 2011).

34. Frank Partnoy, *Financial Innovation and Corporate Law* 113-121 (Univ. of San Diego Sch. of Law, Research Paper No. 07-89, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=976931; Frank Partnoy, *Adding Derivatives to the Corporate Law Mix* 6 (Univ. of San Diego Sch. of Law, Research Paper No. 03, 2000), *available at* http://papers.ssrn.com/ sol3/papers.cfm ?abstract_id=245553; Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of May*, 48 Vill. L. Rev. 1245, 1250 (2003); Andriy Krahmal, *International Hybrid Instruments: Jurisdiction Dependent Characterization*, 5 Hous. Bus. and Tax L.J. 98, 103 (2005); Emilios Avgouleas, The Reform of 'Too-Big-To-Fail' Bank: A New Regulatory Model for the Institutional Separation of 'Casino' from 'Utility' Banking 4-22 (Feb. 14, 2010) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/ papers.cfm?abstract_id=1552970.

35. Ben Bernanke, Chairman, Fed. Reserve, Address at the Federal Reserve Bank of Boston 54th Economic Conference: Financial Regulation and Supervision after the Crisis: The Role of Federal Reserve 1 (Oct. 23, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke 20091023a.htm ("Not much more than a year ago, we and our international counterparts faced the most severe financial crisis since the Great Depression. Fortunately, forceful and coordinated policy actions averted a global financial collapse . . . . However, even though we avoided the worst financial

have been called to support markets which suffered from an insufficient quality of capital rather than merely the quantitative lack of it.[36] Many academic and policymaking groups[37]

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and economic outcomes, the fallout from the crisis has nonetheless been very severe, as reflected in the depth of the global recession and the deep declines in employment both here and abroad.").

36. Blundell-Wignall & Atkinson, *supra* note 13, at 89, 24.

37. Nout Wellink, Chairman, Basel Comm. on Banking Supervision, Fundamentally Strengthening the Regulatory Framework for Banks, Address at the Korea-FSB Financial Reform Conference: An Emerging Market Perspective 2 (Sept. 3, 2010), *available at* http://www.bis.org/speeches/sp100903a.pdf ("Let me be clear: The change to the definition of capital represents – by itself – a substantial strengthening of the global capital regime. This is the case before we even begin to discuss an increase in the level of minimum capital requirements or the introduction of buffers."); WORLD GOLD COUNCIL, RESPONSE TO BASEL COMMITTEE ON BANKING SUPERVISION'S CONSULTATIVE DOCUMENT: INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS AND MONITORING, DECEMBER 2009, at 5 (2010), *available at* http://www.bis.org /publ/bcbs165/worldgoldcounci.pdf ("WGC fully supports the work of the G20, believing that it is imperative that steps are taken to improve the quality of capital held by financial institutions as this will play a crucial role in mitigating future crises."); Bernanke, *supra* note 35, at 2 ("By conducting [the stress test], U.S. supervisors took a significant step toward ensuring that our banks hold adequate levels of high-quality capital .... Firms that were not projected to have enough high-quality capital under this scenario were required to raise additional capital within six months.") (citation omitted); Jaime Caruana, Gen. Manager, Bank for Int'l Settlements, Speech at the 3rd Santander International Banking Conference: Basel III: towards a safer financial system 2 (Sept. 15, 2010), *available at* http://www.bis.org/speeches/sp100921.pdf ("First, Basel III will considerably increase the quality of bank capital. This crucial feature tends to be forgotten because observers are mainly focusing on the *level* of regulatory capital required by Basel III ....The new definition of capital is every bit as significant as the increased level of capital, and was an essential step in the process: it was imperative to define capital adequately before setting its level. Higher capital quality means more loss-absorbing capacity, which in turn means that banks will be stronger, allowing them to better withstand periods of stress .... By strengthening the quality of capital, Basel III will lead to a substantial improvement in the loss-absorbing capacity of banks."); Daniel K. Tarullo, Member, Bd. of Governors of the U.S. Fed. Reserve Sys., Address at the Peterson Institute for International Economics: Financial Regulation in the Wake of the Crisis 6 (Jun. 8, 2009), *available at* http://www.bis.org/review/r090611d.pdf ("Some of the more important of these initiatives include upgrading the quality of capital held by regulated institutions, overhauling the capital requirements applicable to market risk, and assessing the various ways in which regulation has had an undesirable pro-cyclical effect."); Nout Wellink, Chairman, Basel Comm. on Banking Supervision, Address at the 16th International Conference of Banking Supervisors: A New Regulatory

have called for the adoption of elevated quality capital requirements that reflect the systemic risk posed by financial institutions, rather than merely focusing on the quantity of capital. Of course, this is not a univocal view, as Blundell-Wignall and Atkinson (2010) in an OECD paper have argued: "Improvements in the definition of capital are welcome, but the amount of capital banks have is easily the most important issue in terms of conducting their activities with reduced risk of future crises."[38]

As a counter-example to Blundell-Wignall and Atkinson's assertion, shortly before Northern Rock was declared insolvent and taken over by the UK government in 2007, it had reported the highest capital ratio of any leading British bank.[39] Or, consider that just fifteen days before its bankruptcy on September 15th, 2008, Lehman Brothers boasted a Basel-type tier 1 capital ratio of 11%,[40] almost three times the regulatory minimum,

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Landscape 2 (Sept. 22, 2010), *available at* http://www.bis.org/speeches/sp100922.pdf ("Raising the quality, consistency and transparency of the capital base . . . represent[s] a substantial strengthening of the definition of capital. By itself, the new definition of capital is a significant improvement to the global capital regime, which will be enhanced further by better risk coverage, the introduction of buffers and higher minimum capital requirements."); BANK FOR INT'L SETTLEMENTS BASEL COMM. ON BANKING SUPERVISION, THE BASEL COMMITTEE'S RESPONSE TO THE FINANCIAL CRISIS: REPORT TO THE G20, at 4 (2010), *available at* http://www.bis.org/publ/bcbs179.pdf ("The global banking system entered the crisis with an insufficient level of high quality capital."); FINANCIAL SERVICES AUTHORITY, A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 7 (2009), *available at* http://www.fsa.gov.uk/pubs /discussion/dp09_02.pdf ("The evidence from various stages of the crisis indicates significant shortcomings in the international framework for bank capital adequacy. In particular, it is clear that even though banks, both in the UK and elsewhere, held capital above and, in many cases, well above the 8% Basel minimum before the onset of the crisis, this was rapidly depleted to levels that required recapitalisation or government support. In particular, there was not enough high quality capital, to absorb the losses the banks were facing while allowing them to continue as a going concern.").

38. Blundell-Wignall & Atkinson, *supra* note 13, at 24.

39. Daniel Pimlott, *King Calls for Radical Bank Reforms*, FIN. TIMES, Oct. 26, 2010, at 2.

40. Lehman Brothers' tier 1 capital ratio was estimated to be a well-satisfactory 11% as of August 31, 2008, and Lehman Brothers announced this ratio on September 10, 2008. SCOTT SPRINZEN & TANYA AZARCHS, STANDARD & POOR'S RATINGS DIRECT, WHY WAS LEHMAN BROTHERS RATED 'A'? 5 (2008), *available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/Lehman _Brothers.pdf; DK Matai, *Basel III: Making Banks Stronger or Not?*, ASYM-

which is 4% and was also characterized as 'well-capitalized' under U.S. regulations.[41] A calculation of Lehman's tier 1 capital ratio would have shown an amount more than the sum of Basel III-type total capital and conservation buffer.[42] However, when the share price collapsed, counter-party confidence descended much faster than the capital ratio would have suggested.[43] Capital adequacy ratios appear to be marginalized and hardly a predictive factor for 21st century market runs on publicly traded banks.[44] The importance of distinguishing between quality and quantity of capital is simply that Basel III tightens what qualifies as tier 1 capital by excluding lower quality instruments. According to Jenkins and Masters:

> [I]t was a mistake in the past not to think about the quality of capital when setting quantity targets. It was an insufficient supply of top-notch equity within the banks, and a surfeit of lower-quality debt capital that was unable to absorb losses, that allowed the financial crisis to wreak such havoc on the whole system.[45]

METRIC THREATS CONTINGENCY ALLIANCE, Jan. 25, 2010, http://www.mi2g . com/cgi/mi2g/frameset.php?pageid^{H}$_{T}$tp%3A//www.mi2g.com/cgi/mi2g/ press/250110.php.

41. A bank shall be deemed to be *adequately capitalized* if the bank has a Tier 1 risk-based capital ratio of 4.0 percent or greater; and necessary leverage and total risk-based capital ratios. A bank shall be deemed to be *well capitalized* if the bank has a Tier 1 risk-based capital ratio of 6.0 percent or greater; and necessary leverage and total risk-based capital ratios. 12 C.F.R. § 325.103 (2005).

42. As shown in Table 2, the minimum total capital ratio plus conservation buffer is 10.5% under Basel III capital regime, which is still less than the tier 1 ratio of 11% of Lehman Brothers as of August 31, 2008.

43. SPRINZEN & AZARCHS, *supra* note 40 ("[W]ith the completion of the investment-management transaction, Lehman's Tier 1 capital ratio (estimated to be a satisfactory 11% as of Aug. 31) *would remain basically flat*, taking account of the substantial anticipated reduction in risk-weighted assets . . . . However, facing a likely complete collapse in confidence on the part of creditors, counterparties, and customers when it opened for business on Monday, Sept. 15, Lehman Brothers Holdings Inc. filed for Chapter 11 bankruptcy protection . . . . We believe the downfall of Lehman reflected escalating fears that led to a loss of confidence – ultimately becoming a real threat to Lehman's viability in a way that fundamental credit analysis could not have anticipated.") (emphasis added).

44. Matai, *supra* note 40 ("When there is a 21st century stock market run on a publicly traded bank, capital adequacy ratios become marginalized.").

45. Patrick Jenkins & Brooke Masters *Financial Regulation: The Money Moves On*, FIN. TIMES, Sept. 14, 2010, http://www.ft.com/intl/cms/s/0/

It is usually the case that a dollar today is worth more than a dollar tomorrow. However, given that Basel III-type tier 1 capital is of higher quality than the Basel II-type, theoretically, "tomorrow's money" under Basel III is worth more than "today's money" under Basel II. Quality of tier 1 capital is substantially strengthened in Basel III, as certain types of instruments are removed,[46] fewer assets are eligible for capital treatment[47] and some assets are defined as riskier than they were under Basel II.[48] The net effect of raising the quality of capital is to lower amount of hybrid capital qualifying as tier 1 capital. The purported purpose of whittling down the hybrid capital instruments and phasing out innovative hybrid instruments is to reduce the specter of future idiosyncratic and systemic crises in the international banking sector.[49]

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abf1599e-c02d-11df-b77d-00144feab49a,s01=1.html#axzz1XNxHbboY (quoting anonymous source).

46. BASEL III, *supra* note 1, ¶ 9 ("Innovative hybrid capital instruments with an incentive to redeem through features such as step-up clauses, currently limited to 15% of the Tier 1 capital base, will be phased out. In addition, Tier 2 capital instruments will be harmonised and so-called Tier 3 capital instruments, which were only available to cover market risks, eliminated.")

47. *See id.* ¶¶ 67-85 (In calculating the common equity tier 1 capital, certain items must be fully deducted or de-recognised, including: "[g]oodwill and other intangibles (except mortgage servicing rights)"; "deferred tax assets . . . that rely on future profitability of the bank to be realised"; "[t]he amount of the cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet"; "any increase in equity capital resulting from a securitisation transaction"; "unrealised gains and losses that have resulted from . . . changes in the bank's own credit risk" on fair valued liabilities; "[a]ll of a bank's investments in its own common shares"; "[r]eciprocal cross holdings in the capital of banking, financial and insurance entities"; and "investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity."). *See also id.* ¶ 87. (Certain assets, such as significant investments in the common shares of unconsolidated financial institutions, mortgage servicing rights, and deferred tax assets that arise from temporary difference, "may each receive limited recognition when calculating Common Equity Tier 1, with recognition capped at 10% of the bank's common equity (after the application of all regulatory adjustments set out in paragraphs 67 to 85) . . . .").

48. *Id.* ¶¶ 98-118.

49. *Id.* ¶ 1. ("[Basel III] presents the Basel Committee's reforms to strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector. The objective of the reforms is to improve the

III.
RAISING THE QUALITY OF REGULATORY CAPITAL

The intention of Basel III is to restrict the rules relating to instruments qualifying as regulatory capital and as a consequence of these restrictions, improve the quality and reliability of regulatory defined capital to absorb losses on both a going concern and gone concern[50] basis via deduction and adjustment requirements.[51] Tier 1 capital under Basel III consists of common shares, retained earnings and other reserves,[52] which are subject to write downs as well as additional going concern capital requirements.[53] Under Basel II, tier 1 capital allowed the inclusion of hybrid instruments.[54] Under Basel III, the Basel II definition of tier 2 capital[55] is simplified with the tier 2

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banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy. . . . The Committee's comprehensive reform package addresses the lessons of the financial crisis." (footnotes omitted)). *See also* WALTER W. EUBANKS, CONG. RESEARCH SERV., R41467, THE STATUS OF THE BASEL III CAPITAL ADEQUACY ACCORD 2 (2010), *available at* http://www.fas.org/sgp/crs /misc/R41467.pdf ("The purpose of Basel III is to remedy the regulatory capital and liquidity failures that resulted in the 2007-2009 global financial crisis.").

50. According to the Basel Committee on Banking Supervision, "going concern capital" and "gone concern capital" mean "tier 1 Capital" and "tier 2 Capital," respectively. BASEL III, *supra* note 1, ¶ 49.

51. *Id.* ¶¶ 66-87.

52. *Id.* ¶¶ 52-53. ("Common Equity Tier 1 capital consists of the sum of the following elements: Common shares issued by the bank that meet the criteria for classification as common shares for regulatory purposes (or the equivalent for non-joint stock companies); Stock surplus (share premium) resulting from the issue of instruments included Common Equity Tier 1; Retained earnings; Accumulated other comprehensive income and other disclosed reserves; Common shares issued by consolidated subsidiaries of the bank and held by third parties (ie [sic] minority interest) that meet the criteria for inclusion in Common Equity Tier 1 capital; and Regulatory adjustments applied in the calculation of Common Equity Tier 1. Retained earnings and other comprehensive income include interim profit or loss. National authorities may consider appropriate audit, verification or review procedures. Dividends are removed from Common Equity Tier 1 in accordance with applicable accounting standards.").

53. *Id.* ¶¶ 54-55.

54. INTERNATIONAL CONVERGENCE 2006, *supra* note 2, Annex 1 at 243.

55. *Id.* Annex 1a at 244 (Tier 2 capital includes five broad categories: "(a) Undisclosed reserves (b) Asset revaluation reserves (c) General provisions/general loan-loss reserves . . . (d) Hybrid (debt/equity) capital instruments (e) Subordinated debt.").

sub-categories removed, and the tier 3 capital of Basel II is entirely eliminated in Basel III.[56]

The fundamental assumption of Basel III is that common equity component of tier 1 capital provides the greatest "loss absorption" capacity.[57] The Basel Committee on Banking Supervision in the precursor consultative document to Basel III stated:

> In particular, it is strengthening that component [common equity] of the Tier 1 capital base which is fully available to absorb losses on a going concern basis, thus contributing to a reduction of systemic risk emanating from the banking sector. To this end, the predominant form of Tier 1 capital must be common shares and retained earnings.[58]

The term "predominant" is crucial since common equity is set at 4.5% whilst the overall tier 1 capital excluding the conservation buffer is 6%.[59]

The minimum requirement for common equity, the highest form of loss absorbing capital, has been raised from the

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56. BASEL III, *supra* note 1, ¶ 9. ("Tier 2 capital instruments will be harmonised and so-called Tier 3 capital instruments, which were only available to cover market risks, eliminated.").

57. *See* INCI ÖTKER-ROBE ET AL., INT'L MONETARY FUND, IMPACT OF REGULATORY REFORMS ON LARGE AND COMPLEX FINANCIAL INSTITUTIONS 10 (2010), *available at* http://www.imf.org/external/pubs/ft/spn/2010/spn1016.pdf ("The key components of the BCBS proposals are: (i) higher and better quality capital (mostly common equity, with better loss absorption features) . . ."); BANK FOR INT'L SETTLEMENTS BASEL COMM. ON BANKING SUPERVISION, STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR ¶ 75 (2009) (hereinafter STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR], *available at* http://www.bis.org/publ/bcbs164.pdf ("To be included in Tier 1, instruments will need to be sufficiently loss absorbent on a going-concern basis."); Press Release, Bank for Int'l Settlements Basel Comm. on Banking Supervision, Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Standards 1 (Sept. 12 2010), *available at* http://www.bis.org/press/p100912.pdf ("[T]he minimum requirement for common equity, the highest form of loss absorbing capital . . .") (emphasis added); BANK FOR INT'L SETTLEMENTS BASEL COMM. ON BANKING SUPERVISION, PROPOSAL TO ENSURE THE LOSS ABSORBENCY OF REGULATORY CAPITAL AT THE POINT OF NON-VIABILITY 1 (2010) [hereinafter PROPOSAL TO ENSURE LOSS ABSORBENCY], *available at* http://www.bis.org/publ /bcbs174.pdf.

58. STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR, *supra* note 57, ¶ 14

59. BASEL III, *supra* note 1, ¶ 94.

Basel II level of 2% before the application of regulatory adjustments, to 4.5% after the application of stricter adjustments under Basel III.[60] The tier 1 capital requirement, which includes common equity and other qualifying financial instruments based on stricter criteria, will increase from 4% to 6% over the period of 2013 to 2015.[61]

In sharp contrast to the new Basel III rules, the trend under previous Basel Accords from 1998 to 2009 had been to loosen the rules of tier 1 capital to allow the inclusion of hybrid instruments[62] as if to assume and therefore to promote the rather disingenuous proposition that such instruments entailed the legal certainty of equity. To assert that hybrid instruments are rather equity-like ignores the fundamental legal substance of core capital. Ever since the initial Basel Accord in 1988 and through the complex iterations of Basel I, II and III, this fundamental legal distinction has been downplayed. Much of the Basel II and III's technical financial economic architecture fails to appreciate the legal risk characteristics of such instruments and represents the deeply flawed technical economic approach of the Basel II which relegated legal risk to a mere sub-category of operational risk.[63] One of elementary failures of the Basel II approach is in its treatment of regulatory capital that places a legally unjustified reliance on the concept that certain required terms and conditions of financial instruments are sufficient for the instruments to be treated as if they represent legal categories that are equivalent to legal certainty. This of course is not legally justified, non-justiciable and cannot be effectively dictated by any regulatory authority. One of the authors has argued in an early paper critiquing Basel II's securitization framework that the terms and conditions of Basel II setting out when securitized instruments will not attract a capital charge are dependent on the establishment of an impossibly ideal state of risk symmetry between the parties.[64] A full consideration of the 'quality' of any financial

60. *Id.*

61. *Id.*

62. *Tier One Capital*, FIN. TIMES LEXICON, http://lexicon.ft.com/Term?term=tier-one-capital (*last visited* Sept. 19 2011).

63. *See* INTERNATIONAL CONVERGENCE 2006, *supra* note 2, ¶ 644.

64. *See* Joseph A. Tanega, *Securitisation Disclosures and Compliance Under Basel II: Part II - Applications of the Risk Symmetry Principle to Economic Substance Over Legal Form*, 21 J. INT'L BANKING L. & REG. 1, 3-4 (2006).

instrument should entail an understanding of the legal risks of the instrument in question, and it may be impossible to quantify the value of such risks since much depends on the legal interpretations of the transaction parties, their successors and assigns and the juridical authorities resolving disputes relating to such instruments. Basel II's "risk weightings" definitions taking account of various factors in the form of "haircuts" and probabilistic models relating to values of instruments prior to default, post default and on collection, are simply absurd without an understanding of the specific legal risks of the financial instrument in question.[65]

This absurdity was allowed to proliferate under Basel I and II. Hybrid capital instruments, with features "such as giving the borrower the right not to redeem them on a particular date and to withhold or skip interest payments under certain conditions,"[66] had been allowed for up to one-half of tier 1 capital under Basel I. Under any critical legal analysis, rather than economic consultative studies, Basel II should have been prevented from inheriting this regulatory gap. But such was not the case.[67]

Basel III's focus on the loss absorption capacity of additional going concern capital comes from reducing the amount of qualifying hybrid capital instruments down to 25% of tier 1 capital and from completely phasing out innovative hybrid instruments, which were allowed to comprise up to 15% of tier 1 capital since the 1998 "Instruments Eligible for Inclusion in Tier 1 Capital Accord."[68] The amendments relating to tier 1 capital under Basel III are tantamount to an edict on dehybridization (i.e., the lowering the amount of allowed hy-

65. *See* INTERNATIONAL CONVERGENCE 2006, *supra* note 2, ¶¶ 50-51, 91-92, 215, 244 (Basel II's internal ratings-based approach relies on banks' own internal credit-based estimates of risk parameters to determine credit capital requirements without inquiry into counterparty, or legal, risk.). On the contrary, Basel III has added legal risks such as counterparty risk into the credit risk framework in recognition of Basel II's flawed approach. *See* BASEL III, *supra* note 1, ¶¶ 98-117.

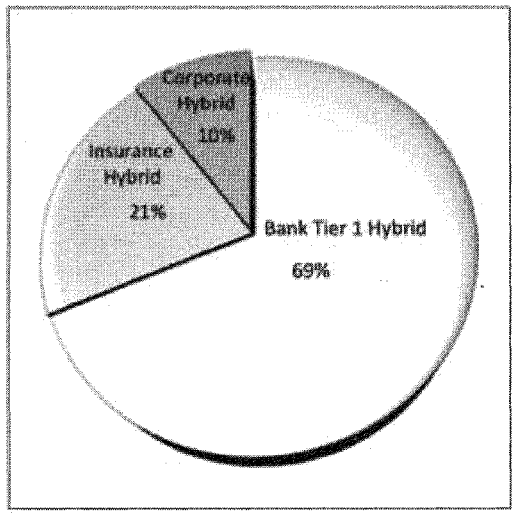
66. Anousha Sakoui et al., *Regulatory Thaw Helps Hybrid Return*, FIN. TIMES, Aug. 3, 2010, at 30.

67. For a brief history of the Basel I and II risk of hybrid proliferation, *see infra*, Part 4.1.

68. *See* Press Release, Bank for Int'l Settlements Basel Comm. on Banking Supervision, Instruments eligible for inclusion in Tier 1 capital (Oct. 27, 1998), *available at* www.bis.org/press/p981027.htm.

brid capital and phasing out of innovative hybrid capital instruments) and distinguish it from the previous Basel accords and current regulations in the U.S. and EU.[69] Up to the time of Basel III, hybrid capital instruments were "issued in massive amounts, particularly by European banks . . . as a means to gear up in size without damaging credit ratings, or diluting shareholders."[70] In 2005, the global hybrid capital market reached over U.S.$ 80 billion, an 80% increase from 2004, and by 2006 the global hybrid market reached over U.S.$ 120 billion by year-end.[71] By 2007, tier 1 hybrid capital issued by banks had the dominant position in the global hybrid market.[72] Figure 2 plots the dominance of tier 1 hybrid capital instruments issued by banks in relation to hybrid capital instruments issued by insurance and corporate sectors.

FIGURE 2: GLOBAL HYBRID CAPITAL INSTRUMENTS SUPPLY AND DOMINANCE OF BANK TIER 1 HYBRID[73]



69. For a detailed comparison between Basel III, previous Basel Accords and U.S. and E.U. regulation in relation to hybrid capital instruments, *see infra* Part 4.

70. *Tier One Capital, supra* note 60.

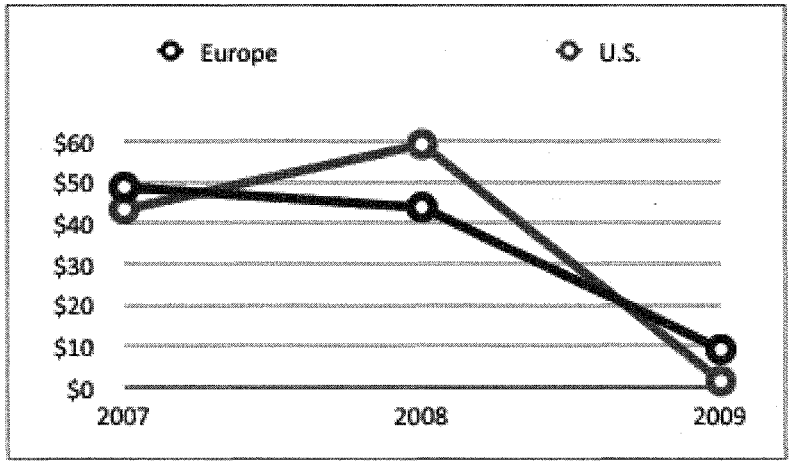
71. STEVE SAHARA & ANNABEL DAWS-CHEW, THOMSON FIN. GRP, HYBRID CAPITAL SECURITIES: A DEFINITIVE GUIDE FOR ISSUERS AND INVESTORS 9 (Thomson Fin. Grp. ed., 2007).

72. *Id.* at 11.

73. *Id.* at 12.

In 2006 and the first half of 2007, tier 1 hybrid capital instruments issued by banks were the most dominant, contributing to approximately 69% of the total global supply of hybrid securities, whereas the insurance and corporate sectors' hybrid supply contributed approximately 21% and 10% respectively.[74] "This issuance ha[d] been driven primarily by M&A and the growth of banks' risk weighted assets as the majority of banks have been fully capitalized up to hybrid limits."[75] Tier 1 hybrid capital instruments issued by banks accounted for approximately €42 billion in Europe, roughly 57% of the market and nearly €43 billion, around 76% of the U.S. hybrid market in 2006 and first half of 2007.[76] In the wake of the credit crisis and before the hybrid market froze up, hybrid capital instruments continued to be issued in massive amounts in both 2007 and 2008. Figure 3 demonstrates the vast volume and the tumble in Europe and the U.S.

FIGURE 3: HYBRID DEBT ISSUANCE BY BANKS (IN BILLIONS OF $ U.S.)[77]



74. *Id.* at 11.

75. *Id.*

76. *See id.* at 12, 14, 18, 20.

77. Anousha Sakoui, *Europe's Banks Face Questions Over Funding Levels*, FIN. TIMES, Sept. 8, 2009, at 33, *available at* http://www.ft.com/cms/s/0/293a0e38-9bda-11de-b214-00144feabcdc0,s01=1.html (the figure shows the results of the first three quarters of 2009).

In 2007, hybrid debt issuance by banks amounted to approximately $48.8 billion in Europe and $43.4 billion in the U.S. . The volume in 2008 was similar to 2007: hybrid debt issued by banks in 2008 was $59.2 and $43.9 billion in the U.S. and Europe respectively.[78] However, in 2009, the market saw nearly an 80% decrease from 2008, with hybrid debt issuance by banks at $9.2 billion in Europe. The tumble was more severe in the U.S. with hybrid debt issuance by banks amounting to $1.5 billion.[79]

As shown in Figure 2 and 3, through the tier 1 capital of Basel II, banks were able to achieve a vast expansion of false and near worthless capital—false and worthless because hybrid capital instruments fail to absorb capital losses, as does equity. However, so long as a hybrid instrument was manufactured according to the specifications of the Basel I and II tier 1 capital definitions, its legal uncertainty was magically erased or confused with legal certainty. This financial legerdemain is such a fundamental flaw in regulatory design that one wonders whether the financial economic bias of the Basel III warning against the use of "legal form" over "economic substance"[80] could be read anti-symmetrically with greater confidence and providence, i.e., that legal substance should trump any proposed regulatory reform based on financial economic models. The insistence that financial regulations be based on financial economic models merely induces false beliefs in the reliability and accuracy of models that can only ever be tested in the real world. Obvious legal distinctions that differentiate and determine the quantum of legal risks of financial instruments tend to be ignored under the somewhat disingenuous provenance of regulatory and supervisory rules and approvals.

A. *Why Issue and Invest in Hybrids?*

Sakoui, Hughes and Jenkins make a similar point when they say, "Since regulators have allowed [hybrid instruments] to count towards regulatory capital, their appeal to issuers is that they look like relatively cheap equity."[81] The issuing entity can dramatically "cut the weighted cost of capital by issuing

78. *Id.*
79. *Id.*
80. INTERNATIONAL CONVERGENCE 2006, *supra* note 2, ¶ 538.
81. Sakoui et al., *supra* note 66.

hybrids instead of equity where [the] cost of capital of equity exceeds that of debt."[82] Therefore, hybrid capital instruments are seen as relatively cheap ways to raise capital. For example, Lee, Lochhead, Ritter and Zhao in 1996 show that the average direct cost of an initial common equity offering was 11% and the average direct cost of a secondary equity offering was 7.1%.[83] In sharp contrast, Bajaj, Mazumdar and Sarin in 2001 showed that the average direct cost of issuing preferred stocks was only 2.79% in the U.S.[84] Issuing hybrid capital instruments also provides the issuing entity the benefit of not having to grant shares with traditional voting rights, and therefore, are not dilutive of the existing shareholders' power and influence.[85] In addition, banks may be able to achieve a greater expansion of their investor base by placing hybrid instruments on the international bond market.

Generally, the objective in issuing hybrids is to treat securities as equity for regulatory capital and credit rating purposes. However, issuers also generally desire hybrids to be treated as debt for tax purposes since interest payable on debt is tax deductible and therefore, tax efficient.[86] From the investor's perspective, hybrids are "attractive because they carry a higher yield than straight debt (in response to the higher risk involved therein) [and therefore] investors who purchase hy-

82. Hiroki Aoyama, Hybrid Securities: A Comparative Study Between the U.S. and Japan 5 (Apr. 23, 2007) (unpublished student note, Harvard Law School), *available at* http://www.law.harvard.edu/programs/about/pifs/education /sp6.pdf.

83. Inmoo Lee et al., *The Costs of Raising Capital*, 19 J. FIN. RES. 59, 59 (1996), *available at* http://bear.warrington.ufl.edu/RITTER/publ_papers/TheCosts OfRaisingCapital.pdf.

84. Mukesh Bajaj et al., *Cost of Issuing Preferred Stock*, 25 J. FIN. RES. 577, 579 (2006), *available at* http://econpapers.repec.org/article/blajfnres/v_3a25_3ay_3a2002_3ai_3a4_3ap_3a577-592.htm. *See also* SAHARA & DAWS-CHEW, *supra* note 71, at 31-33 (describing hybrid capital securities as having low cost equity).

85. Peiyi Yu & Bac Van Luu, Lessons from the Collapse in Hybrid Bank Capital Securities 9 (Mar. 13, 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1359430.

86. Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital, 70 Fed. Reg. 11,827, 11,828 (Mar. 10, 2005), *available at* http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050301/attachment.pdf.

brids issued by investment-grade borrowers can enjoy [relatively] high yields . . ."[87]

Figure 4 plots the yields of (1) the 20-year U.S. treasury bond,[88] (2) Moody's AA-Rated Corporate Bond Yield Index, which represents the dividend yield of lower quality firms that issue bonds,[89] and (3) hybrid capital instruments as preferred stocks[90] from March 2005 to March 2007.

87. Aoyama, *supra* note 82, at 5.

88. *Treasury Bonds in Depth*, U.S. DEP'T OF THE TREASURY, BUREAU OF THE PUB. DEBT, http://www.treasurydirect.gov/indiv/research/indepth/tbonds/res_tbon d.htm (last visited Sept. 3, 2011) (explaining that Treasury bonds pay a fixed rate of interest every six months until they mature, and that when a Treasury bond matures, the holder is paid its face value).

89. *See* Jerry Mingione, *Pension Finance Watch*, TOWERS WATSON 4 (2010), http://www.towerswatson.com/assets/pdf/3347/Pension-Finance-Watch-November-2010.pdf; Guohua Li etal., *The Risks of Preferred Stock Portfolios* 7 (June 2010) (Sec. Litig. and Consulting Grp., Working Paper dated 06-2010), *available at* http://www.slcg.com/pdf/workingpapers/Preferred%20 Stock%20Paper.pdf ("Moody's AA Corporate Bond Yield Index, which we use to proxy the dividend yield of lower quality firms that issue preferred stocks.").

90. Culp et al., *supra* note 29, at 17 ("Hybrid securities (which include convertibles, adjustable-rate preferred securities, and trust-preferred stock) are either preferred stock with debt-like features or deeply subordinated debt with equity-like features.").

FIGURE 4: YIELDS OF AA RATED CORPORATE DEBT, U.S. GOVERNMENT 20-YEAR TREASURY BONDS AND PREFERRED STOCKS[91]

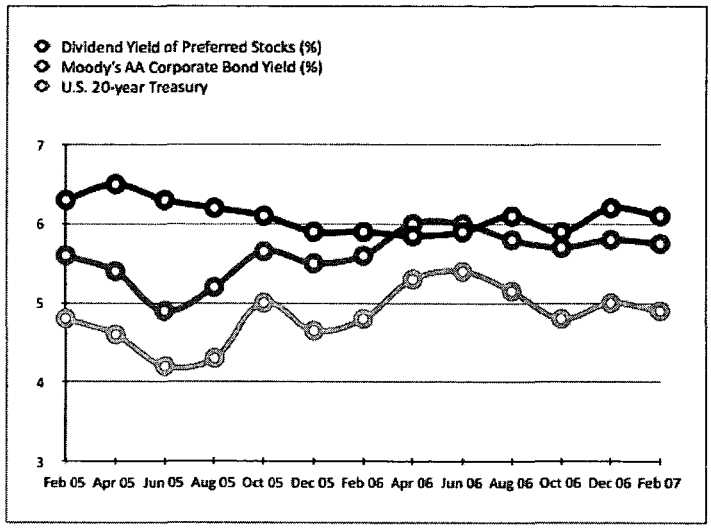
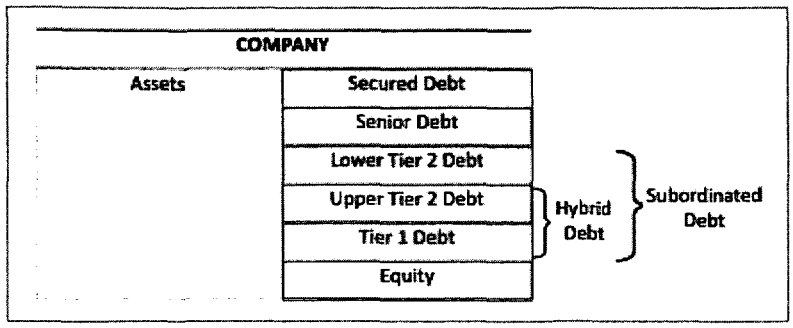


Figure 4 shows that over the period of March 2005 to the commencement of the financial crisis, the yield on 'preferred stocks' fluctuated between 5.7% and 6.7%. Over this same period, the Moody's AA corporate bond index varied between 4.9% and 6.0%, and the U.S. Government 20-year Treasury yield varied between 4.2% and 5.4%.[92] From Figure 4 we can see that the yield on preferred stocks was always higher than the U.S. 20-year Treasury yield and in general, higher than the Moody's AA corporate bond yield.

Hybrid capital instruments usually have a yield that is relatively higher than straight debt due to their relatively different risk and return characteristics in the capital structure hierarchy. Hybrids are junior to debt obligations of the company and senior to common equity. Figure 5 is a simple illustration of the locus of hybrid instruments in the classes of securities and their higher yields in case of default.

91. Li et al., *supra* note 89, at 7.
92. *Id.* at 6.

FIGURE 5: HYBRID SECURITIES IN THE CAPITAL HIERARCHY



As shown in Figure 5, hybrid debt is a sub-division of subordinated debt. Therefore hybrid capital securities have lower status of protection against senior debt and secured debt in case of bankruptcy and recovery, but have a higher yield in return for the lower protection. In addition, hybrid capital securities provide investors with protection during bankruptcy as compared to common equity. That is, hybrid investors are paid before common stockholders in case of bankruptcy. This is not always the case depending on the facts of the bankruptcy case, but it is the intention of the documentation. When a firm is liquidated, debt holders are normally paid first. If debt holders are made whole and value remains, hybrid security holders are then paid. But any residual value that remains, after debt holders and hybrid security holders are paid, is divided among the common equity holders.

As another advantage for the investors, investors' portfolio would be deemed more stable in case of the treatment of hybrids as debt. Therefore, "investors subject to regulatory supervision as to financial healthiness, such as insurance companies, may desire treatment of hybrids as debt so that their portfolio would be evaluated to be more stable."[93]

B. *The Fungibility and Non-Fungibility of Loss Absorbency*

Li et. al. assert: "An investor that invests only in a portfolio of preferred stock essentially invests almost entirely in the fi-

93. Aoyama, *supra* note 82, at 5-6.

nancial industry, exposing them to unnecessary and unrewarded risks."[94]

In some sense all financial instruments are connected through the system of global financial trading, but Li's somewhat exaggerated point may be toned down from a legal perspective to say that the value of a particular hybrid capital instrument is essentially linked by reference to whatever events are dictated by the instrument in question. However, when investigating a portfolio of such instruments, positive and negative feedback loops, as well as simultaneous interactions between instruments, are more likely to occur, which together may magnify or dampen the overall effects in unintended ways. Thus, a portfolio designed to absorb losses under one scenario are primed to experience much greater loss in another scenario. It is a fact of real life that no live portfolio is riskless under any scenario.

To separate the Basel III salesman's puffing from the hard realities of the financial crisis, was it so surprising that hybrid instruments were unable to absorb losses?[95] The presumed characteristic of "loss absorbency" of regulatory defined capital under Basel II as we have argued above was a fundamental mistake that came from a conflation of legal distinctions between "equity" and "equity-like" instruments. Deep within the assumptions of financial economics is the idea that financial contracts are fungible.[96] In order to protect ourselves from future financial crises, it is important to understand that the idea of fungibility is merely an assertion or hypothesis by financial

94. Li et al., *supra* note 89, at 12.

95. PROPOSAL TO ENSURE LOSS ABSORBENCY, *supra* note 57, at 1; Andrew Haldane, *What is the Contribution of the Financial Sector: Miracle or Mirage?*, *in* THE FUTURE OF FINANCE: THE LSE REPORT 87, 100 (Adair Turner et al. eds., 2010); CEYLA PAZARBASIOGLU ET AL., INT'L MONETARY FUND, CONTINGENT CAPITAL: ECONOMIC RATIONALE AND DESIGN FEATURES 30 (2011), *available at* http://www.imf.org/external/pubs/ft/sdn/2011/sdn1101.pdf ("The hybrid capital instruments did not provide meaningful loss absorption during the recent crisis."); *Tier One Capital*, *supra* note 61.

96. *Action Alert No. 03-30*, FIN. ACCT. STANDARDS BD., http://www.fasb.org/aa073003.shtml (last visited Sept. 1, 2011) ("The Board noted that the subjects of most contracts are fungible, although the subjects of some contracts are unique."). *See also* Darius P. Miller & John J. Puthenpurackal, *Security Fungibility and the Cost of Capital Evidence from Global Bonds* 5 (Eur. Cent. Bank, Working Paper No. 426, 2005), *available at* http://www.ecb.int/pub/pdf/scpwps/ecbwp426.pdf ("[Global bonds] are fully fungible . . .").

market participants, and not a doctrine that is fundamental to law. In fact, fungibility in the law is limited and exceptional,[97] and wherever possible, the law distinguishes each thing (res) according to its unique characteristics. Thus, for tier 1 capital definition purposes, it is permissible to treat certain types of financial instruments as being equivalent under Basel II or III, but the equity and equity-like features should not be treated as equivalents, nor are they isomorphic since each has a different path to legal uncertainty. To put this point even more forcefully, the fungibility of equity amongst identical equity instruments is perfectly symmetric, but the fungibility of equity-like instruments with equity is simply asymmetric, experimental and a suspiciously speculative proposition.

Thus, the concept of "loss absorbency" being a sine qua non of Basel III makes sense only if the financial instruments used as tier 1 capital do their job as expected—that is, they must be perfectly symmetric and fungible. As per the "Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability" ("Proposal"), the Basel Committee on Banking Supervision confirms the inability of hybrid instruments to fully absorb losses: "[I]n some cases non-common Tier 1 instruments did not absorb losses incurred by certain

97. *See* Letter from Joseph F. Danowsky, Managing Dir., Bear, Stearns & Co. Inc., to Jonathan G. Katz, Sec'y, SEC (May 29, 1997), *available at* http://www.sec.gov/rules/proposed/s7797/danowsk1.htm ("In the 1995 Release and the Rule 144 Release, the [Securities and Exchange] Commission sought comment on whether the fungibility doctrine should be reintroduced. . . . This doctrine, however, proved highly problematic, and the *Wheat Report* sponsored by the Commission examined the doctrine and ultimately rejected it. This report rightfully pointed out that 'the present fungibility concept bears little relationship to the needs of investors for disclosure' and 'introduces an additional element of uncertainty into an already clouded situation.' The Commission wisely followed the lead of the *Wheat Report* when it adopted Rule 144 in 1972, stating that '[f]or purposes of the rule, the doctrine of fungibility will not apply.'") (footnotes omitted); SEC, DISCLOSURES TO INVESTORS - A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 172-231 (1969), *available at* http://c0403731.cdn.cloudfiles.rackspacecloud.com/collection/papers/1960/1969_Wheat_CH06.pdf; A. Peter McGraw et al., *The Limits of Fungibility: Relational Schemata and the Value of Things*, 30 J. OF CONSUMER RES. 219, 219-29 (2003), *available at* http://www.jstor.org/stable/pdfplus/10.1086/376805.pdf?acceptTC=true.

large internationally-active banks that would have failed had the public sector not provided support."[98]

In response to the financial crisis, Basel III has imposed heightened criteria on hybrid capital instruments and additional going concern capital,[99] with the likely effect of restricting qualifying hybrid tier 1 capital to equity-like instruments and requiring the cancellation of coupons on future hybrids in periods of stress.[100]

For hybrid debt, where bonds with some features of equity count towards capital requirements, Basel III has set out changes to the terms of the bonds that make explicit how investors will lose if there is a government rescue.[101] "Its 'gone concern' rule [spells] out these bonds convert to equity in a bail-out, encouraging investors to evaluate the risk of failure."[102]

The proposal of Basel III in August 2010 warned investors 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."[103] Further, the consultative document of December 2009 proposed the phasing out of innovative tier 1 instruments with embedded incentives to redeem, such as coupon step-ups.[104] This was taken up by Basel III.[105] In our opinion, these actions signal an intention to require hybrid tier 1 capital to have equity-like characteristics. Thus, features such as re-

98. PROPOSAL TO ENSURE LOSS ABSORBENCY, *supra* note 57, at 1.

99. BASEL III, *supra* note 1, ¶¶ 54-55.

100. *Id.*; Barnes et al., STANDARD & POOR'S RATING DIRECT, BASEL 3 FOR GLOBAL BANKS: THIRD TIME'S THE CHARM? 3 (2010), *available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/20100304CR_Basel3Glbl Bnks.pdf.

101. BASEL III, *supra* note 1, ¶ 55; BANK FOR INT'L SETTLEMENTS BASEL COMM. ON BANKING SUPERVISION, BASEL COMMITTEE ISSUES FINAL ELEMENTS OF THE REFORMS TO RAISE THE QUALITY OF REGULATORY CAPITAL 3 (2011), *available at* http://www.bis.org/press/p110113.pdf.

102. James Mackintosh, *The Circular Effect of Bank Bail-outs*, FIN. TIMES, July 21, 2010, http://www.ft.com/cms/s/0/370f3dba-9681-11df-9caa-00144feab49a.html.

103. PROPOSAL TO ENSURE LOSS ABSORBENCY, *supra* note 57, at 3.

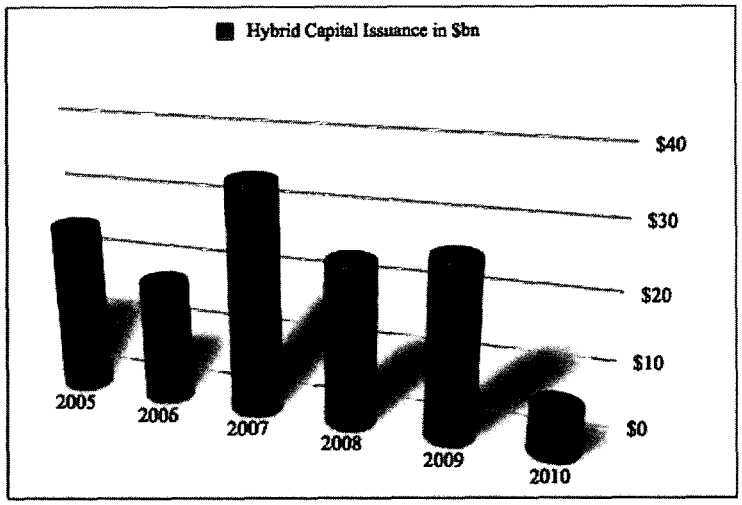
104. STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR, *supra* note 57, ¶ 15.

105. BASEL III, *supra* note 1, ¶ 9.

demption through step-ups lack the essential equity feature of having "no maturity" and will therefore, be disallowed.

These changes are likely to "reduce banks' flexibility in offering instruments to different classes of investors . . . ."[106] Until recently, the Basel Committee on Banking Supervision has recommended that members consider allowing the grandfathering of instruments issued by banks prior to December 2009.[107] This recommendation has coincided with an effective freezing of the market for hybrid capital instruments. In effect, grandfathered instruments could in practice decimate the value of the portfolios held for tier 1 capital purposes. Figure 6 demonstrates the impact of Basel III on the hybrid market.

FIGURE 6: PUBLIC MARKET ISSUES GREATER THAN $200 MILLION FOR EUROPEAN FINANCIAL ISSUERS[108]



As indicated in Figure 6, although there may have been many other factors, the proposal of the grandfathering clause (Para 84) in December 2009 appears have taken a toll on the hybrid instruments market. The amount of hybrid capital issuance in Europe in mid-2010 is approximately one fifth of 2009.

106. EUR. BANKING FED'N INST. FOR INT'L FIN., *supra* note 11, at 40.

107. STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR, *supra* note 57, ¶ 84; BASEL III, *supra* note 1, ¶ 94.

108. Sakoui et al, *supra* note 66.

The amount of issuances decreased with the financial crisis in 2008, but the decrease after the introduction of Para 84 has been even greater. A plausible explanation is that investors perceive that hybrids falling within the Basel III tier 1 capital treatment will be expected to bear more risks, both in terms of loss absorption and the potential absence of redemption.[109] As Young and Welsh state: "This will make products more expensive. Investors would be asked to take equity risk when it matters most (when the bank is unhealthy). "That comes at a cost and investors will price these products differently from the hybrid products that used to exist."[110]

Offerings meeting these new requirements could at least in the short term be in high demand. For example, Credit Suisse's July 28, 2010 offering of tier one hybrids attracted bids worth about seven times the paper it planned to offer, allowing it to borrow more and cut the interest rate it would normally have paid.[111]

"Many banks have relied extensively on hybrid securities to provide tier 1 capital, often on a tax-deductible basis."[112] Therefore, the effects of Basel III will vary greatly across banks, but the impact on banks will be driven by the same rule change, namely, the level of hybrid capital instruments allowed will be 25% of tier 1 capital instead of the current 50% and innovative hybrid capital instruments will be phased out. However, in many jurisdictions where regulations permitted, banks have had considerable flexibility in determining the amounts and levels of hybrid capital instruments in tier 1 capital. Consequently, Basel III will bring significant changes to the regulations, and have potentially large effects on banks' balance sheets, particularly on the capital costs of the U.S. and European banks.

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109. BARNES ET AL, *supra* note 100, at 3.

110. Tom Young, *UK Banks' Biggest Basel III Worries*, INT'L FIN. L. REV. (Feb. 26, 2010), http://www.iflr.com/Article/2401216/UK-banks-biggest-Basel-III-worries.html (quoting Carson Welsh).

111. Patrick Jenkins & Anousha Sakoui, *Credit Suisse Issues New Hybrid Bonds*, FIN. TIMES, July 28, 2010, http://www.ft.com/intl/cms/s/0/8a9fc570-9a74-11df-87fd-00144feab49a.html#axzz1X5nOFFYy.

112. EUR. BANKING FED'N INST. FOR INT'L FIN., *supra* note 11, at 40.

IV.
CURRENT REGULATORY APPROACH TO HYBRID CAPITAL INSTRUMENTS

In 2009 and 2010, the comments and lobbying from financial institutions were set against the tightening-move on hybrid instruments of the Basel Committee.[113] It is no surprise that financial institutions would prefer to maintain the current loose regulatory regime. Despite the clamor by institutions, the Basel Committee virtually ignored the protests to hybrid reduction.[114] In the following sub-sections, we review the relevant U.S. and EU regulations relating to hybrid capital instruments to assess the possible consequences of the adoption and adaptation of Basel III.

A. *Hybrid Capital Instruments in Basel Accords*

Hybrid instruments were treated as supplementary capital under the Basel Accord from 1988,[115] and from the 1998 amendment relating to "Instruments Eligible for Inclusion in Tier 1 Capital," hybrid instruments were included as part of tier 1 capital.[116] Subsequent to the 1998 amendment, the market for hybrid securities expanded rapidly since they were perceived to be a timely financial solution satisfying the demands by both issuing institutions and investors. Innovative capital instruments for the purpose of generating capital at lower cost were allowed in up to a 15% limit after the 1998 amend-

113. *See* Letter from Mary Frances Monroe, Vice President, American Bankers Ass'n to Secretariat, Basel Comm. on Banking Supervision 8-9 (April 16, 2010), *available at* http://www.bis.org/publ/bcbs165/ambac.pdf; Letter from Andrew Procter, Global Head of Gov't & Regulatory Affairs, Deutsche Bank AG, to Stefan Walter, Sec'y Gen., Basel Comm. on Banking Supervision 4 (April 16, 2010), *available at* http://www.bis.org/publ/bcbs165/deutschebankcap.pdf; Letter from Mark D. Linsz, Treasurer, Bank of America, to Basel Comm. on Banking Supervision 5-6 (April 16, 2010), *available at* http://www.bis.org/publ/bcbs165 /boac.pdf.

114. The comments on STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR, *supra* note 57, from financial institutions were quite against the tightening move on hybrid instruments; however, the amount of hybrid capital instruments will be 25% of Tier 1 capital instead of the current 50% ratio. *See* BASEL III, *supra* note 1, ¶ 50.

115. INTERNATIONAL CONVERGENCE 1988, *supra* note 2, ¶ 22.

116. *See* Press Release, Basel Comm. on Banking Supervision, Instruments Eligible for Inclusion in Tier 1 Capital (Oct. 27, 1998), *available at* http://www.bis.org/press/p981027.htm.

ment.[117] Basel II amended the capital adequacy rules for financial institutions, but the 15% limit for innovative tier 1-hybrid instruments was maintained.[118] Banks searched for structures that would appeal to investors and "began to issue non-innovative capital instruments that had a call date and often included a switch from fixed rate to floating rate at that day, but [without] a coupon step-up . . . after banks filled their 15% allowance of innovative [hybrid] capital securities . . . .[119]

Basel II created incentives for banks to adjust their capital structures to optimize the cost of capital associated with the assets on their balance sheets. Banks could minimize the proportion of common equity in their capital structure but still maintain stable Basel II capital ratios by issuing hybrid debt. Basically, the Basel Committee allowed individual governments to bend the rules over time through their own legislation,[120] which, in turn, favored the international banking community.

B. *Hybrid Capital Instruments under U.S. Regulations*

Hybrid instruments qualify as regulatory capital and are an important issuance alternative to common equity for U.S. financial institutions, which are subject to capital adequacy requirements. Table 3 summarizes the regulatory capital and types of the hybrid capital instruments in the U.S.

117. *Id.* ("Such [innovative] instruments will be subject to stringent conditions and limited to a maximum of 15% of Tier 1 capital.").

118. INTERNATIONAL CONVERGENCE 2006, *supra* note 2, Annex 1 at 243.

119. Yu & Luu, *supra* note 85, at 11-12.

120. *Id.* at 11.

TABLE 3: QUALIFYING CAPITAL FOR BANK HOLDING COMPANIES IN THE U.S.[121]

Component	Minimum requirements
1. Core Capital (tier 1)	Must exceed or equal 4% of weighted assets.
1.a. Common Stockholders' Equity (Common Equity and Retained Earnings).	No limit.
1.b. Qualifying non-cumulative perpetual preferred stock.	No limit.
1.c. Qualifying cumulative perpetual preferred stock and qualifying trust preferred securities	Limited to 25% of the sum of common stock, qualifying perpetual stock, and minority interests.
1.d. Minority interest in equity accounts of consolidated subsidiaries.	Organizations should avoid using minority interests to introduce elements not otherwise qualifying for tier 1 capital.
1.e. Less: Goodwill, other intangible assets, credit-enhancing interest-only strips and non-financial equity investments required to be deducted from capital.	Deduct these elements from tier 1.
2. Supplementary Capital (tier 2)	Total of tier 2 capital is limited to 100% of tier 1.
2.a. Allowance for loan and lease losses.	Limited to 1.25% of weighted-risk assets.
2.b. Perpetual preferred stock.	No limit within tier 2 capital.
2.c. Hybrid capital instruments.	No limit within tier 2 capital.
2.d. Subordinated debt and intermediate-term preferred stock -original weighted average maturity of min 5 years.	Subordinated debt and intermediate-term preferred stock are limited to 50% of tier 1; amortized for capital purposes as they approach maturity.

121. Table 3 is prepared in accordance with Regulation Y, 12 C.F.R. § 225 app. A (2011), Attach. 2.

2.e. Revaluation reserves (equity and building).	Not included; organizations encouraged to disclose; may be evaluated on a case-by-case basis for international comparisons; and taken into account in making an overall assessment of capital.
3. Deductions (from sum of tier 1 and tier 2)	
3.a. Investments in unconsolidated subsidiaries; Reciprocal holdings of banking organizations' capital securities; Other deductions as determined by supervisory authority.	As a general rule, one-half of the aggregate investments will be deducted from tier 1 capital and one-half from tier 2 capital. On a case-by-case basis or as a matter of policy after a formal rule-making.
Total Capital (tier 1 plus tier 2 minus deductions).	Must equal or exceed 8% of weighted-risk assets.

There is a variation between Bank Holding Companies (BHC)[122] and State Member Banks[123] in terms of hybrid instrument treatment, therefore unless otherwise indicated, this article addresses the hybrid instrument regulation on both State Member Banks and BHCs (together, Banks) in the U.S. Table 4 summarizes the appearance of hybrid instruments in the regulatory capital for U.S. Banks.

122. A "Bank Holding Company" is "any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this Act." Bank Holding Company Act of 1956 § 2(a), 12 U.S.C. § 1841(a) (West 2010).

123. 12 U.S.C. § 1813(d)(2) (2006) ("The term 'State member bank' means any State bank, which is a member of the Federal Reserve System.").

TABLE 4: HYBRID CAPITAL INSTRUMENTS IN THE U.S.[124]

Category	Sub-Category	Classes of Hybrids in State Member Banks' Capital	Classes of Hybrids in Bank Holding Company Capital
Core capital (tier 1)	-	- Qualifying non-cumulative perpetual preferred stock	- Qualifying non-cumulative perpetual preferred stock - Restricted tier 1 elements (limited to 25%) - Qualifying cumulative perpetual preferred stock - Qualifying trust preferred securities
Supplementary Capital (tier 2)	Upper tier 2	-Hybrid capital instruments -Perpetual preferred stock	-Hybrid capital instruments -Perpetual preferred stock -Perpetual debt
Supplementary Capital (tier 2)	Lower tier 2	-Term subordinated debt and intermediate-term preferred stock	-Term subordinated debt and intermediate-term preferred stock

The Federal Reserve System's Capital Adequacy Guideline for Bank Holding Companies sets out the definition for qualifying non-cumulative perpetual preferred stock, which is considered a hybrid instrument qualifying as tier 1 capital, with the following conditions:

124. Table 4 is prepared in accordance with Aoyama, *supra* note 82, at 17.

(a) It has no maturity date, (b) It cannot be redeemed at the option of the holder, (c) If it can absorb losses whilst the issuer operates as a going concern, (d) It may not have any provisions restricting the bank's ability or legal right to defer . . . or waive dividends, and (e) Its redemption at the option of the issuer may qualify only if the redemption is . . . subject to prior approval of the Federal Reserve.[125]

In addition, perpetual preferred stock that is non-cumulative generally may not permit the accumulation or payment of unpaid dividends in any form, including in the form of common stock.[126] On the other hand, perpetual preferred stock that provides for the accumulation or future payment of unpaid dividends is deemed to be cumulative.[127] These conditions of the Guideline are in accordance with the "Criteria for inclusion in Tier 1 Additional Going Concern Capital,"[128] but there are substantial clauses that do not meet the Basel III requirements.

The Institute of International Finance states, that "The greater emphasis on "core" tier 1 equity (TCE) versus total tier 1 would not greatly stress U.S. banks, given their holdings of TCE amounted to 92% of total tier 1 capital at the end of 2009."[129] As an issue of nuance, the term 'core' is differently defined in Basel III terminology and U.S. Bank Holding Act. According to the Guideline, "Tier 1 capital generally is defined as the sum of core capital elements (tier 1 capital elements) . . . ."[130] In other words, the Guideline does not distinguish tier 1 capital from core tier 1 capital and defines core capital elements as (i) qualifying common stockholders' equity; (ii) qualifying noncumulative perpetual preferred stock; (iii) qualifying minority interests; and (iv) restricted core capital elements.[131] Restricted core capital includes cumulative perpetual preferred stock and trust preferred securities, which are the appearances of innovative hybrid capital instruments in the Bank Holding Company Act. However, in Basel III language, common equity tier 1 capital, which does not include

125. 12 C.F.R. § 225, app. A, II.A.1.c.ii(1)-(2).
126. *Id.* at II.A.1.c.ii.(3).
127. *Id.*
128. BASEL III, *supra* note 1, ¶ 15.
129. EUR. BANKING INT'L INSTITUTE OF FIN., *supra* note 11, at 54.
130. 12 C.F.R. § 225 app. A., II.A.1.
131. *Id.* at II.A.1.(a).

any type of hybrid capital instruments must make up 75% of tier 1 capital; thus, common equity tier 1 capital could be seen as a form of core capital.[132]

According to criterion (7)(a) of Basel Committee on Banking Supervision's consultative document of December 17, 2009, Para 89, the bank must have full discretion at all times to cancel, and not merely defer, distributions or payments (that is, no cumulative dividends).[133] This criterion disallows the cumulative preferred stock, a component of tier 1 capital for BHCs, (though not for the state member banks) since perpetual preferred stock that provides for the accumulation or future payment of unpaid dividends is deemed to be cumulative.[134] Criterion 4[135] disallows trust preferred securities, a popular form of tax-advantaged tier 1 capital that includes a maturity date.[136]

BHCs may currently include restricted core capital elements, including trust preferred securities, in tier 1 capital up to 25% of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability.[137] Another quantitative limitation included in the Federal Reserve rule is a 15% limit on inclusion of restricted core capital elements in tier 1 capital by "internationally active banking organization."[138] As a restricted core capital element, trust preferred securities have reduced the cost of tier 1 capital for a wide range of BHCs and as of 2005, over 800 bank holding companies had issued and out-

132. BASEL III, *supra* note 1, Annex 4 at 69.

133. *Id.* at ¶ 55 ("[T]he bank must have full discretion at all times to cancel distributions/payments.").

134. 12 C.F.R. § 225 app. A., II.A.1.iv(1), II.A.1.c.ii.(3).

135. BASEL III, *supra* note 1, ¶ 55.

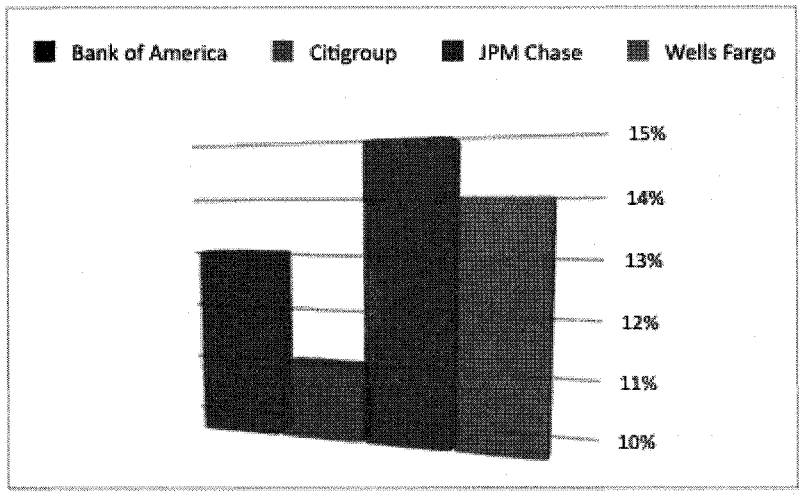
136. H.Rodgin Cohen, *Basel Committee Proposes Strengthening Bank Capital and Liquidity Regulation,* HARV. L. SCHOOL FORUM ON CORP. GOVERNANCE AND FIN. REGULATION (Jan. 07, 2010, 9:19 AM), http://blogs.law.harvard.edu/corpgov /2010/01/07/basel-committee-proposes-strengthening-bank-capital-and-liquidity-regulation/.

137. 12 C.F.R. § 225 app. A, II.A.1.b.i.(1) (2011).

138. *Id.* at II.A.1.b.i.(2), n.6 (" . . . an internationally active banking organization is a banking organization that (1) as of its most recent year-end FR Y-9C reports total consolidated assets equal to $250 billion or more or (2) on a consolidated basis, reports total on-balance-sheet foreign exposure of $10 billion or more on its filings of the most recent year-end FFIEC 009 Country Exposure Report.").

standing trust preferred securities totaling over $85 billion dollars.[139] Figure 7 illustrates the percentage of trust preferred securities relative to tier 1 capital of Bank of America, Citigroup, JPM Chase and Wells Fargo, the "big four" in the sense of total assets[140] that would be disqualified over ten years starting with 2013 for regulatory capital purposes in the U.S. if Basel III were fully implemented.[141]

FIGURE 7: TRUST PREFERRED SECURITIES RELATIVE TO TIER 1 CAPITAL OF THE BIG FOUR[142]



According to Figure 7, 15% tier 1 capital of JPM Chase will be disqualified in accordance with the phase out provision of innovative hybrid capital instruments under Basel III.[143] Bank of America, Citigroup and Wells Fargo will have 13%, 11% and 14% respectively of their tier 1 capital disqualified in

139. Press Release, Federal Reserve System, Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital (Mar. 4, 2005), *available at* http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050301/attachment.pdf.

140. *Top 50 BHCs*, NAT'L INFO. CTR. (Sept. 30, 2011), http://www.ffiec.gov/nicpubweb/nicweb/top50form.aspx.

141. *See* BASEL III, *supra* note 1, ¶ 94.

142. *See* Tracy Alloway, *All TruPSed up*, FIN. TIMES ALPHAVILLE (June 9, 2010 1:00 PM), http://ftalphaville.ft.com/blog/2010/06/09/255456/all-trupsed-up/.

143. *See* BASEL III, *supra* note 1, ¶ 94.

case of adoption and adaptation of Basel III.[144] However, the Dodd-Frank Wall Street Reform and Consumer Protection Act[145] (the Dodd-Frank Act) is already one step ahead of Basel III in regard to phasing out innovative hybrid capital instruments.

Section 171 of the Dodd-Frank Act, the so-called "Collins Amendment," directs the appropriate federal banking agencies to establish minimum leverage and risk-based capital requirements, on a consolidated basis, for insured depository institutions, depository institution holding companies and nonbank financial companies that are supervised by the Federal Reserve.[146] According to the Act, the term "depository institution holding company" means a bank holding company or a savings and loan holding company.[147] The minimum leverage and risk-based capital requirements shall not be less than the generally applicable leverage capital and generally applicable risk-based capital requirements, respectively, which shall serve as floors for any capital requirements that the agency may require. Nor may they be quantitatively lower than the generally applicable leverage and risk-based capital requirements that were in effect for insured depository institutions as of the date of enactment of the Act.[148] Thus, generally applicable leverage and risk-based capital requirements are now crucial for the calculation of regulatory capital.

The Dodd-Frank Act defines "generally applicable risk-based capital requirements" and "generally applicable leverage capital requirements" to mean the risk-based capital requirements and minimum ratios of tier 1 capital to average total assets, respectively, as established by the appropriate Federal banking agencies to apply to insured depository institutions under the prompt corrective action provisions of the Federal Deposit Insurance Act (FDIA), regardless of total consolidated asset size or foreign financial exposure.[149]

In brief, the minimum leverage and risk-based capital requirements are to be determined based on the minimum ra-

144. *See* Alloway, *supra* note 142.
145. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
146. *Id.* § 171(b)(1)-(2).
147. *Id.* § 171(a)(3).
148. *Id.* § 171(b)(1)-(2).
149. *Id.* § 171(a)(1)-(2).

tios established by the federal banking agencies that apply to insured depository institutions[150] under §38 Prompt Corrective Action of the FDIA.[151] The Dodd-Frank Act does not specifically disqualify trust preferred securities or cumulative perpetual preferred securities. Instead, the Act sets the same capital requirements on BHCs as State Member Banks. As shown in Table 4, trust preferred securities or cumulative perpetual preferred securities issued by state member banks do not qualify for tier 1 regulatory capital treatment because they allow for cumulative rather than non-cumulative dividend or coupon discretion.[152] This treatment is extended to trust preferred securities and cumulative perpetual preferred securities issued by bank holding companies under Dodd-Frank Act §171.

For innovative hybrid capital instruments issued before May 19, 2010, by depository institution holding companies or by nonbank financial companies supervised by the Board of Governors, any regulatory capital deductions required under §171 shall be phased in incrementally over a period of three years, with the phase-in period to begin on January 1, 2013[153] unless these instruments issued "by depository institution holding companies with total consolidated assets of less than $15,000,000,000 as of December 31, 2009, and by organizations that were mutual holding companies on May 19, 2010."[154] "For [issuances] on or after May 19, 2010, by depository institution holding companies or by nonbank financial companies [§171] shall be deemed to have become effective as of May 19, 2010."[155] Since Basel III requires innovative hybrid capital instruments to be phased out over 10 year horizon beginning 2013,[156] the Dodd-Frank Act is stricter than Basel on innovative hybrid capital instruments in terms of timing. Given Dodd-Frank Act's §171, neither trust preferred securities nor cumulative perpetual preferred stock would qualify for inclusion as tier 1 capital among the top 50 BHCs.

150. 12 U.S.C. § 1813(a)-(d) (2006).

151. 12 U.S.C. § 1831o (2006).

152. *See* Federal Reserve System, *supra* note 139, at 6-10.

153. Dodd-Frank Wall Street Reform and Consumer Protection Act, *supra* note 145, § 171(b)(4)(B).

154. *Id.* § 171(b)(4)(C).

155. *Id.* § 171(b)(4)(C).

156. BASEL III, *supra* note 1, ¶ 94.

C. *Hybrid Capital Instruments Under EU Regulations*

Duncan Wood states: "Government usage of hybrids during the crisis is as follows: Regulators are changing the rules as they go along, governments are arbitraging them, and markets are ignoring them."[157] The statement is an exact synopsis of the hybrid capital track record in EU.

Article 57 of Directive 2006/48/EC, the Banking Consolidation Directive (BCD), sets out a list of eligible components for tier 1 capital, but there is no clear terminology for describing hybrid instruments which are considered to be eligible as tier 1 capital in the BCD and hybrid instruments are undefined.[158] Hybrid instruments are harmonized in "Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management" (CRD II), which was adopted in July 2009 to be applied from December 31, 2010.[159] CRD II establishes the principles and rules that had not been formalized at the EU level, such as the treatment of hybrid capital instruments within original own funds. Hybrids qualify as "original own funds" for regulatory purposes[160] and "to be recognized as 'original own funds,' they need to fulfill the criteria of loss absorption, flexibility of payments and permanence."[161] These terms are defined as follows. "Loss absorption" means "the instrument in question must be available to absorb losses, both on a going concern basis and in liquidation, and to provide support for depositors' funds if neces-

157. Stan Maes & Wim Schoutens, Contingent Capital: An in-Depth Discussion 3 n.3 (Aug. 2, 2010) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1653877.

158. Directive 2006/48/EC, *supra* note 12.

159. Council Directive 2009/111/EC, art. 12(a)(1a)(a)-(c), 2009 O.J. (L 302) 97, 104 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF.

160. *Accompanying document to the Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management*, at 4, COM (2008) 602 final (Jan. 10, 2008), *available at* http://ec.europa.eu/internal_market/bank/docs/regcapital/resume_impact_assessment_en.pdf.

161. *Id.*

sary."[162] "Flexibility of payments" means "the instrument must contain features permitting the noncumulative deferral or cancellation of payment of coupons or dividends in times of stress."[163] And "permanence" means "the instrument must be permanently available so that there is no doubt that it can support depositors and other creditors in times of stress."[164] Table 5 shows the variation on hybrid instruments supervision across the European jurisdictions in 2007.[165]

TABLE 5: HYBRID INSTRUMENTS LIMITS AS A PROPORTION OF TIER 1 CAPITAL IN 2007

Country	Supervisory Limit on Innovative Tier 1	Supervisory Limit on Hybrids Excluding Non-cumulative Preference Shares (includes the limit of the first column)	Limit on Non-cumulative Preference Shares under National Law
Austria	15%	30%	33%
Belgium	15%	33%	33%
Denmark	15%	15%	No limit
France	15%	25%	25%
Germany	15%	50%	Not Recognized
Greece	10%	25%	No Limit
Ireland	15%	49%	No Limit
Italy	15%	20%	50%
Netherlands	15%	50%	No limit
Portugal	20%	20%	50%
Spain	15%	30%	50%
UK	15%	15%	50%

162. *Id.* at 4 n.8
163. *Id.* at 4 n.9.
164. *Id.* at 4 n.10.
165. COMM. OF EUR. BANKING SUPERVISORS [CEBS] *Quantitative analysis of eligible own funds in the EEA*, EUR. BANKING AUTH. 41 (Mar. 13, 2007), http://www.eba.europa.eu/getdoc/fada4844-dd0c-4144-b77e-285c51ca5b0e/OF_analysis15062007.aspx.

As Table 5 shows, the ratios of hybrid capital instruments vary across the EU countries. Part of the explanation for this variation is that the Basel Accords are not formal treaties and are not necessarily fully implemented by way of national law or regulations.[166] Governments conspicuously and frequently ignored or skirted around Basel II hybrid guidelines in their own bank investments during the height of the credit crisis. "The German government, for example, purchased €8.2 billion of hybrids from Commerzbank having a feature where losses are shared with common equity but are redeemable at par if no further losses occur. Those hybrids accounted for about 60% of Commerzbank's tier 1 capital at the time - well above the 35% [regulatory] maximum."[167]

The ratios required by CRD II are 50% and 15% for hybrid instruments and innovative hybrid instruments, thus, Art. 66 BCD and current Basel Accords are fully consistent.[168] However, an amendment to Art. 66 BCD is necessary to accommodate the allowance of hybrid capital instruments up to 25% of tier 1 capital and phase out of innovative capital instruments under Basel III. In line with the necessity, European Commission announced further amendments for consistency on hybrid capital instruments in the consultation document on CRD IV, Further possible changes to the Capital Requirements Directive.[169]

Innovative hybrids have been shown to be woefully ineffective during the crisis in their purported function to absorb losses on a going concern basis. Therefore, the European Commission deemed that it would be inappropriate to continue recognizing them as non-Core Tier 1 capital. In ensuring that only the highest quality instruments may be eligible as going concern capital, the European Commission further recommended that it was necessary to also strengthen the requirements for permanence. The extreme conclusion taken by the European Commission was not only to tighten the qualifying

166. Douglas J. Elliott, *Basel III, the Banks, and the Economy*, THE BROOKINGS INSTITUTION 2 (July 23, 2010), http://www.brookings.edu/~/media/Files/rc/papers /2010/0726_basel_elliott/0726_basel_elliott.pdf.

167. Culp et al., *supra* note 29, at 18.

168. Directive 2009/111/EC, *supra* note 159.

169. *Possible Further Changes to the Capital Requirements Directive*, EUR. COMM. 1, (Feb. 26, 2010), http://ec.europa.eu/internal_market/consultations/docs /2010/crd4/consultation_paper_en.pdf.

criteria for non-Core Tier 1 capital, but also to eliminate altogether the inclusion of innovative and dated hybrid instruments as qualifying instruments.[170]

The massive volume of hybrid instruments in European Banking Authority[171] member states was estimated at €213 billion in 2007.[172] UK and Germany composed almost half this amount[173], and innovative hybrid instruments represented nearly €40 billion of capital of UK and German banks.[174] Consequently, in case of adoption and adaptation of Basel III, UK and German banks will find themselves short of €40 billion in tier 1 capital. Therefore, tier 1 capital requirements of Basel III mark one of biggest concerns of UK banks.[175] Germany would also have significant problems implementing Basel III since, "[the] Basel proposals to tighten standards for hybrid capital could make it very difficult for German Landesbanken to raise regulatory capital, as they have little access to equity markets."[176] Almost 50% of Germany's banking market is made up of the state-owned Landesbanken.[177] As a result, Germany has wrangled against the more conservative assessment of what counts as capital in the Basel III,[178] and Germany refused to endorse the agreement reached on July 26, 2010 on the overall design of the capital regulations under Basel III

170. *Id.* ¶ 48.

171. "The EBA has officially come into being as of 1 January 2011 and has taken over all existing and ongoing tasks and responsibilities from the Committee of European Banking Supervisors (CEBS)." EUR. BANKING AUTH., http://www.eba.europa.eu/ (last visited Sept. 14, 2011).

172. CEBS, *Proposal for a common EU definition of Tier 1 hybrids*, EUR. BANKING AUTH. ¶ 2 (Mar. 26, 2008), http://www.eba.europa.eu/getdoc/06e25083-2f37-4146-90f3-9e9a40365117/hybrids.aspx.

173. CEBS, *Quantitative analysis of eligible own funds in the EEA*, EUR. BANKING AUTH. ¶ 62 (Mar. 13, 2007), http://www.eba.europa.eu/getdoc/fada4844-dd0c-4144-b77e-285c51ca5b0e/OF_analysis15062007.aspx.

174. *See id.* ¶ 67.

175. Tom Young, *UK banks' biggest Basel III worries*, INT'L FIN. L. REV., Feb. 26, 2010, http://www.iflr.com/Article/2401216/UK-banks-biggest-Basel-III-worri es.html.

176. Elizabeth Fournier, *Basel threatens German hybrids*, INT'L FIN. L. REV., Feb. 23, 2010, http://www.iflr.com/TopicListArticle/2398191/Home/Basel-threatens-German-hybrids.html?TopicListId=73.

177. *Id.*

178. *See* Tom Braithwaite, *FDIC chief says watchdogs 'succumbing' to bank lobby*, FIN. TIMES, July 21, 2010, at 18.

until it had clarification on the calibration.[179] "At the heart of Germany's objections to the draft Basel III rules [was] a form of [hybrid] capital known as 'silent participations.'"[180]

"'A quarter to a third of the capital reserves of German savings banks, cooperative banks, private banks and Landesbanks come in the form of silent participations, adding up to a little less than €50 billion ($64 billion) altogether.' said Karl-Heinz Boos, executive managing director of the Asso-

179. Brooke Masters & Megan Murphy, *Suspense over*, FIN. TIMES, Aug. 18, 2010, http://www.ft.com/cms/s/0/ab02375c-aafb-11df-9e6b-00144feabdc0.html #axzz1BWzrt8qz; Daniel Pruzin, *Financial Sector Gives Cautious Welcome to Agreement on Bank Capital Standards*, BNA INT'L, Sept. 14, 2010, http://www.bnai.com/BankCapitalStandards/default.aspx.

180. Arno Scheutze & Jonathan Gould, *German deal expected to permit Basel bank reforms*, REUTERS, Sept. 2, 2010, http://money.uk.msn.com/news/articles.aspx?cp-documentid=154568800. See generally CEBS, *Quantitative analysis of eligible own funds in the EEA*, EUR. BANKING AUTH 45 (Mar. 13, 2007), http://www.eba.europa.eu/getdoc/fada4844-dd0c-4144-b77e-285c51ca5b0e/OF_analysis15062007.aspx ("In a 'typical' silent partnership, the silent partner invests cash or other assets into a company. However, he does not appear as an owner of the company in the trade register and does not participate in operating the company's business. In return for his investment, the silent partner participates in the gains and losses the company makes. In addition he receives the annual accounts of the company and is allowed to check their correctness through access to the company's books. The loss absorption capacity of the silent partnership (write down of the principal) is usually limited to the amount of the investment of the silent partner and in most cases takes place *pari passu* with the company's paid up capital. If the contract which governs the silent partnership meets certain requirements (such as subordination to all claims of senior and subordinated creditors in the case of the insolvency or liquidation of the company and permanence of the silent partner's investment), the silent partnership may be accounted for as paid up capital under German accounting standards. . ..There has to exist an agreement between the institution and the silent partner that, in the event of the initiation of insolvency proceedings over the institution's assets or of the institution's liquidation, the silent partnership will not be repaid until all creditors have been satisfied. The institution, when establishing the silent partnership, has to refer explicitly and in writing to the legal consequences of the silent partnership. These consequences are that participation in any loss cannot be changed to the detriment of the institution and the subordination of claims cannot be limited. Any premature repayment shall be returned to the institution, notwithstanding any arrangements to the contrary, unless the capital has been replaced by other own funds of at least equivalent status or the Federal Financial Supervisory Authority has agreed to the premature repayment.").

ciation of German Public Sector Banks, 'There is no way these banks could find a substitute quickly.'"[181]

The Basel Committee on Banking Supervision, on September 12, 2010, announced the transitional periods,[182] which were also maintained in Basel III,[183] and Germany received a 10-year grace period from 2013 to phase out so called 'silent participations'.[184] In the end, Germany went along with the agreement.[185]

In comparison to existing U.S. and EU regulations, the Basel III requirements on hybrid instruments are very exacting. The experience of 2008 to 2010 has shown that U.S. and EU regulatory approaches to hybrid instruments failed to capture true risk and have left banks with insufficient quality of capital and, ultimately, a much higher risk profile.[186] Credit rating agencies aided in the failure to capture the risk and to some extent, they will influence the future of the hybrid capital market.

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181. Scheutze and Gould, *supra* note 180.

182. Press Release, Basel Comm. on Banking Supervision, Group of Governors and Heads of Supervision announces higher global minimum capital standards 4 (Sept. 12, 2010), *available at* http://www.bis.org/press/p100912.pdf.

183. BASEL III, *supra* note 1, ¶¶ 94-95.

184. Natsuko Waki & Catherine Bosley, *Global regulators agree on tougher Basel III bank rules*, REUTERS, Sept. 12, 2010, http://www.reuters.com/article / 2010/09/12/us-basel-banks-idUSTRE68B16L20100912.

185. James Wilson, Patrick Jenkins and Brooke Masters, *Basel III sets stage for Landesbank reform*, FIN. TIMES, Sept. 14, 2010, http://www.ft.com/cms /s/ 0/a3158900-c026-11df-b77d-00144feab49a,s01=2.html#axzz1ZdOYHSfF; Masters, *supra* note 16.

186. *See* Peter Boone & Simon Johnson, *Will the Politics of Global Moral Hazard Sink Us Again?*, *in* THE LSE REPORT: THE FUTURE OF FINANCE 247, 252, 267 (London Sch. of Econ. and Political Sci. ed., 2010), *available at* http://harr123et.files.wordpress.com/2010/07/futureoffinance5.pdf ("Lax rules on hybrid capital made those instruments ineffective. . ..The program of the G-20's Financial Stability Board and the new Basel 3 plans all introduce tighter regulatory requirements. We are confident that capital requirements at banks are set to be raised, and many of the most egregious errors in bank regulation, such as the treatment of hybrid securities as capital, will be adjusted."); Orlando Fernandez, *Contingent convertible instruments and the brave new world of regulatory capital*, PRAC. L. COMPANY, Apr. 6, 2010, http://crossborder.practical law.com/7-501-5719 ("The regulatory and commercial appeal of hybrids nose-dived during the recent crisis, prompting issuers and regulators to seek more effective forms of shock-absorbing capital.").

D. *Credit Rating Agencies' Approach*

The treatment of hybrid instruments by rating agencies is of great importance to banks, as it influences the banks' cost of refinancing.[187] When rating an issuer as a whole, credit rating agencies generally first consider whether a given hybrid is relatively more equity-like or more debt-like. If it is relatively more equity-like then it poses an enhancement to the issuer's rating, and if it is debt-like, then it is likely to have an adverse effect on the issuer's rating.[188] Hybrid capital issuance saw a boom in 2005 when rating agencies first clarified their newly evolved methodologies and hybrid securities were deemed more beneficial to financial issuers.[189] However, it is generally acknowledged that the failure of major credit rating agencies' methodology to anticipate the rise in risks pertaining to hybrid instruments contributed to the financial crisis.[190] We believe that one reason for this failure is that credit rating agencies focused only on credit risk or default risk. As stated by S&P, credit rating agencies do ignore obvious additional legal risks such as extension risk: "The extension of the maturity of a hybrid security at the date on which the issuer has the option to call the security and repay the principal has no impact on the rating of the security."[191]

Learning from these failures, the rating agencies began to evolve their rating methodologies both in U.S. and Europe[192]

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187. Yu & Luu, *supra* note 85, at 12.

188. Aoyama, *supra* note 82, at 10.

189. *See* Sahara & Daws-Chew, *supra* note 71, at 10; Andrew Carey, *Hybrid Capital: a serious alternative for corporates?*, IBERIAN LAW., Apr. 30, 2007, http://www.iberianlawyer.com/in-house-/know-how/732-hybrid-capital-a-serious-alternative-for-corporates. ("This sudden growth initially resulted from a decision by Moody's in February 2005 to change its methodology for hybrid products. Moody's announced that it would give more equity credit (ie [sic] in assessing the ratings on a company's other debt) for certain structural features in what are, in legal terms, debt instruments."). For example, cumulative European hybrid issuance volume roughly quadrupled in 2005 compared to 2004. Sahara & Daws-Chew, *supra* note 72, at 5.

190. *See* Yu & Luu, *supra* note 5 at 12-13.

191. SCOTT BUGIE ET AL., HYBRID SECURITIES OF OVER 60 EUROPEAN FINANCIAL INSTITUTIONS DOWNGRADED FOLLOWING S&P REVIEW, STANDARD & POOR'S (2009), *available at* http://www2.standardandpoors.com/spf/pdf/media /Hybrid_Securities_04_16_09.pdf.

192. BARBARA HAVLICEK & MATTHIAS OGG, MOODY'S, MOODY'S GUIDELINES FOR RATING BANK HYBRID SECURITIES AND SUBORDINATED DEBT (2009), *availa-*

at a time when the market for hybrid capital instruments had already weakened.[193] In 2010, credit rating agencies adapted new criteria in response to Basel III.[194]

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ble at http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_120307; SCOTT SPRINZEN ET AL., STANDARD & POOR'S, HYBRID CAPITAL HANDBOOK: SEPTEMBER 2008 EDITION (2008), *available at* http://www2.standardandpoors.com/spf/pdf/media/Hybrid_Capital_Handbook_Sept_2008.pdf; SCOTT BUGIE & TANYA AZARCHS, STANDARD & POOR'S, FRANCHISE STABILITY, CONFIDENCE SENSITIVITY, AND THE TREATMENT OF HYBRID SECURITIES IN A DOWNTURN (2008), *available at* http://www2.standardandpoors.com/spf/pdf/media/Franchise_Stability_12_01_08.pdf; SCOTT SPRINZEN ET AL., STANDARD & POOR'S, REVIEW RESULTS IN CHANGES TO CERTAIN U.S. FINANCIAL INSTITUTIONS' HYBRID CAPITAL ISSUE RATINGS (2009), *available at* http://www2.standardandpoors.com/spf/pdf/events/FITconHybrid2.pdf; SCOTT BUGIE ET AL., STANDARD & POOR'S, ISSUE RATINGS LOWERED ON HYBRID INSTRUMENTS OF SOME EUROPEAN BANKS ON HEIGHTENED DEFERRAL RISK (2009), *available at* http://www2.standardandpoors.com/spf/pdf/events/FITconHybrid5.pdf.

193. *See* Nancy Bennett, *Academy Invested Asset Work Group Status Report: Required Capital for Hybrid Securities*, AM. ACAD. OF ACTUARIES, 6 (June 4, 2007), http://www.actuary.org/pdf/life/iawg_june07.pdf ("[The Academy Invested Asset Work Group] recognizes that the NRSRO rating methodologies . . . evolve along with developments in the hybrid market."); Yu & Luu, *supra* note 85, at 14 ("The prices of hybrid bank capital securities started weakening in the summer of 2007 . . . ."). Thus, although there are many other simultaneous factors, it appears that the introduction of new rating methodologies correlates to the beginning of the period when hybrid securities declined. In addition, the methodologies of credit rating agencies are all different and subject to changes. Therefore, the period 2008 to 2010 also saw the evolution of rating methodologies.

194. *See Criteria — Financial Institutions — Request for Comment: Bank Hybrid Capital Criteria: Methodology and Assumptions*, STANDARD & POOR'S (Dec. 6, 2010), http://www2.standardandpoors.com/spf/pdf/media/BankHybridCapitalCriteria.pdf; Barbara Havlicek & Matthias Ogg, *Revisions to Moody's Hybrid Tool Kit*, MOODY'S INVESTORS SERVICE 1 (July 1, 2010), http://v2.moodys.com/cust/content/content.ashx?source=StaticContent/Free%20Pages/Products%20and%20Services/Downloadable%20Files/Revisions%20to%20Moodys%20Hybrid%20Tool%20Kit.pdf ("The catalyst for revisions to our hybrid guidance was the financial crisis, which brought hybrid performance into sharp focus and allowed us to test our largely theoretical assumptions regarding their behavior. What became clear is that many of the 'bells and whistles' used in hybrid design over the last five years do not necessarily enhance their loss absorption characteristics for a 'going concern' – that is, a concern that is not in imminent danger of default. Instead, a simple principle has emerged, which is the basis for our revised methodology: non-cumulative preferred securities tend to provide better loss absorption for a 'going' concern than does cumulative subordinated debt.").

According to the Standard & Poor's proposal for the bank hybrid criteria:

> The Basel Committee on Banking Supervision's proposals for hybrid securities herald a tightening of bank regulatory requirements that will result in many traditional hybrid structures no longer qualifying for regulatory capital. Accordingly, S&P will no longer give equity credit for many bank hybrid structures that currently are eligible for our intermediate equity content category. . . . To the extent that the Basel proposals lead to tighter rules for regulatory classification of bank hybrids, this will influence our treatment of the affected hybrids in our rating analysis.[195]

Hybrid capital instruments are not yet treated as non-eligible by credit rating agencies, but it is proposed to exclude innovative hybrid capital instruments from total adjusted capital and revise the equity credit classifications of hybrid capital instruments.[196] The treatment is expected to be clarified once Basel III comes into effect.[197]

E. *Underestimated Risk of Hybrid Instruments by Investors*

Investor Marilyn Cohen asks: "How can anybody have any confidence in that market? . . . Those hybrids and preferreds [sic] are going to be the dinosaurs of the market."[198] Investors

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195. *See Criteria — Financial Institutions — Banks: Implications of the December 2009 Basel III Proposals for our Bank Hybrid Criteria*, STANDARD & POOR'S, ¶¶ 7-8 (Feb. 9, 2010), http://www.standardandpoors.com/prot/ratings /articles/ en/us/?articleType=HTML&assetID=1245319265719.

196. *Bank Hybrid Capital Criteria: Methodology and Assumptions, supra* note 194, ¶¶ 32-35 ("We propose to exclude bank hybrids with coupon step-ups associated with an optional call date (or equivalent features that may act as a financial incentive to redeem) from [Total Adjusted Capital]. We propose to classify such instruments in our 'Minimal' equity credit category (regardless of their regulatory classification) unless there are more than 20 years to run until the step-up date.").

197. BASEL III, *supra* note 1, ¶ 94(a) ("National implementation [of the new capital standards] . . . will begin on 1 January 2013. Member countries must translate the rules into national laws and regulations before this date.").

198. Caroline Salas & Neil Unmack, *Citigroup Leads Hybrid Bond Drop on Bailout Concern*, BLOOMBERG, Feb. 3, 2009, http://www.bloomberg.com/ apps/news?pid=newsarchive&sid=aZXBs8UOpXyY (quoting Marilyn Cohen, President of Envision Capital Management Inc.).

of hybrid securities need a full understanding of the legal features and risk of the securities to determine an adequate level of return relative to the risk. In Figure 5, we pointed out that hybrid instruments carry a higher yield for investors through the default risk, but hybrid instruments are subject to a number of additional major legal risks such as extension and deferral risks.

1. *Extension Risk*

An issuer may decide not to call a hybrid security at the call date, usually when the issuer's credit quality has deteriorated. Therefore, investors need to take into consideration the probability of the call not being exercised.[199] Most issues are also structured with an issuer call option effective after a number of years and frequently these call dates are combined with a step-up in coupon that occurs at the call date.[200] If the bond is not called at the first opportunity, the issuer often has the option to call the bonds at regular intervals thereafter, but because a step-up in the coupon rate would create reputation risk, issuers with high credit ratings have usually called hybrid securities at the first opportunity,[201] at least prior to the financial crisis.[202]

2. *Deferral Risk*

The issuing entity usually holds a deferral option, allowing issuers to defer coupons at their discretion, and may even have the power to cancel.[203] An interesting example involved the Royal Bank of Scotland (RBS). "While the government owned RBS's preference shares, bond investors assumed they would always get a coupon because their securities ranked equally with the government. They removed that certainty. The Edinburgh-based bank's €1.3 billion of 7.092 percent undated subordinated Tier 1 notes slumped 21.9 cents to 9 cents

199. *See* BENNETT, *supra* note 193, at 14.

200. Yu & Luu, *supra* note 85, at 19 n.8 ("The mechanics of the step-ups are as follows: if the bond is not called, the coupon changes from a fixed to a floating rate and also 'steps up' versus the spread to swaps at the time of issuance.").

201. Yu and Luu, *supra* note 85, at 19.

202. *See* Bugie et al., *supra* note 191, at 2.

203. Li et al., *supra* note 89, at 1-2.

on the euro on Jan. 20."[204] While deferral "restricts the ability to pay dividends on common equity or to undertake share repurchases,"[205] it is condicio non grata also for the financial institutions. But in some instances, it is compulsory. As discussed below, in some cases, governments constrained banks from making payments on hybrid securities and forced some banks to use the deferral option.[206]

V.
EXCESSIVE HYBRIDIZATION OF TIER 1 CAPITAL AND SUBSEQUENT WORSENING OF FINANCIAL CONDITIONS

Research by Robert DeYoung, based on the hybrid instruments market between 1990 and 2000 in the U.S., shows that "issuance of hybrid capital securities is mainly conducted by larger banks with lower capital ratios and greater emphasis on their stock price performance."[207] In line with this observation, our argument is that aggressive aims of obtaining shareholder value and minimizing the cost of capital through hybrid capital securities issuance could be detrimental to the solvency of a financial institution and result in a subsequent government bail-out. Therefore, Basel III crucially addresses hybridization risk of tier 1 capital by at once recognizing and de-coupling the link between hybridization of tier 1 capital and worsening financial conditions of financial institutions in the US and Europe.

A. *Fannie Mae 'Series T' and Bank of America 'Series M' Prospectuses*

On May 19, 2008, Fannie Mae issued hybrid capital instruments called "Series T." Series T included non-cumulative perpetual preferred shares with no voting right, 8.25% dividend rate, value of $25 per share and optional redemption on May

204. Salas & Unmack, *supra* note 198 (quoting statements made by Phil Roantree, a portfolio manager for New Star Asset Management).

205. *See* Yu & Luu, *supra* note 85, at 21.

206. For government actions against hybrid capital instruments, *see infra* Part 5.4.

207. Yu & Luu, *supra* note 85, at 26 (summarizing DeYoung's research). *See* Robert DeYoung, Mark J, Flannery, William W. Lang, & Sorin M. Sorescu, *The Information Content of Bank Exam Ratings and Subordinated Debt Prices*, 33 J. MONEY, CREDIT & BANKING 900 (2001).

20, 2013.[208] At the time, Fannie Mae had a worsening financial condition, according to the Prospectus.[209] The estimated fair value of Fannie Mae net assets had declined 65% from $35.5 billion to $12.2 billion in the previous quarter.[210] Fannie Mae had just cut the common stock dividend. All three credit-rating agencies had placed outstanding Fannie Mae preferred stocks and debt on their ratings watch lists.[211] Loan loss reserves had been increased from $3.4 billion to $5.2 billion in the most recent quarter.[212] Earnings per share had dropped steadily from a $6.04 per share profit in 2005 to a $2.57 per share loss in 2008.[213] Return on assets and return on equity followed the same pattern as earnings per share, becoming negative beginning in 2007 and more negative in 2008.[214]

Series T instruments were non-cumulative, meaning any omitted dividend payments would be lost forever, not just deferred, and given the financial condition of Fannie Mae, dividends payable to Series T investors were uncertain.[215] However, "core capital as of March 31, 2008 was $42.7 billion . . . exceeding the statutory minimum capital requirement by

208. FANNIE MAE, 8.25% NON-CUMULATIVE PREFERRED STOCK, SERIES T OFFERING CIRCULAR 6-7 (May 19, 2008), *available at* http://www.fanniemae.com/ir/pdf/resources/preferred/series_T_05152008.pdf.

209. *Id.* at 3-5.

210. *Id.* at 4.

211. *Id.* at 4-5 ("On May 6, 2008, the three U.S. ratings agencies that rate us and our securities made the following announcements: (a) Standard & Poor's Ratings Services announced that they placed our preferred stock, subordinated debt and 'Risk to the Government' ratings on 'CreditWatch Negative'; (b) Moody's Investors Service, Inc. announced that they placed a 'negative outlook' on our preferred stock rating and downgraded our 'Bank Financial Strength' rating from 'B+' to 'B,' with a negative outlook; and (c) Fitch Ratings announced that they placed our preferred stock rating on a 'rating watch negative.'").

212. *Id.* at 3.

213. *Id.* at 25.

214. *Id.* at 26.

215. *Id.* at 22 ("Dividends on the Preferred Stock are non-cumulative. Consequently, if our Board of Directors does not authorize and declare a dividend for any dividend period prior to the related dividend payment date, holders of the Preferred Stock would not be entitled to receive a dividend for that dividend period, and the unpaid dividend will not accrue or be payable at any future time. We will have no obligation to pay dividends . . .").

$11.3 billion."[216] As we mentioned earlier, this amount of capital may sound more than sufficient, but only if one fails to realize that quantity by itself does not mean very much. According to the Fannie Mae Offering Circular: " 'Core capital' is defined as the sum of the stated value of outstanding common stock (common stock less treasury stock), the stated value of our outstanding non-cumulative perpetual preferred stock, paid-in capital, and retained earnings . . ."[217]

The combination of the excessive capital hybridization and the risk relating to mortgage assets in 2008 was a main driver of the federal takeover as of September 7, 2008.[218] Figure 8 describes the performance of the share price of Fannie Mae during 2008 and the evolution of the share price subsequent to Series T Preferred Stock issuance.

216. *Id.* at 4 ("Core capital as of March 31, 2008 was $42.7 billion compared with $45.4 billion as of December 31, 2007, exceeding the statutory minimum capital requirement by $11.3 billion, and exceeding the statutory minimum capital requirement plus the 20% Office of Federal Housing Enterprise Oversight ("OFHEO")-directed capital surplus requirement by $5.1 billion.").

217. *See Id.* at 27; FANNIE MAE, COMMON STOCK OFFERING CIRCULAR 30 (May 8, 2008), *available at* http://www.fanniemae.com/ir/pdf/resources/preferred/Com monStock.pdf.

218. *See generally The Present Condition and Future Status of Fannie Mae and Freddie Mac: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. (2009) (arguing that the old hybrid model and the size of the mortgage entities posed a systemic risk leading to the federal takeover).

FIGURE 8: SERIES T ISSUANCE AND SHARE PRICE EVOLUTION OF FANNIE MAE IN 2008[219]

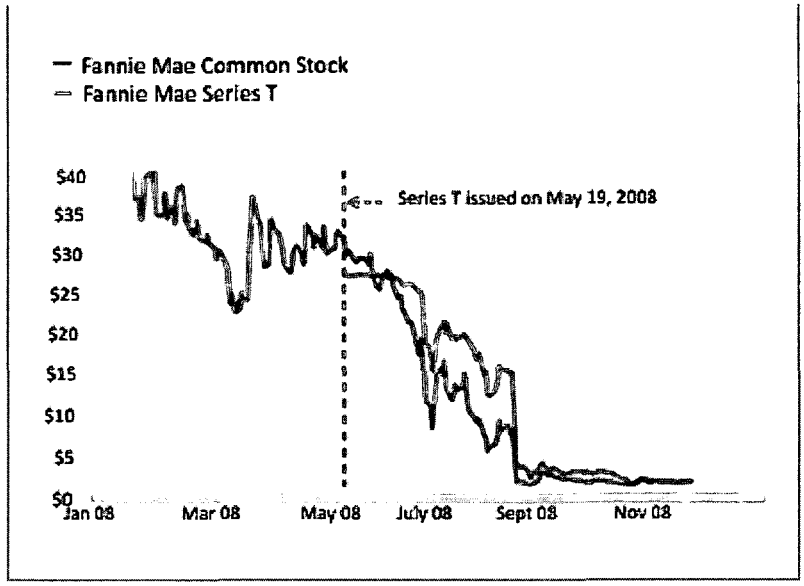


Figure 8 plots a significant point in the share price history of Fannie Mae. That is, the issuance of the non-cumulative perpetual preferred shares marks the start of stock price decrease. "Within 4 months of being issued at $25 per share, the Series T preferred stock was worth only $1.16 a share" in Black September, a loss of approximately 95%, almost $1.9 billion.[220] Whilst Fannie Mae announced a $2.2 billion and $2.3 billion net loss for the first and second quarter of 2008 respectively,[221] the $1.9 billion investors lost in the newly issued hybrid capital instruments was also significant enough to erode confidence in the institution. It would not be implausible to say that the loss in confidence shown in the share price drop and the decrease in value of the Series T hybrid capital instruments drove the federal takeover of Fannie Mae in September 2008.

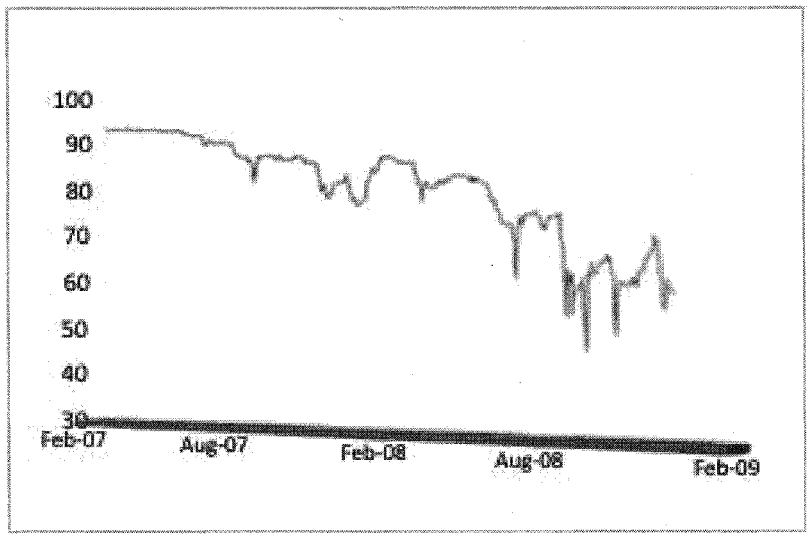
219. *See* Li et al., *supra* note 89, at 10 Figure 6.

220. *Id.* at 9.

221. Press Release, Fannie Mae, Fannie Mae Reports Second Quarter 2008 Results 1 (Aug. 8, 2008), *available at* http://www.fanniemae.com/media/pdf/newsreleases/q22008_release.pdf.

"Hybrid notes, whose interest can in some cases be deferred without penalty at the borrower's discretion, have plunged around the world since the US took control of Fannie and Freddie, the largest mortgage-finance companies."[222] Figure 9 demonstrates the sharp fall on preferred stock and hybrid securities index since September 2008.

FIGURE 9: MERRILL LYNCH PREFERRED STOCK AND HYBRID SECURITIES PRICE INDEX[223]



"Only $694 million of preferred securities were sold in the U.S. from September [2008], when the government closed the market by seizing Fannie Mae and Freddie Mac, [until February 2009]. . . . [C]ompare[d] with about $44 billion in the first three quarters of [2008] . . .[224] The average price for issues in the Merrill Lynch Preferred Stock and Hybrid Securities Index decreased 8 cents on the dollar in January 2009 to 64 cents on the dollar.[225] Citigroup had a substantial role in the above figure. Its "$1.4 billion of 6.95 percent preferred shares lost 34

222. Salas & Unmack, *supra* note 198.

223. *See* PAM GLOBAL INVS., PREFERRED SHARES AND PERPETUAL DEBT 2 (Feb. 11, 2009), *available at* http://www.peilim.co.il/wps/icmm/uploads/files /Preferred.pdf.

224. Salas & Unmack, *supra* note 198.

225. *Id.*

percent in January [2009], the worst performing securities in the Merrill Lynch Preferred and Hybrid Index."[226] Bank of America (BoA) filed a Form 10-Q for the quarterly period ended September 30, 2008. According to the Form 10-Q: "In April 2008, the Corporation issued 160 thousand shares of Bank of America Corporation Fixed-to-Floating Rate Non-Cumulative Preferred Stock, Series M (Series M Preferred Stock) with a par value of $0.01 per share for $4.0 billion. The fixed rate is 8.125 percent through May 14, 2018."[227]

Bank of America, however, experienced sharp drops on its Series M preferred stock, as did Fannie Mae. "Bank of America's $4 billion of 8.125 percent perpetual hybrid bonds have tumbled to 48 cents on the dollar from 73 cents at 2008 end . . . The securities were issued in April at 100 cents on the dollar."[228] On January 16, 2008 Bank of America reported a loss of $1.8 billion for the fourth quarter of 2008, its first loss since 1991, and received emergency government funds.[229]

All of these market facts highlight how hybridization of tier 1 capital could worsen the financial conditions of the institutions. This became very clear during the credit crisis as it was transmitted from the U.S. to Europe.

B. *Hybrid Capital Issuance and Subsequent Government Bail-outs in Europe*

"The expansion of bank assets and the corresponding issuance of hybrid capital securities led to a number of banks reaching their 15% limit on innovative Tier 1 securities to total Tier 1 capital" in the early 2000s to 2008,[230] and some to breach the 15% limit by bending the rules over time. Our view is that institutions which exhaust their allowance of innovative tier 1 securities are more likely to require subsequent government aid, and this correlation distinguishes in Europe. Figure 10 below shows the capacity of a sample of large European banks to issue innovative tier 1 as of January 2008. These banks

226. *Id.*

227. Bank of America Co., Quarterly Report (Form 10-Q) 37 (November 06, 2008), *available at* http://markets.financialcontent.com/stocks/action/getedgar window?accesscode=119312508228086.

228. Salas & Unmack, *supra* note 198.

229. *Id.*

230. Yu & Luu, *supra* note 85, at 22-23.

subsequently participated in respective government bailout plans in 2008 or 2009.

FIGURE 10: RATIO OF INNOVATIVE TIER 1 TO TOTAL CAPITAL AND ISSUANCE CAPACITY IN 2008[231]

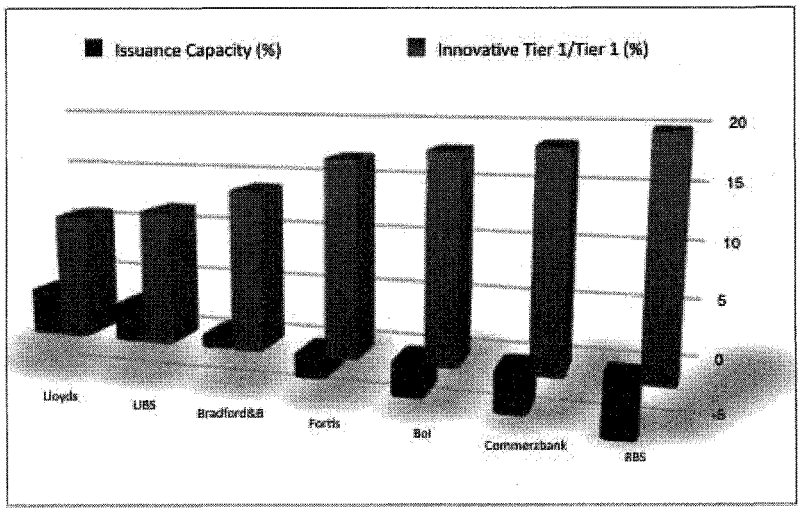


Figure 10 shows the remaining capacity to issue innovative tier 1 for a cross-section of large European banks as of January 2008. From left to right, the percentage of remaining innovative hybrid capital issuance capacity is decreasing.[232] Table 6 suggests a potential link between the capacity of a bank to issue more innovative hybrid securities and subsequent government bail-outs as per Figure 10.

231. *Id.* at 23; *see also* Hans P. Lorenzen, Peter A. Groves, Mikhail Foux & Matt King, *Supply Outlook 2008*, CITIGROUP EUR. QUANTITATIVE CREDIT STRATEGY & ANALYSIS (2008).

232. By capacity of issuance, we mean the proportion of tier 1 capital available for issuance of new hybrid securities.

TABLE 6: CAPACITY TO ISSUE ADDITIONAL INNOVATIVE HYBRID CAPITAL AND GOVERNMENT BAIL-OUTS AS PER FIGURE 10[233]

Bank	Capacity to Issue Additional Innovative Hybrid Capital in 2008	Subsequent Participation in Respective Governments' Bailout Plan
Lloyds	4%	Yes
UBS	3.2%	Yes
Bradford & Bingley	1%	Yes
Fortis	-2%	Yes
Bank of Ireland	-2.9%	Yes
Commerzbank[234]	-3.6%	Yes
Royal Bank of Scotland	-4.8%	Yes
Santander	+10%	No
Credit Suisse	+10%	No

As per Figure 10 and Table 6, Lloyd's, UBS, Bradford & Bingley, Fortis, Bank of Ireland, Commerzbank and RBS are examples of banks that have almost reached or breached the 15% limit for innovative hybrid capital and have had a government bailout.[235] In sharp contrast, Santander and Credit

233. Yu & Luu, *supra* note 85, at 24.

234. The source table omits data for Commerzbank, but an accompanying graph shows that the bank's Capacity to Issue Additional Innovation Hybrid Capital in 2008 was approximately -3.6%. *See id.* at 23-24.

235. *See,* Press Release, European Commission, State Aid: Commission Approves Recapitalisation of Bank of Ireland (Mar. 26, 2009), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/483 ("The European Commission has approved, under EC Treaty state aid rules, an emergency recapitalisation worth €3.5 billion that the Irish authorities intend to grant to Bank of Ireland. . . . On 11th March 2009 the Irish authorities formally notified the Commission of their intention to recapitalise Bank of Ireland with €3.5 billion."); Press Release, European Commission, State Aid: Commission Approves Recapitalisation of Commerzbank (Jul. 5, 2009), *available at* http://europa.eu /rapid/pressReleasesAction.do?reference=IP/09/711 ("The European Commission has approved under EC Treaty state aid rules the recapitalisation of Commerzbank. On the basis of the German financial crisis scheme, Germany already granted €8 billion of capital to the bank in December 2008 and intends to grant another €10 billion of capi-

Suisse, which held a small amount of innovative hybrid capital instruments in their tier 1 capital, did not need any government support.

The definition of appropriate capital is crucial in determining whether there can be effective regulation and prevention of banking crises. By contrast, where inappropriate definitions of capital exist, it is possible for banks to circumvent the prudential and conservative intent of any definition of capital. For example, the Swiss have a reputation for extremely conservative banking and high bank capital standards -requiring as much as 20 percent more capital than specified under Basel II.[236] But this proved to be a delusion of epic proportions during the credit crisis. UBS, one of the "big two" Swiss banks, was required to have a non-public ratio of additional capital: the "Swiss Finish."[237] However, in 2009 UBS had outstanding billions of Swiss francs in hybrid capital securities, which reached a high of 81% of tier 1 capital.[238] According to S&P: "The high proportion of hybrid debt in UBS' Tier 1 capital, combined with large capital market operations . . . are we believe the most important drivers explaining the gap between our low 2.4% RAC [risk adjusted capital] ratio and UBS' 13.2% Tier 1 ratio . . ."[239]

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tal. . . ."); Press Release, European Commission, State Aid: Commission Approves UK Rescue Aid Package for Bradford & Bingley (Oct. 1, 2008), *available at* http://europa.eu/rapid/pressReleases Action.do?reference=IP/08/1437.

236. Nicholas Kulish, *Switzerland Rejects Intervention, Expecting Its Banks to Grow Stronger*, N.Y. TIMES, Oct. 16, 2008, http://www.nytimes.com/2008/10/16 /business/worldbusiness/16swiss.html?_r=1&fta=y.

237. The so-called "Swiss finish" is the extra capital that Swiss regulators have long made Credit Suisse and UBS hold on top of international Basel II requirements. The new, proposed "Swiss Finish" regulations will oblige the banks to hold total capital equivalent to 19 percent of their risk weighted assets as a buffer to cope with future financial crises, which is sharply higher than the 10.5 percent baseline for Basel III total capital, including the conservation buffer. *See* Patrick Jenkins & Haig Simonian, *Swiss Urge Capital Boost for Banks*, FIN. TIMES, Oct. 3, 2010, http://www.ft.com/cms/s/0/4a24a1c8-cf26-11df-9be2-00144feab49a,s01=1.html#axzz1C9SREFqV; *Swiss Banks*, FIN. TIMES, Oct. 4, 2010, http://www.ft.com/cms/s/3/49c0c526-cf95-11df-a51f-00144feab49a.html #axzz1C9SREFqV.

238. *S&P Ratio Highlights Disparate Capital Strength Among The World's Biggest Banks*, STANDARD & POOR'S RATINGSDIRECT 7 (Nov. 30, 2009), http://media.ft.com/cms/5c511664-de50-11de-89c2-00144feab49a.pdf.

239. *Id.* at 15.

Thus, hybrid securities comprised a substantial portion of UBS's capital and the Swiss government was forced to inject 6 billion Swiss francs into UBS in exchange for a 9-percent ownership stake, because of the insufficient quality of hybrid capital instruments.[240]

C. *Credit Rating Agencies Downgrade Hybrid Capital Instruments*

The actions of the credit rating agencies during the credit crisis of 2008-2010 confirmed the riskiness of hybrid instruments. There are two rather antagonistic views as to how credit rating agencies view the relationship between hybrids and credit risk. On the one hand, there is the direct relationship theory. The thesis under this theory is that there is a direct correlation, if not causation, between the issuance of hybrid instruments and the subsequent need for state aid.[241] A somewhat contrary view, the government deferral option theory, is that credit rating agencies are likely to downgrade only where financial institutions have already received government support. In such situations, there is an enhanced probability of regulatory capture and moral hazard, as governments will look to protect the value of their new ownership interest by deferring the option embedded in hybrid instruments, thus leading to a downgrade. Although both theories are plausible and the evidence for one or the other theory is intertwined, the historical record appears to favor the former theory over the latter. The evidence in support of this view is as follows.

First, S&P notes in its review of hybrid securities dated March 31, 2009, that "in the large majority of cases through the first quarter of 2009, European governments have permitted supported banks to service their hybrid capital securities."[242] A close reading of the historical facts shows that the willingness of governments to exercise the deferral option on

240. *See* Nelson D. Schwartz, *UBS Given an Infusion of Capital*, N.Y. TIMES, Oct. 17, 2008, http://www.nytimes.com/2008/10/17/business/worldbusiness/17 swiss.html.

241. *See* Bugie et al., *supra* note 191, at 4 ("[W]e have rated preference shares . . . issued by Lloyds Banking Group PLC and Royal Bank of Scotland Group PLC one notch below . . . to reflect what we view as this incremental 'nationalization risk' . . . of these two government-supported banking groups.").

242. *Id.* at 3.

the hybrid instruments of government-supported financial institutions had not always manifested.[243]

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243. Until the end of the first quarter of 2009, first Deutsche Bank, then South Korea's Woori Bank, Spain's Banco Sabadell and Japan's Mizuho Bank decided not to repay a bond as expected. Gwen Robinson, *To Redeem or Not to Redeem, Mizuho's Question*, FIN. TIMES ALPHAVILLE (Mar. 31, 2009, 11:50 AM), http://ftalphaville.ft.com/blog/2009/03/31/54237/to-redeem-or-not-to-redeem-mizuhos-question/. Nevertheless, in general, the exercise of deferral options was a surprise to investors until most deferrals were authorized or imposed by the relevant national authorities or the European Commission in the second half of 2009. *See* Commission Communication on the Return to Viability and the Assessment of Restructuring Measures in the Financial Sector in the Current Crisis Under the State Aid Rules, 2009 O.J. (C 195) 9, 13; *Special Comment: Debt Redemption Extension Risk*, MOODY'S INVESTORS SERVICE 2 (Dec. 2008), *available at* http://www.iflr.com/pdfs/web-seminars/regulatory-capital/moodys _12-08_2.pdf; Orlando Fernandez, *Contingent Convertible Instruments and the Brave New World of Regulatory Capital*, PRACTICAL LAW COMPANY 4 (April 6, 2010), http://crossborder.practicallaw.com/7-501-5719; Anna T. Pinedo & James R. Tanenbaum, *A Requiem for Hybrids?*, *in* EUROMONEY INTERNATIONAL DEBT CAPITAL MARKETS HANDBOOK 2011 ch. 10, at 2 (Euromoney Yearbooks ed., 2010), *available at* http://www.mofo.com/files/Uploads/Images/100801Hybrids .pdf. For instance, the UK government allowed Bradford & Bingley to defer the payments of hybrid securities. Bradford & Bingley PLC Transfer of Securities and Property etc. (Amendment) Order 2009, SI 2009 No. 320, Art. 2, *available at* http://www.legislation.gov.uk/uksi/2009/320/article/2/made. During 2009, several banks also decided not to redeem or defer hybrid capital securities. In August 2009, Northern Rock deferred coupon payments on some of its hybrid debt in an effort to conserve its capital base, which had fallen below minimum requirements since the bank was nationalized in 2008. *See* Tracy Alloway, *Hybrid Security (Or Not)*, FIN. TIMES ALPHAVILLE (Aug. 24, 2009, 12:33 PM), *available at* http://ftalphaville.ft.com/blog/tag/hybrid-debt/page/2/. In October 2009, Royal Bank of Scotland announced that, in the context of ongoing discussions between the UK Government and the European Commission regarding its restructuring plans, it might elect to defer payments on hybrid capital securities. *See* Press Release, Royal Bank of Scotland Group PLC, Preference Shares and Subordinated Securities (Oct. 20, 2009), *available at* http://www.investors.rbs.com/news/releasedetail.cfm?ReleaseID=416815. In November 2009, the bank announced the deferral of coupons and payments on certain hybrid capital securities for a period of two years. Press Release, Royal Bank of Scotland Group PLC, Accession to the Asset Protection Scheme, Issue of £25.5 Billion of B Shares and One Dividend Access Share to Her Majesty's Treasury and State Aid Commitments (Nov. 27, 2009), *available at* http://files.shareholder.com/downloads/RBS/987359006x0x334098/d9786460-223b-4f2c-8f27-18d33aceebc8/Accession_to_the_Asset_Protection_Scheme.pdf. For a detailed discussion regarding the deferral of payments on hybrid securities as a condition to receiving state aid, see *infra* Part 5.4.

Second, S&P in April 2009 published "Hybrid Capital Issue Ratings Of Certain European Banks Lowered,"[244] which itemizes the downgrades of hybrid capital securities by financial institutions, including subsidiaries, holding companies or other group members with hybrid capital instruments. The list consists of more than 60 financial institutions. On the one hand, some of those institutions' hybrid capital issuances had been downgraded due to the previous government bailout, such as Bank of Ireland. On the other hand, hybrid instrument issuances of some institutions, which had neither applied nor received any government bail-out, had also been downgraded. Tellingly, in the following period of June 2010, these institutions such as Cajasur financial institutions of Spain needed government bailouts.[245] There was practically no public evidence available relating to Cajasur financial institutions' need for a government bailout in the last quarter of 2008 or early 2009. However, there was satisfactory correlation between government bail-out and hybrid capital issuance for S&P to downgrade the hybrid capital issuance of more than 60 financial institutions including Cajasur. Further, S&P explicitly refers to this correlation of hybrid issuance and bailouts in "Hybrid Securities of Over 60 European Financial Institutions Downgraded Following S&P Review".[246]

The relative sensitivity of credit rating downgrades of hybrid capital securities of financial institutions continues to

244. Scott Bugie et al., *Hybrid Capital Issue Ratings of Certain European Banks Lowered*, STANDARD & POOR'S RATINGSDIRECT 3 (Apr. 2, 2009), http://www.aibjerseyisleofman.com/servlet/BlobServer/document.pdf?blobkey=id&blobwhere=1237536538350&blobcol=urlfile&blobtable=AIB_Download&blobheader=application/pdf&blobheadername1=Content-Disposition&blobheadervalue1=document.pdf.

245. There are three Cajasur banks on the Standard & Poor's list, and the hybrid capital securities of two of them, Caja de Ahorros Madrid and Caja de Ahorros Rioja, were downgraded to BBB- from BBB+ by Standard & Poor's. *Id.* at 3. However, these two banks joined the integration operation by the Fund for the Orderly Restructuring of Banks on June 29, 2010, almost 15 months later than Standard & Poor's' downgrades. *See* Commission Decision No. N 317/2010, Extension of the Recapitalisation Measures in Favour of the Banking Sector in Spain, 2010 O.J (C 242) 1, 3, *available at* http://ec.europa.eu/eu_law/state_aids/comp-2010/n317-10-en.pdf; Victor Mallet, *Spain's Cajas Pay Price of Inaction*, FIN. TIMES, June 1, 2010, http://www.ft.com/cms/s/0/0735b94a-6da8-11df-b5c9-00144feabdc0.html#axzz1Cc6TkKZ1.

246. Bugie et al., *supra* note 191, at 3.

haunt the banking industry in Europe.[247] Combining the direct relationship theory with the government deferral option theory, the effect of the latter is to reinforce the view that both European and U.S. banking groups with relatively high levels of hybrid capital securities and with creditworthiness supported by already-received and potential future government aid are most vulnerable to rating downgrades.[248] With the publication of Basel III in December 2010 and its implementation over the course over the next few years, it is likely that rating agencies will review the correlation between hybrid capital securities and potential government bailouts and downgrade the hybrid instruments which face risks of extension or roll-over.

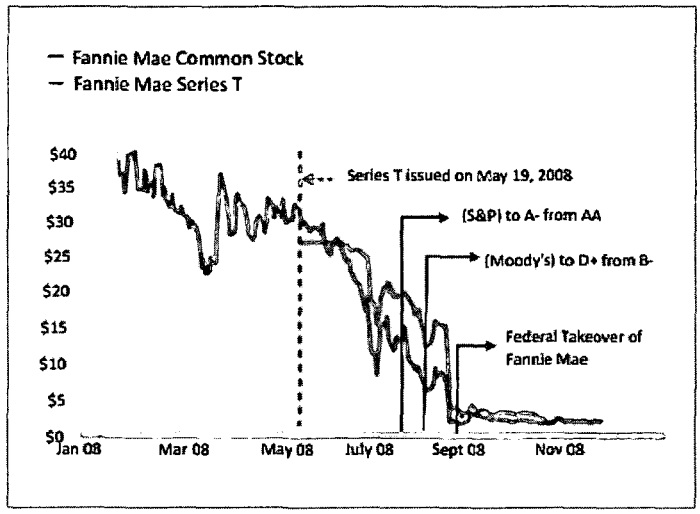
Another example of rating agency action with regards to downgrading hybrids in the face of government bailout is Fannie Mae's "Series T" non-cumulative perpetual preferred shares discussed above. The federal bailout and takeover of Fannie Mae occurred on September 7, 2008.[249] Figure 11 plots the credit ratings given between the date of the issuance and the takeover.

247. *See* Bugie & Azarchs, *supra* note 192.

248. Bugie et al., *supra* note 191, at 4.

249. *The Present Condition and Future Status of Fannie Mae and Freddie Mac: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. 6 (2009) (statement of Rep. Joe Baca, Member, Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters.).

FIGURE 11: DOWNGRADES OF SERIES T BETWEEN PUBLIC ISSUANCE AND GOVERNMENT TAKEOVER[250]



On August 11, 2008, S&P cut its rating on Fannie Mae's preferred stock from AA to A-.[251] "Moody's so-called bank financial strength ratings on Fannie . . . were cut four steps to D+ from B-."[252] Fannie Mae's "preferred stock was downgraded to the lowest-investment-grade rating" on August 22, 2008 by Moody's, which said there was an "increased likelihood of direct support from the U.S. Treasury."[253] Although the financial markets were in significant turmoil during the May to September 2008,[254] the issuance of hybrid capital in-

250. Li et al., *supra* note 89, at 10; Jody Shenn, *Fannie, Freddie Preferred Stock Downgraded by Moody's*, BLOOMBERG, Aug. 22, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=alqivnzYs9hc&refer=home; *Infra* note 289.

251. Shenn, *supra* note 249.

252. *Id.*

253. *Id.*

254. *See, e.g.*, *Financial Market Highlights – May 2008: The Recent Financial Market Turmoil, Contagion Risks and Policy Responses*, ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT 9, 10-22 (May 2008), http://www.oecd.org/dataoecd/55/51/40850026.pdf; Francesco Guerrera, Michael Mackenzie & Nicole Bullock, *Shares Hit as Fears Grow over Financial Turmoil*, FIN. TIMES, June 27, 2008, at A1, *available at* http://www.ft.com/cms/s/0 / 7dbc2890-43a9-11dd-842e-0000779fd2ac.html#axzz1C9SREFqV; BANK FOR INT'L SETTLEMENTS COMM. ON THE GLOBAL FIN. SYS., CGFS PAPERS NO. 31:

struments, which weakened Fannie's balance sheet over the long term and eroded confidence in the short term, can be seen as a main driver of the federal takeover, and the accelerated downward thrust of the credit ratings of the Series T hybrid instruments was simply part of an irresistible endgame. As of the publication of this article in late 2011, Fannie Mae continues to be under government ownership.[255]

D. *The Regulators' Perspective*

As can be seen in Figure 6 above, the attitudes towards hybrid securities have changed markedly, with their issuance falling approximately 60% since 2008. This phenomenon may be in explained in part in terms of the disincentives created by government actions to re-write contractual obligations. The government actions translate into extension and deferral risks where the normal legal obligations of bonds may result in failure of payment of principal and/or coupons. Ironically, another factor contributing in part to the decline in hybrids is the reliance by the banks on the grandfathering provision of Basel III.[256] Finally, a major factor in deterring the market demand for hybrids is the aggressive actions taken by regulators which have encouraged or arm-twisted banks to suspend payments on hybrid securities as a condition to receive state aid.[257] One proposed justification for regulators' blatant inter-

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CENTRAL BANK OPERATIONS IN RESPONSE TO THE FINANCIAL TURMOIL (2008). The collapse of Lehman Brothers was dated September 15th, 2008 and the nationalizations of Fannie Mae and Freddie Mac occurred on September 7th, 2008. In addition, Merrill Lynch was taken over by Bank of America and AIG was part nationalized on September 15th and September 16th, 2008, respectively. *See* Francesco Guerrera, Aline van Duyn & Krishna Guha, *US to Take Control of AIG*, FIN. TIMES, Sept. 16, 2008, http://www.ft.com/cms/s/0/271257f2-83f1-11dd-bf00-000077b07658.html#axzz1C9SREFqV.

255. *See Board of Directors*, FANNIE MAE, http://www.fanniemae.com/governance/board/index.jhtml?p=Corporate+Governance&s=Board+of+Directors (last visited [Nov. 29, 2011]) ("The directors of Fannie Mae shall serve on behalf of the [Federal Housing Finance Agency] and shall exercise their authority as directed by [the Agency].").

256. *See* EUR. BANKING FED'N INST. FOR INT'L FIN., *supra* note 11, at 40 ("The BCBS is considering the terms of grandfathering existing hybrids . . . it is unclear how markets and rating agencies will treat banks that attempt to continue to rely on grandfathered instruments for a protracted period").

257. Commission Communication on the Return to Viability and the Assessment of Restructuring Measures in the Financial Sector in the Current Crisis under the State Aid Rules, at 7-8, COM (2009) RUNNING# (Jul. 22,

ference and indeed, re-writing of private contracts, is that to save institutions it is necessary to preserve their cash and build capital by suspending or deferring payments to holders of hybrid securities.[258] Of course, market participants are likely to interpret these sorts of government strong-arm tactics as expropriation, and manifest regulatory and political risks.

Institutions such as the European Commission have pushed for banks that have received state aid not to make payments on hybrid debt. Notably, Commerzbank, Lloyds and RBS all received approval from the European Commission for state aid conditioned on them not paying hybrid coupons.[259]

2009), *available at* http://ec.europa.eu/competition/state_aid/legislation/restructuring_paper_en.pdf ("In order to limit distortions of competition and address moral hazard, [state] aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the [state] aid beneficiary. . . . The banks should be able to remunerate capital, also in the form of dividends and coupons on outstanding subordinated debt, out of profits generated by their activities. However, banks should not use State aid to remunerate own funds (equity and subordinated debt) when those activities do not generate sufficient profits. Therefore, in a restructuring context, the discretionary offset of losses (for example by releasing reserves or reducing equity) by beneficiary banks in order to guarantee the payment of dividends and coupons on outstanding subordinated debt, is in principle not compatible with the objective of burden sharing.").

258. *See* Bugie et al., *supra* note 191, at 2.

259. *See* Letter to member state explaining European Commission State Aid Decisions N 422/2009 and N 621/2009, from Neelie Kroes, Member, Eur. Comm., to David Miliband, Sec'y of State for Foreign Affairs 21 (Dec. 12, 2009), *available at* http://ec.europa.eu/eu_law/state_aids/comp-2009/n422-09.pdf ("The UK authorities have committed that neither RBS nor any of its direct or indirect subsidiaries shall pay investors any dividends or coupons on existing hybrid capital instruments (including preference shares, B shares and upper and lower tier-2 instruments) from a date starting not later than 30 April 2010 and for a period of two years thereafter or exercise any call rights in relation to the same until the end of this two-year period, unless there is a legal obligation to do so."); Press Release, Eur. Comm'n, State Aid: Commission Approves Recapitalisation of Commerzbank (May 7, 2009), *available at* http://europa.eu/rapid/press ReleasesAction.do?reference=IP/09/711 ("The plan includes a number of measures aimed at keeping the aid to the minimum necessary. These measures include the suspension of dividend and interest payments to holders of hybrid capital."); *Hybrid Capital Securities - Update on Negotiations with the European Commission Regarding Hybrid Capital Securities (Including Preference Shares) Issued by Lloyds Banking Group plc and its Subsidiaries*, LLOYDS BANKING GROUP 1 (Nov. 3, 2009), *available at* http://www.lloydsbankinggroup.com/media/pdfs/investors/2009/2009 Nov3_LBG_Hybrid_Capital_Securities.pdf ("These negotiations have made

In one instance involving Germany's Bayerische Landesbank (BayernLB) the EC requested that the bank defer payments on hybrid capital instruments, which reflected the direness of BayernLB's financial situation and the need to re-consider the scope of its recapitalization measures.[260]

The key factor and the overriding concern, if not major assumption of the government bail-outs discussed above is the relatively low quality characteristic of hybrid capital. Hybrid capital instruments are generally thought of as having a quality lower than adjusted common equity, which is viewed as core capital. One major concern is that "financial institutions could increasingly substitute common equity with hybrid capital instruments that will weaken the financial strength of institutions individually, as well as the industry as a whole."[261] The fear is that with increased hybrid capital issuance, government aid will not be used to strengthen capitalization and will instead be paid out to holders of hybrids, benefiting investors

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clear that the European Commission intends to require a commitment that members of the Group will not make a discretionary payment of coupons or dividends on hybrid capital securities issued by members of the Group -other than members of the Company's insurance group.").

260. Letter to member state explaining European Commission State Aid Decision N 615/2008, from Neelie Kroes, Member, Eur. Comm, to Herrn Frank-Walter Steinmeier, Fed. Minister for Foreign Affairs, Ger. 12 (Dec. 18, 2008), *available at* http://ec.europa.eu/competition/state_aid/register/ii/doc/N-615-2008-WLWL-en-18.12.2008.pdf. ("The Commission also notes as positive the fact that BayernLB Holding has undertaken to suspend dividend payments. Moreover, the funds raised in the current financial year are not to be deployed in financing coupons paid to holders of hybrid capital (i.e. holders of silent investments, profit-sharing rights and other hybrid capital holders) in that financial year.").

261. Gavin Gunning, *Hybrid Instruments Capital or Debt in Disguise?*, J. BANKING AND FIN. SERV. 1, Dec. 2000, *available at* http://findarticles.com/p /articles/mi_hb3252/is_6_114/ai_n28810832/; see also Communication from the Commission, The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, 2009 O.J. (C 10) 2, 7, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:010:0002:0010:EN:PDF ("A restrictive dividend policy would be coherent with the objective of safeguarding lending to the real economy and strengthening the capital basis of beneficiary banks."); Press Release, Eur. Comm'n, State Aid: Commission Rejects ING's Request to Repay Hybrid Capital to Private Investors (Nov. 30, 2010), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1619&format=HTML&aged=0&language=EN&guiLanguage=en.

who are effectively guaranteed against adverse equity movements. Whether or not this is true should depend on a reading of the terms and conditions of the specific hybrid instruments in question. However, it is generally agreed that a financial institution can meet the need for adequate quality of capital by government bailout where its stock value is low in comparison to book value. But by whatever measure we use, it is also generally agreed that hybrid capital instruments offer a higher risk and return than the purest cash instruments. Hence, regulators are not keen that government bailouts should let banks ignore this "lack of quality" issue. In situations where institutions have used up most of their allowance for lower quality capital by capital hybridization, they are more likely to require subsequent government bail-outs to meet requirements for adequate capital.[262] We contend that regulators have also started to recognize the link between hybrid securities issuance and the subsequent decrease in the quality of capital, and we also speculate that such degradation in the quality of capital may naturally be interpreted by market participants as increasing the risks of restructuring and government bailout.

More crucially, as we mentioned above, the Basel Committee on Banking Supervision issued its Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability on August 19, 2010 and the Proposal is an important element of the Committee's strategy for strengthening the banking sector.[263] The Proposal notes:

> 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

262. *See infra* Table 6 (Lloyd's, UBS, Bradford & Bingley, Fortis, Bank of Ireland, Commerzbank and RBS are the examples of banks that have used up most of their allowance for hybrid capital and have had a government bailout; Yu & Luu, *supra* note 85, at 22 ("[T]here may be a correlation between issuance of hybrid capital securities by financial institutions and the subsequent need for a government bailout.").

263. *Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non-viability* BANK OF IN'T SETTLEMENTS BASEL COMM. ON BANKING SUPERVISION (Aug. 19, 2010), *available at* http://www.bis.org/publ/bcbs174.htm ("The proposal is an important element of finalising the Committee's package of measures to strengthen the resilience of the banking sector, set out in the December 2009 consultative document *Strengthening the resilience of the banking sector.*").

> had the public sector not provided support. The numerous public sector injections of capital during the crisis and other forms of public sector support have had the indirect consequence of ensuring that in many instances capital instruments issued by banks that have been bailed out have not taken any losses at all.[264]

The crisis has prompted calls by the academic and policymaking communities for adopting standards for higher quality capital and consequently, lowering the absolute amount of capital and increasing the proportion of cash instruments. For example, Squam Lake Working Group has suggested the creation of "regulatory hybrid securities" whereby banks would issue a new kind of debt that automatically converts into equity if the regulators determine that there is a systemic or idiosyncratic financial crisis.[265] The Basel Committee on Banking Supervision followed a similar line by proposing that: "All non-common Tier 1 instruments . . . at internationally active banks must have a clause in their terms and conditions that requires them to be written-off on the occurrence of the trigger event."[266] In line with this proposal, on January 13, 2011, the Basel Committee on Banking Supervision finalized its reforms to improve regulatory capital.[267] "These requirements are in addition to the Basel III capital rules that were published on December 16, 2010."[268] The final elements require that banks would have to make sure that hybrid capital instruments include a mechanism for taking losses, known as a "bail-in" that allows them to be converted into equity or written off.[269] As the Basel Committee's proposal concludes:

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264. PROPOSAL TO ENSURE LOSS ABSORBENCY, *supra* note 57, at 1, 3.

265. *Squam Lake Working Grp. on Financial Regulation, An Expedited Resolution Mechanism for Distressed Financial Firms: Regulatory Hybrid Securities* 3 (Council on Foreign Relations Ctr. for Geoeconomic Studies, Working Paper no. 3, Apr. 2009), *available at* http://www.cfr.org/content/pub lications/attachments/Squam_Lake_Working_Paper3.pdf.

266. PROPOSAL TO ENSURE LOSS ABSORBENCY, *supra* note 56, at 5.

267. Press Release, Bank for Int'l Settlements, Basel Committee Issues Final Elements of the Reforms to Raise the Quality of Regulatory Capital (Jan. 13, 2011), *available at* http://www.bis.org/press/p110113.pdf.

268. *Id.* at 1.

269. Jennifer Hughes & Brooke Masters, *Basel Hardens Bank Hybrid Bond Rules*, FINANCIAL TIMES, Jan. 13, 2011, http://www.ft.com/cms/s/0/4151fc aa-1f4c-11e0-8c1c-00144feab49a.html.

> The terms and conditions of all non-common Tier 1 and Tier 2 instruments issued by an internationally active bank must have a provision that requires such instruments, at the option of the relevant authority, to either be written off or converted into common equity upon the occurrence of the trigger event.[270]

In addition, any compensation paid to the hybrid capital instrument holders as a result of the write-off must be paid immediately in the form of common stock and the issuing bank must maintain at all times all prior authorization necessary to immediately issue the relevant number of shares specified in the instrument's terms and conditions should the trigger event occur.[271] What is meant by a trigger event is the earlier of: (i) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority[272] and (ii) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority.[273] Hybrid capital instruments issued prior to 1 January 2013 that do not meet these criteria, but that meet all of the entry criteria for Para 55 set out in Basel III

270. Bank for Int'l Settlements, *supra* note 268, ¶ 1 (also noting exceptions to this rule if "(a) the governing jurisdiction of the bank has in place laws that (i) require such Tier 1 and Tier 2 instruments to be written off upon such event, or (ii) otherwise require such instruments to fully absorb losses before tax payers are exposed to loss; (b) a peer group review confirms that the jurisdiction conforms with clause (a); and (c) it is disclosed by the relevant regulator and by the issuing bank, in issuance documents going forward, that such instruments are subject to loss under clause (a) . . . .").

271. *Id.* ¶ 2-3

272. *Id.* ¶ 4. See also *id.* ¶ 6 ("The relevant jurisdiction in determining the trigger event is the jurisdiction in which the capital is being given recognition for regulatory purposes. Therefore, where an issuing bank is part of a wider banking group and if the issuing bank wishes the instrument to be included in the consolidated group's capital in addition to its solo capital, the terms and conditions must specify an additional trigger event. This trigger event is the earlier of: (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority in the home jurisdiction; and (2) the decision to make a public sector injection of capital, or equivalent support, in the jurisdiction of the consolidated supervisor, without which the firm receiving the support would have become non-viable, as determined by the relevant authority in that jurisdiction.").

273. *Id.* ¶ 4.

(December 16, 2010), will be considered as an "instrument that no longer qualifies as additional tier 1 Capital."[274] Para 94(g) of Basel III steps in at this point, because according to Para 94(g) of Basel III, as we mentioned above, instruments that no longer qualify as additional tier 1 will be phased out from 1 January 2013.[275]

VI.
CONCLUSION

The general consensus among the academic and policymaking communities is that hybridization of tier 1 capital contributes to systemic risk by lowering the quality of capital of individual banks. In turn, when amplified as a matter of generally accepted financial practice, it becomes a major factor that reduces the resilience of financial institutions to weather financial crises. Hybrid capital instruments with both debt and equity features took root and grew into massive booms throughout the complex ecology of U.S. and European financial institutions, offering funding usually in tax-deductible forms cheaper than traditional equity instruments. The fertilizer, or steroids, if you will, that encouraged the rapid replication of hybrids were the Basel II rules defining tier 1 capital. The Basel II quantitative models in effect encouraged all internationally active banks to treat hybrids as riskless capital as if they were fungible with equity. Although these equation-fuelled assertions equating hybrid capital to equity capital made little sense from a substantive legal perspective, the Basel II rules were good enough to induce bankers and regulators into acts of mutual self-deception. With the credit crisis of 2008 and the government policies to save internationally active banks with government bailouts, the pivotal condition for the handouts was for hybrids to suffer and die. In contrast to the long entangled dance of regulators and investment bankers for the creation of Basel II, the rather disingenuous fait accompli consultative process engaged by the Basel Committee on Banking Supervision in 2009 rapidly produced the Basel III "preparatory" documents in 2009 and 2010, which were consolidated into the official Basel III of December 2010. The result is a set

274. *Id.* at 4.
275. BASEL III, *supra* note 1, ¶ 95(g).

of rules that attempt to reverse the trend set by Basel II where we hope that the son does not have to die for the sins of the father.