

**REPORT TO CONGRESS ON STUDY OF A CONTINGENT CAPITAL REQUIREMENT
FOR CERTAIN NONBANK FINANCIAL COMPANIES AND BANK HOLDING
COMPANIES**

FINANCIAL STABILITY OVERSIGHT COUNCIL

Completed pursuant to Section 115(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act

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I. Executive Summary

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)¹ requires the Financial Stability Oversight Council (Council) to submit a report to Congress regarding a study on the feasibility, benefits, costs, and structure of a contingent capital requirement for nonbank financial companies supervised by the Board of Governors of the Federal Reserve System (Federal Reserve) and for large, interconnected bank holding companies (BHCs). This report addresses statutory mandates for the study through a review of the types and structures of contingent capital instruments and consideration of the potential benefits from and drawbacks of the use of contingent capital, including its potential to enhance the safety and soundness of nonbank financial companies supervised by the Federal Reserve and large, interconnected BHCs. In conclusion, the Council recommends that contingent capital instruments remain an area for continued private sector innovation, and encourages the Federal Reserve and other financial regulators to continue to study the advantages and disadvantages of including contingent capital and bail-in instruments in their regulatory capital frameworks.

II. Introduction

a. Overview of Statutory Mandate and its Application in the Study

Section 115(c) of the Dodd-Frank Act² requires the Council's study to include:

- an evaluation of the degree to which a contingent capital requirement for nonbank financial companies supervised by the Federal Reserve and large, interconnected BHCs would enhance the safety and soundness of companies subject to the requirement, promote the financial stability of the United States, and reduce risks to U.S. taxpayers (section 115(c)(1)(A));
- an evaluation of the characteristics and amounts of contingent capital that should be required (section 115(c)(1)(B));
- an analysis of the potential prudential standards that should be used to determine whether the contingent capital of a company would be converted to equity in times of financial stress (section 115(c)(1)(C));
- an evaluation of the costs to companies, the effects on the structure and operation of credit and other financial markets, and other economic effects of requiring contingent capital (section 115(c)(1)(D));

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

² 12 U.S.C. 5325(c).

- an evaluation of the effects of a contingent capital requirement on the international competitiveness of companies subject to the requirement and the prospects for international coordination in establishing such requirement (section 115(c)(1)(E)); and
- recommendations for implementing regulations (section 115(c)(1)(F)).

This report provides a general overview of the potential for contingent capital issuances to enhance the safety and soundness of issuing firms and promote financial stability in the United States, thereby reducing risk to the taxpayer, as directed by section 115(c)(1)(A) of the Dodd-Frank Act.

The benefits and drawbacks of a contingent capital requirement are discussed in further detail in section III of this report (“Structural Considerations”), in the context of the various options and considerations for contingent capital instruments and their structural characteristics. This discussion includes policy options and considerations that would be involved in any statutory, regulatory, or supervisory framework setting standards for the issuance and conversion of such instruments. In addition, this section also addresses the other statutory considerations set forth by Congress. Specifically, section III contains:

- an overview of features of contingent capital instruments that would enable them to absorb losses (such as conversion to common equity) and the types of “host instruments” that would be initially issued to investors as contingent capital (relevant to the study requirements in section 115(c)(1)(B) of the Dodd-Frank Act);
- a review of considerations for the pricing of, and conversion ratio for, contingent capital instruments (relevant to the study requirements in section 115(c)(1)(D));
- a discussion of the different types of “triggers” for a conversion, write off or write down of contingent capital instruments, including triggers based on market, macroeconomic, and firm-specific factors, and the potential benefits, costs, and drawbacks of each, both with respect to firms individually and the financial markets as a whole (relevant to the study requirements in sections 115(c)(1)(C) and (D));
- a general overview of tax, accounting, and legal considerations relevant to contingent capital instruments;
- conclusions regarding next steps for policymakers in the United States (relevant to the study requirements in section 115(c)(1)(F)); and
- an appendix that reviews international developments in the issuance of contingent capital instruments and policy standards for such issuances, including an overview of ongoing discussions by international supervisory bodies and steps taken by some foreign regulators to incorporate contingent capital into regulatory capital (relevant to the study requirements in section 115(c)(1)(E)).

b. Definition of Contingent Capital

There is not a well-established definition of contingent capital, and there are often differences in the definitions of contingent capital and associated terms as used by the regulatory community, commenters, and market participants. For example, contingent capital can refer to instruments that (1) are not regulatory capital instruments but convert into a regulatory capital instrument, (2) are regulatory capital instruments but convert into a more subordinate form of regulatory capital (such as common equity capital) that would absorb losses earlier, or (3) contractually require the holder of the instrument to purchase a regulatory capital instrument of the issuer upon the occurrence of a trigger event. In addition, the term “contingent capital” is sometimes used to describe a debt instrument subject to “bail-in” or write off at the point of failure of an institution to provide capital for an orderly resolution of the institution without government support.

For purposes of this study, contingent capital is generally considered to be regulatory capital and other financial instruments (such as “bail-in” debt) that generate additional common equity capital upon the occurrence of a trigger event. Such instruments may create additional capital in various ways, including conversion and write off or write down of the value of the instrument. This report discusses recommendations for any regulations that implement a contingent capital requirement.

c. Potential Benefits from and Drawbacks of the Use of Contingent Capital³

Issuance of contingent capital instruments in the United States, whether pursuant to a regulatory requirement or done voluntarily by large financial firms, could potentially enhance the safety and soundness of financial companies issuing contingent capital and promote financial stability in the United States, thereby reducing risk to the U.S. taxpayer. Potential benefits include: (1) generating additional common equity capital to strengthen a firm’s ability to absorb losses on its balance sheet (while it is a going concern), (2) improving incentives for management to raise capital when needed (*i.e.*, before the instrument converts) and heightening market discipline on management from common stockholders and contingent capital investors, particularly if such instruments are issued in place of debt, (3) generating increased liquidity at times of stress by a reduction in required debt service payments, (4) facilitating the orderly resolution of failing institutions, and (5) providing more flexibility for satisfying regulatory capital requirements (where contingent capital may be included in regulatory capital). This report focuses on points (1) and (2) because they are most important for evaluating the potential for contingent capital to enhance the safety and soundness of issuing institutions and to contribute to financial stability.

Contingent capital and similar instruments also have potential drawbacks. For example, if contingent capital is issued in lieu of common stock, the loss absorption potential of a company’s capital structure could be lower, because uncertainty may exist prior to conversion about whether the instrument would actually convert to common equity in time to effectively absorb losses.

³ See 12 U.S.C. § 5325(c)(1).

Conversion also may provide the market with a negative signal about the health of the firm whose instrument has been converted and could lead to the “death spiral” effect discussed below. In addition, contingent capital instruments could further interconnect the banking and nonbank sectors, and the European and U.S. financial systems, particularly if financial institutions invest significantly in each other’s contingent capital instruments. Some commenters have advised caution that while such instruments may spread risk as intended, they also could spread contagion of financial distress unintentionally, which could be widespread depending on the capital demand of any regulatory requirement.

d. The Use of Contingent Capital by Insurance Companies

Insurance companies in the United States have issued instruments with characteristics similar to contingent capital. Insurance companies have used these types of instruments to facilitate raising new equity following a catastrophic event that requires them to pay large amounts in claims. One arrangement involves an option to issue surplus notes upon the occurrence of extreme event losses that exceed a predetermined threshold.⁴ Another involves an equity put option that enables insurers with catastrophic loss exposure to issue new preferred or convertible preferred stock following a natural catastrophe. These transactions can help insurers during periods of financial stress, in addition to absorbing losses.

III. Structural Considerations

a. Conversion Features

Contingent capital instruments can have a variety of characteristics, including various structural features designed to cause a contingent capital instrument to absorb losses (conversion features) and those features exhibit different benefits and drawbacks. Most conversion features that have been contemplated by issuers, market observers, and regulators would not provide new funding to the issuer. Potential conversion features, other possible characteristics of contingent capital instruments, and related prudential standards that could be applied to such features are discussed below.

Conversion to common equity. In general, a convertible contingent capital instrument (referred to as the “host instrument”) would convert to common equity upon occurrence of a trigger event (examples of such trigger events are discussed below). In order for the conversion to provide additional common equity in a timely manner, the issuance of shares upon conversion may need to be pre-authorized by shareholders, whose holdings would be diluted as a result of the conversion.

The price at which the instrument would convert into common shares would determine whether the contingent capital instrument holders absorb losses or whether the conversion is a value-neutral event to the holders of the instrument. For example, if the conversion price is set at a

⁴ Surplus notes are hybrid debt instruments where the payment of principal and interest, which can also be contingent upon the occurrence of a trigger event, are subject to regulatory approval.

level such that the value of common shares received upon conversion generally would be less than the value of the host instrument prior to conversion, the potential for economic loss absorption by the contingent capital instrument holders is greater because the holders are likely to regain the value of their investment only if the value of the common stock increases. This potential for the contingent capital instrument holders to bear economic loss, along with the accompanying dilution of the existing common equity holders, could provide incentive to both existing holders of common shares and holders of contingent capital instruments to more closely monitor the risk and financial performance of the issuer, thus providing additional market discipline on the issuer's behavior.

It should be noted that while these may be potential benefits of contingent capital, the conversion feature of converting such instruments into common equity may limit the pool of potential investors for various reasons. These reasons may include legal or contractual restrictions on certain investors' holdings of common shares of the issuing institution. For example, some potential investors could be subject to contractual investment limits that would restrict the amount of common shares they could hold in a single institution or multiple institutions in the same industry, which would necessarily restrict the amount of convertible contingent capital they could purchase. Depending on the type of institution issuing the instrument, other institutions could be prevented by regulation, or unwilling due to regulatory consequences, to own more than a specified amount of this type of contingent capital because of its potential to convert into common equity. For example, some investors may not be willing or able to hold more than a specific amount of convertible contingent capital issued by a regulated banking organization such as a BHC, because they could be deemed to control the institution if the instrument could convert to common stock beyond certain thresholds, and thereby become subject to a regulatory regime incompatible with their business model.

An additional drawback, from the perspective of potential issuers, is that depending upon the structure of the instrument, the interest payment may not be tax deductible by the issuer, potentially resulting in the issuance of a debt instrument that is significantly more costly than typical subordinated debt.

Conversion would have no additional benefit to U.S. insurance companies due to the treatment of surplus note debt instruments as policyholder surplus and not as liabilities on their statutory financial statements.

Permanent write off or temporary write down. An alternative feature to conversion to common equity is a permanent write off or temporary write down of the contingent capital instrument. If temporary, the write down generally is reversed if the issuer's financial condition improves. Write-down instruments have not generally been issued by U.S. banks and BHCs because of complications presented by the application of U.S. generally accepted accounting principles (GAAP) and U.S. tax law. Instruments with this type of feature have been extensively issued, and permitted to be included in tier 1 capital, in Europe. However, the international capital standards established by the Basel Committee on Banking Supervision (BCBS) in "Basel

III: A Global Regulatory Framework for More Resilient Banks and Banking Systems” (Basel III) placed additional requirements on the inclusion of this type of instrument in tier 1 capital.⁵ Until the rules implementing Basel III in Europe are finalized, the future regulatory capital treatment of such instruments is not certain.⁶

Partial or full conversion. Through any of the features discussed above, the amount of loss-absorbing capital created when the conversion trigger is activated could be equal to the full face amount of the contingent capital instrument or a portion of such amount. Under a partial conversion or write off, only the amount necessary to restore the issuer’s regulatory capital ratio above the trigger point converts or is written off or down. Alternatively, the terms of the instrument could specify a fixed amount of a conversion, write off, or write down upon activation of the trigger. With partial conversion or write off, the potential for multiple conversions, write offs, or write downs if the condition of the issuer or the markets continues to deteriorate adds to the complexity of the instrument. This potential for multiple conversions also creates additional uncertainty and risk for investors, potentially increasing the cost of issuing the instrument.

b. Host Instruments

Under the U.S. banking agencies’ current capital rules, if the host instrument meets the regulatory requirements, it may be included in tier 1 capital, which is the higher (that is, more loss absorbing) form of regulatory capital (including common stock and non-cumulative perpetual preferred securities), or in tier 2 capital, which is the lower form of regulatory capital (including subordinated debt), provided qualifying criteria are met.⁷

⁵ The BCBS is a committee of banking supervisory authorities, which was established by the central bank governors of the G–10 countries in 1975. It currently consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Documents issued by the BCBS are available through the Bank for International Settlements at <http://www.bis.org>. For a discussion of tier 1 and tier 2 capital requirements under Basel III, see App. B: International Developments.

⁶ The U.S. banking agencies have released joint proposals for implementing Basel III in the United States that would amend the banking agencies’ regulatory capital rules. The proposals are available at www.federalreserve.gov, www.occ.gov, and www.fdic.gov.

⁷ Generally, depository institutions may include common stock and non-cumulative perpetual preferred stock instruments as well as certain minority interests in consolidated subsidiaries in regulatory capital. See 12 C.F.R. pt. 3, app. A (national banks); 12 C.F.R. pt. 167 (savings associations); 12 C.F.R. pt. 208, app. A (state member banks); 12 C.F.R. pt. 325, app. A (state nonmember banks); and 12 C.F.R. pt. 390, subpt. Z (state savings associations). The Federal Reserve’s current regulatory capital rules for BHCs, in addition to instruments that depository institutions may include in tier 1 capital, allow limited inclusion in tier 1 capital of cumulative preferred stock and trust preferred securities and certain other minority interests. See 12 C.F.R. pt. 225, app. A. Section 171 of the Dodd-Frank Act (12 U.S.C. 5371) and the proposals released by the banking agencies to implement section 171 and Basel III in the United States would place additional limitations on instruments that may be included in tier 1 capital for all banking organizations, including BHCs and savings and loan holding companies. Generally, instruments that would

A contingent capital instrument that qualified as tier 2 capital (which must have a minimum original maturity of at least five years) could help the issuer satisfy its total capital requirement prior to conversion, thereby increasing its usefulness to the issuer. Upon conversion of a tier 2 instrument to common stock, the institution's total capital ratio generally would remain the same, but the institution's tier 1 risk-based capital and leverage ratios would improve. Thus, the conversion from a tier 2 instrument upon the activation of an appropriately early trigger could help a firm avoid triggering various prompt corrective action thresholds. The inclusion of the host instrument in regulatory capital is considered important for issuers because contingent capital instruments are generally expected to be more expensive than other (otherwise similar) nonconvertible instruments. A contingent capital instrument that qualified as tier 1 capital would not yield an improvement in the firm's tier 1 risk-based capital and leverage ratios under the banking agencies' current capital regulations.⁸

For example, European insurers with U.S. insurance and reinsurance operations have recently begun to issue contingent capital instruments. Such actions appear to be aimed at maintaining regulatory solvency requirements that could be strained by large loss events or credit defaults, as well as in preparation for the European Union's Solvency II capital requirements.⁹

In addition, as discussed in Appendix B, European banks have issued various forms of contingent capital instruments. Appendix B also discusses the potential effects of a contingent capital requirement on international competitiveness of companies subject to the requirement and the international coordination efforts regarding contingent capital issues.¹⁰

c. Pricing

The pricing of a contingent capital instrument is determined by a number of factors in addition to the issuer's credit quality. The likelihood of conversion and of the contingent capital instrument holders suffering significant loss upon a conversion are the most significant price drivers. Limits on the ability and willingness of various investors to purchase contingent capital that converts

meet the proposed requirements for tier 1 capital would only include common stock, non-cumulative perpetual preferred stock, and certain minority interests.

⁸ The federal banking agencies have proposed to implement a minimum common equity tier 1 risk-based capital ratio requirement, consistent with Basel III. While there is no distinct minimum common equity tier 1 ratio in the agencies' regulatory capital rules at this time, under the proposal a tier 1 contingent capital instrument that converted into common equity could result in an improvement in the bank's common equity tier 1 capital ratio.

⁹ The European Parliament and the Council of the European Union adopted the Solvency II Directive in 2009 which sets out revised EU-wide prudential, capital, and risk management regulations for insurers and reinsurers doing business in the European Union. *See* Directive 2009/138/EC, of the European Parliament and of the Council of 25 November 2009 on the Taking-Up and Pursuit of the Business of Insurance and Reinsurance (Solvency II) (Recast), 2009 O.J. (L 331) 1. Implementation is currently anticipated in the next few years by supervisors in all 27 European Union (EU) Member States, 3 European Economic Area (EEA) countries, and the European Insurance and Occupational Pensions Authority (EIOPA). However, many insurers and reinsurers have begun compliance efforts ahead of actual implementation.

¹⁰ *See* 12 U.S.C. § 5325(c)(1)(E).

into common stock (as discussed above with respect to conversion features) could also affect pricing. Additionally, to date, issuances of contingent capital have been limited and heterogeneous with respect to trigger design and conversion mechanism. This lack of standardization and of investors' experience with conversions more generally has made contingent capital instruments relatively expensive to issue. Taken together, these issues (as well as other issues, such as difficulties obtaining credit ratings for these instruments, as discussed below) contribute to significant difficulties in the pricing of contingent capital issuances and tend to make them relatively expensive. Moreover, as a result of the diversity of characteristics, the effect of this diversity on pricing, and the ongoing international efforts regarding contingent capital discussed in Appendix B, it is premature to determine the potential effects on the international competitiveness of companies subject to a contingent capital requirement.

d. Conversion Ratio

Generally, it is important for the efficacy of contingent capital instruments that convert into common equity that investors and the market know the maximum number of common shares issuable upon conversion of a contingent capital instrument. In the absence of such clarity, there is a risk that short sellers and arbitrage investors could create excessive downward pressure on the issuer's common stock price as the firm approaches a trigger event, resulting in so-called "death spirals" and "infinite dilution." That is, without a maximum conversion ratio of common shares that may be issued per specified unit of the host instrument, or a cap on the aggregate number of shares that may be issued upon conversion, the potential exists for unlimited dilution of existing shareholders as a firm's financial condition deteriorates. More specifically, the holders of contingent capital instruments that lack maximum conversion ratios or share issuance caps are subject to significantly less risk and therefore would be less likely to be a source of market discipline on the issuing firm because, upon conversion, they will receive the full face value of their contingent capital instruments, in the form of an equivalent value of shares based on the then-current market value of the issuer's common stock. The lower the stock price, the more shares that each contingent capital holder will receive. To forestall a death spiral that could make raising capital via the sale of new common shares very challenging and threaten the continued listing of the common stock on an exchange, a viable institution under stress could seek to undertake actions that are not safe and sound to prop up its stock price, such as increasing dividends, buying back shares, or redeeming the convertible instrument at a large premium.

As an example of the reaction of one financial institution facing a potential death spiral phenomenon, in the early 1990s Manufacturers Hanover Company (a BHC) had outstanding preferred stock convertible into common equity at a ratio that implied significant dilution to existing common shareholders if a certain stock price threshold was crossed. As prices of bank and BHC stocks declined generally, the company faced the possibility that the threshold would be crossed and experienced resulting downward pressure on its stock price. Ultimately, the company repurchased the convertible instruments rather than risk the possibility of a swift decline in common stock price from the potential conversion and dilution. This case exhibits potential difficulties a firm may experience in carrying out conversion of a convertible instrument without risking swift market pressures that destabilize the firm further.

To address these death-spiral concerns, the contingent capital instrument could be structured with a conversion ratio that is either fixed *ex ante* (for example, the holders of the contingent

capital instrument would receive the face value of their contingent capital instruments in shares priced at x, where x is specified in the terms of the contingent capital instrument) or determined *ex post* by a formula to be applied at the time of conversion (for example, the holders of the contingent capital instrument would receive the face value of their contingent capital instruments in shares priced at x, where x is calculated according to the behavior of the share price of the issuer's common equity during a predetermined time period prior to the activation of the trigger). Alternatively, contingent capital instrument holders could receive common shares of the issuer based on the market price of the issuer's common stock at the time of conversion, but with a predetermined floor on the conversion price or cap on the number of shares issuable. Such terms would make it possible for market participants to determine, *ex ante*, the maximum dilution that could occur upon conversion.

While the inclusion of terms such as those described above would prevent the activation of the trigger from causing a "death spiral," there may be other factors that generate continued downward pressure on the issuer's share price post-conversion. For example, the holders of the host contingent capital instrument could be motivated to immediately rebalance their portfolios in the wake of the conversion by selling their shares of the issuer's common stock.

e. Triggers

Policymakers, researchers, and market participants have proposed many different types of mechanisms that would trigger a contingent capital feature, including: (1) macroeconomic or systemic triggers established by regulators, (2) firm-specific triggers based on market information, (3) firm-specific triggers based on regulatory or accounting information, (4) firm and systemic triggers based on supervisory discretion, and (5) hybrid triggers that combine a firm-specific trigger and a systemic trigger, the latter of which can be based either on supervisory discretion or on an index derived from financial market and macroeconomic factors.

All trigger mechanisms would require relevant stakeholders, including issuers, market participants, and supervisors, to consider the appropriate timing for the activation of the trigger. For example, contingent capital instruments may convert at an early intervention point (at relatively high capital levels) or at a later intervention point (at a lower capital level). While a high trigger may be less likely to signal problems, a low trigger may be activated at a point at which it is difficult for a financial company to recover from problems associated with financial distress, such as a liquidity run. In addition, an early intervention trigger could be a useful supervisory tool to maintain the capital strength of the issuer, while a later intervention trigger could be potentially useful in avoiding resolution of a firm. Conversely, a later intervention trigger could make the execution of resolution easier, for example, under the orderly liquidation authority (OLA) provisions of Title II of the Dodd-Frank Act, which are designed to require shareholders and creditors to bear the losses of a firm's failure.

Further, the size of the contingent capital issuance generally must cover the gap between a firm's capital level at the time the instrument is triggered and the additional cushion necessary to absorb losses. Otherwise, an instrument could be triggered, but still fail to provide the issuer with the necessary amount of loss absorbing capital to remain a going concern. On the other hand, a high trigger could provide an opportunity for further recapitalization if the contingent capital instrument does not provide the amount of loss absorbing capital ultimately needed. Thus, the amount of contingent capital that is appropriate should be considered in conjunction with

analyses of the capacity of capital levels more broadly to absorb losses and the type of trigger that is being implemented.

Macroeconomic or systemic triggers. Some advocates of contingent capital would design the trigger mechanism so that it would be activated during severe macroeconomic conditions, or when financial system stress is very high. The goals of such trigger mechanisms may be to mitigate and shorten a systemic crisis, to stabilize financial markets, or to reduce the contraction of credit. The focus is on the condition of the financial system or the economy as a whole, rather than on the condition of the issuer of the instrument.

Loss absorption. Because historically severe macroeconomic conditions and material stress in financial conditions have occurred infrequently, this triggering mechanism would be expected to cause conversions infrequently. For this reason, an instrument with a macroeconomic or systemic trigger would likely be priced more like debt than equity. A lower cost of contingent capital instruments would incentivize the issuer to fund itself more with such instruments and less with debt.

If the macroeconomic or systemic trigger is calibrated correctly, loss absorption capacity for the financial system would be increased during crisis conditions. With more capital funding for large banks and other issuers of contingent capital instruments, the probability and severity of asset fire sales and the potential for damaging runs by debt holders and counterparties could be reduced. For example, a distressed institution may face a relatively reduced need to sell assets due to the earlier conversion of a contingent capital instrument.

However, contingent capital instruments requiring conversion and creating loss-absorption capacity only based on macroeconomic or systemic triggers would not necessarily increase loss absorption when the issuer incurs a large, idiosyncratic loss. This problem could be addressed by using a dual trigger that would trigger conversion upon the earlier to occur of a macroeconomic/systemic trigger and a firm-specific trigger event.

Incentives. Between crises, financial firms may view changes in the macroeconomic or systemic environment as unrelated to their own actions. For this reason, a trigger based solely on a macroeconomic or systemic index may be ineffective with respect to improving firms' risk management or shareholder discipline.

Macroeconomic or systemic triggers may create an incentive to delay issuance of capital instruments, even for firms that need capital as economic conditions deteriorate or as financial conditions become stressed. If the management of such firms perceives that other firms may also encounter financial distress, they may choose to wait for the trigger to be activated rather than issue additional capital before the triggering event in order to avoid signaling the deterioration in their own financial condition.

Additionally, the regulator (or other governmental entity) with the authority to make the determination to activate a trigger mechanism may face external and internal pressure with respect to this determination. To a certain extent, this problem could be alleviated by making conversions automatic and based only on pre-set levels of market indicators so as to reduce pressure on regulators and on accounting firms at critical times. However, the

macroeconomic/systemic trigger is likely to be difficult to define and therefore imprecise, subject to revisions, and measured with time lags.

Firm-specific market-based triggers. Firm-specific market-based contingent capital trigger mechanisms would typically rely on information derived from public share prices, debt prices, or credit default swap (CDS) premiums to assess the issuer's current and prospective financial condition. A trigger could be based on one or more of these indicators.

Loss absorption. A financial firm with a relatively low-risk business model should be able to issue instruments with a firm-specific market-based trigger mechanism at lower cost than firms with relatively high-risk business models. This is because a relatively low probability of conversion will lower the cost of such instruments. Market-based indicators of a financial firm's condition tend to be forward-looking. Therefore, a firm-specific market-based trigger for conversion, write down, or write off of contingent capital instruments should result in loss absorption capacity being increased when there are insolvency concerns or liquidity pressures with respect to the issuer.

Market-based triggers could increase confidence that there will be greater loss absorption capacity when market participants become concerned about a firm's financial condition. In this manner, basing a contingent capital trigger mechanism on a forward-looking measure of the firm's condition can help limit contagion effects, if the conversion ratio is calibrated to minimize the likelihood of the "death spiral" effect discussed above.

However, a market-based trigger can also be pro-cyclical and cause an institution to be forced to issue additional common stock and dilute existing shareholders based on circumstances such as a drop in the company's share price, even if the company's regulator determines that it is in sound condition. For example, a situation such as the October 1987 stock price drop could trigger conversions even though issuers are in strong financial condition. Such a conversion based on market factors could exacerbate downward pressure on a company's share price.

Additionally, such a trigger may also be hard to define in a way that could be applied consistently and transparently across firms. Individually tailored triggers may be most effective in recapitalizing a firm at a crucial point in time, but may be inconsistently applied, lack transparency due to the need to tailor the trigger based on confidential information, and be subject to disagreements between regulators and an individual firm about its parameters. Conversely, a standardized market-based trigger could be applied more consistently and transparently, but may be difficult to define in a way that would work for a variety of firms and could be triggered at a time when it would be ineffective or harmful to the firm or the financial system. It could also be subject to regulatory arbitrage, particularly where supervisory discretion is limited.

Incentives. For instruments with firm-specific market-based triggers, the cost of issuance likely would be higher for relatively riskier financial firms. This higher cost would directly exert more market discipline on riskier firms than on safer firms by contingent capital and common equity investors. Moreover, higher observed spreads on contingent capital instruments could also potentially boost the indirect market discipline applied by market participants (for example, through greater haircuts on secured borrowings) and increased monitoring by bank supervisors.

To the extent that financial firm stock prices tend to move together, or to the extent that some financial firms are considered to have business models similar to the firm in distress, contagion may result from firm-specific market-value triggers. However, an increase in capital among financial firms with similar business models could help raise investor confidence, stem asset fire sales, and reduce the potential costs associated with orderly resolutions.

In certain situations, firm-specific market-based triggers can exacerbate the problem of “death-spirals” discussed above. Unlimited dilution, for example, can result in trading strategies that are damaging to the firm in which investors buy the firm’s contingent capital instruments while shorting its common stock or other instrument used as the reference for the market-based trigger. These actions could dramatically exacerbate the market’s perception of risk exposure to the issuer, potentially increasing risk to the public or the federal safety net, at a time of severe stress.

Firm-specific non-discretionary regulatory or accounting-based triggers. Regulators use many metrics to gauge the financial condition of a firm or to signal the need for heightened supervision. Trigger mechanisms could be based on such metrics. Metrics can also be based on the issuer’s financial statements or a combination of regulatory reporting and financial statements. Examples of such metrics include regulatory capital ratios (such as the tier 1 risk-based capital ratio and the total risk-based capital ratio), liquidity ratios (such as the liquidity coverage ratio and net stable funding ratio in Basel III), and charge-off rates for loans. A trigger linked directly to a regulatory or accounting measure may be particularly effective in maintaining an adequate capital buffer so that the firm can remain a going concern. However, a trigger linked to regulatory metrics that involve judgment, such as charge-off rates, could result in regulators facing pressure to consider the potential triggering of the contingent capital instrument when evaluating the appropriate level for the particular metric.

Loss absorption. Firm-specific regulatory-based triggers (with fairly high thresholds) may be useful for increasing the loss absorption capacity of a financial firm when it is needed.

One downside to such a trigger is that information from regulatory reports and financial statements is typically only available on a quarterly basis, and, except for year-end data, this information is generally unaudited. Moreover, such information generally lags market perceptions about the health of the firm, particularly as markets encounter severe distress. For these reasons, firm-specific regulatory- or accounting-based triggers may be insufficient to determine when a firm needs additional capital support unless the regulatory or accounting measures are supplemented continuously with market-based metrics. This problem would be most significant for a firm with a business model (such as trading based on overnight funding) where market concerns could quickly result in severe liquidity disruptions or other sudden crises for the firm.

Additionally, as discussed above, it can be difficult to define effective firm-specific triggers that can be applied consistently and accurately across firms by regulators. Standard firm-specific triggers that apply across the system might be set at a relatively low level that only affects firms that are obviously under duress or even approaching insolvency and therefore subject to regulatory action, such as early remediation. Such low triggers are less likely to be effective in enhancing the stability of firms or the financial system before a crisis is underway. Additionally, firms will generally endeavor to operate well above such triggers and may engage in regulatory arbitrage to do so, possibly resulting in a lack of agreement or understanding among investors as

to when a threshold is actually crossed. On the other hand, standard firm-specific triggers can enhance transparency and consistency and provide a regulatory backstop to the financial system by establishing a universal minimum requirement.

Incentives. If market participants believe the regulatory- or accounting-based metrics incorporated into the trigger mechanism are reliable indicators of a financial firm's condition or evidence of its risk appetite, then instruments with such trigger mechanisms would be issued at higher cost when the firm's health is deteriorating or when the firm is viewed as assuming greater risks. A higher cost of such instruments could potentially exert more direct market discipline on the firm's management to raise capital levels when needed or to reduce risks. Moreover, higher observed spreads on contingent capital instruments that are outstanding also could potentially boost the indirect market discipline applied by market participants and by bank supervisors.

Trigger mechanisms based on firm-specific regulatory information may not incentivize a firm to increase its capital available to bear losses associated with macroeconomic or systemic shocks. However, as discussed above, this issue can be addressed by using one or more firm-specific triggers as well as a systemic trigger.

Triggers based on supervisory discretion. While there is a potential risk that the mechanisms described above will not result in the conversion, write off, or write down of contingent capital instruments when needed, a discretionary trigger provides regulators with flexibility to convert the contingent capital instruments while the entity is still a going concern. This option provides a mechanism for regulatory authorities to use contingent capital in concert with other existing supervisory and resolution tools.

This type of trigger involves some significant legal and policy considerations. Outside of resolution, any such trigger would have to be authorized and implemented in a way to avoid any Constitutional concerns and to comply with applicable statutory requirements, including the Administrative Procedure Act (APA).

In general, a supervisory trigger with clearly defined standards and boundaries would provide more certainty, facilitate consistency, and be less susceptible to successful legal challenge. However, defining such standards and boundaries can be difficult and could lead to unintended consequences because it would likely be difficult for rulemakers to foresee all of the relevant issues and circumstances. On the other hand, a trigger activated by supervisory discretion with less specific regulatory standards and boundaries could be difficult to utilize in practice because of due process concerns. Addressing these concerns could involve adhering to lengthy and complex administrative processes that could be difficult to expedite in time to address any problems in the market.

Loss absorption. A trigger based on supervisory discretion may increase loss absorption most reliably because it would allow for a degree of judgment to determine when such an increase is appropriate from either safety and soundness or macroprudential perspectives.

Incentives. Holders of contingent capital instruments subject to discretionary supervisory triggers would likely exert market discipline on the firm as these holders seek to avoid conversion of their instruments. Higher issuance costs for instruments that are subject to such

triggers would be expected for riskier firms. Moreover, observed spreads for such instruments would likely rise as the financial condition of the firm worsened. In addition, investors may demand a large premium for instruments with such triggers because they are untested.

Hybrid: firm-specific trigger with systemic trigger. Hybrid trigger mechanisms could be structured with a dual trigger that requires both a firm-specific trigger event and a macroeconomic or systemic trigger event occur before conversion. Alternatively, the contingent capital instrument conversion could occur if either of the triggers is activated. Such dual triggers can result in conversion in order to buttress the firm's capital for either idiosyncratic or systemic reasons. The legal and policy considerations discussed above for the different types of triggers would also apply to any combined approach, depending on how such triggers were structured.

Loss absorption. Instruments with two (or more) triggers may only provide additional loss-absorption capacity during a systemic crisis, and their loss-absorption capacity will only apply to the financial firms that are in distress.

Firms encountering distress relatively early in a systemic crisis may not benefit from any additional loss absorption capacity in a timely manner through activation of such dual triggers. Instead, this type of dual trigger is most useful in mitigating the effects of contagion after the occurrence of an event that could result in systemic financial instability. As discussed above, this weakness can be addressed by causing conversion when only one of multiple triggers is activated.

Incentives. An instrument requiring that both a macroeconomic or systemic trigger and a firm-specific trigger be activated is designed to provide more loss absorbent capital during periods of systemic distress that coincide with financial difficulty of the issuer.

Firms seeking to protect themselves from tail-risk through the issuance of contingent capital instruments with hybrid triggers would not necessarily receive additional loss absorption capacity in the event of a truly idiosyncratic event (such as a trading strategy mishap) because conversion or write off would not be triggered. Contingent capital that is structured with two (or more) triggers may bolster the resilience of the financial system in a time of generalized strain, but not necessarily of the issuer whenever the firm runs into trouble. For this reason the market may not view a contingent capital instrument with dual triggers as substantially different from such an instrument with only a macroeconomic or systemic trigger. This could limit the incentive to issue contingent capital instruments with hybrid triggers.

f. Tax, Accounting, and Legal Considerations

U.S. tax treatment

Interest paid with respect to a debt instrument is generally deductible from a corporation's income, while dividends paid on equity are not. Moreover, interest paid on debt issued by a U.S. entity to an unrelated foreign holder is generally not subject to U.S. withholding tax, while dividends are subject to a statutory withholding rate of 30 percent (which is typically reduced to 15 percent when paid to a resident of a country with which the United States has a comprehensive income tax treaty). Consequently, the U.S. income tax rules create a financial incentive for a corporation to issue debt rather than equity.

Whether an instrument is debt or equity for U.S. federal income tax purposes is determined by applying a multi-factor analysis. While numerous factors may be relevant in any particular case, some of the factors that would typically be considered most important in this context are: (1) whether the instrument obligates the issuer to pay a sum certain that represents all or substantially all of the principal, (2) whether the instrument entitles the holder to repayment on a fixed maturity date in the reasonably foreseeable future, (3) whether the instrument is senior to equity in payment priority, (4) whether the instrument entitles the holder to enforce payment of principal and interest in the event of a default, (5) whether the instrument provides the holder with a return based on the time value of money, plus a risk premium that does not vary with earnings, and (6) whether the instrument provides the holder with the right to participate in or affect the management of the issuer.

The instruments that have been issued as contingent capital by non-U.S. issuers have been styled as debt instruments that either convert to equity, or provide for a significant write off of principal, upon a triggering event. There would be substantial challenges to characterizing such instruments as debt for U.S. income tax purposes. Other provisions of U.S. tax law could also adversely affect a contingent capital instrument. In particular, U.S. tax law includes certain limitations on the ability of a corporation to deduct interest on debt that is payable in equity and limitations on the rules restricting a corporation's use of its tax losses following an ownership change, either of which could limit the viability of a contingent capital instrument.

Accounting treatment

Implications for issuers. Under GAAP, generally a contingent capital instrument structured and accounted for as a debt instrument with either an embedded stock conversion or principal write-off feature must be evaluated to determine if bifurcation is required under Accounting Standards Codification (ASC) 815, Derivatives and Hedging (formerly FAS 133). With bifurcation, the issuer is required to allocate the proceeds of the debt issuance between (1) the host debt instrument and (2) the embedded derivative. Subsequently, any debt discount is accreted, or premium amortized, through income. Embedded derivative fair value gains and losses are also passed through income.

Implications for investors. Under ASC 320, Investments—Debt and Equity Securities (formerly FAS 115), debt security investors must classify debt in one of three ways: (1) held to maturity, (2) available for sale, or (3) held for trading. It is highly unlikely that institutional investors would classify contingent capital instruments as held-to-maturity, as it would require bifurcation of the debt and the embedded derivative. Most likely, institutional investors would classify contingent capital instruments as available-for-sale or held-for-trading securities, where the entire instrument is held at fair value. Under the available-for-sale treatment, fair value gains and losses are reported through retained earnings (accumulated other comprehensive income), while fair value gains and losses for securities classified as held-for-trading are reported through income. Here, institutional investors may be exposed to income volatility as the contingent capital instrument price varies.

When the trigger is activated for a contingent capital instrument that converts into stock, from a host instrument in the form of debt, the debt is extinguished and common equity is issued to the instrument holder in the case of a conversion. The investor is thus exposed to gain or loss on the stock in the future.

For contingent capital instruments that result in a permanent write off after a triggering event, the write off results in an increase in retained earnings for the issuer and a loss for the instrument holder.

Legal considerations

There are varying legal considerations related to contingent capital issuances. Depending on the type of instrument and its purpose, there may also be applicable statutory or regulatory requirements in addition to the contractual provisions governing the instrument. Some of these considerations are highlighted in discussions above with respect to specific types of conversion triggers.

The federal banking agencies have broad authority to set regulatory capital requirements.¹¹ This authority is sufficiently broad to permit the banking agencies to require in the future the issuance of contingent capital instruments with trigger mechanisms.¹² This could be accomplished through rulemakings that would require the issuance of, and specify requirements related to, contingent capital instruments. If the banking agencies lacked statutory authority to implement a particular triggering mechanism or other requirement related to contingent capital, Congress could address this issue through legislation. If a contingent capital requirement or a particular trigger were authorized or required by a new statutory framework and implemented by regulation, it would be important for regulators to have flexibility to be able to modify the relevant rules on an ongoing basis in response to developments in the financial system.

The above legal considerations generally would not affect contingent capital instruments with contractual triggers that are voluntarily issued by institutions. Laws and requirements applicable to such issuances may include state and federal statutes and regulations regarding shareholder rights and securities issuances, laws regarding the control of banking and related institutions, tax laws, bankruptcy and insolvency law, and stock exchange rules. In addition, to reduce legal uncertainty in enforcing the triggers under contract law, the contractual terms should be as transparent and specific as possible. These legal considerations likely would also affect any issuance of contingent capital made pursuant to a statutory or regulatory requirement.

g. The Role of Ratings Agencies

The opinions of ratings agencies have historically had a large influence on fixed income markets and investors. Most fixed income investors still look to the rating agencies to gauge the credit

¹¹ The federal banking agencies have broad authority to establish regulatory capital requirements for banking institutions under the International Lending Supervision Act (12 U.S.C. 3907). They also have authority to establish capital requirements for depository institutions under the prompt corrective action provisions of the Federal Deposit Insurance Act (12 U.S.C. 1831o). In addition, the Federal Reserve has broad authority to establish various regulatory capital requirements for bank holding companies and savings and loan holding companies under the Bank Holding Company Act, the Home Owners' Loan Act, and the Dodd-Frank Act.

¹² It should be noted that, outside of a bankruptcy or resolution context, application of a new statutory or regulatory requirement to outstanding debt instruments may present different legal issues than application of a similar requirement to future issuances of debt instruments.

risk of particular markets or debt instruments. Many market participants believe that for a deep and liquid market to develop for contingent capital instruments, positive opinions from the ratings agencies are essential. Opinions on tier 2 and tier 2 eligible contingent capital instruments issued by non-U.S. firms may be helpful for gauging future rating agency opinions.

IV. Conclusions

The issuance of contingent capital instruments could provide a useful tool for strengthening financial institutions' capital positions and ability to withstand losses during times of financial stress. Contingent capital issuances have the potential to provide these benefits at a lower cost of capital than additional common equity issuances, although contingent capital instruments are generally not as loss absorbing as common equity. The United States experience with instruments similar to contingent capital is quite limited and, as discussed above, there are a range of potential issues that could be associated with contingent capital instruments, depending on their structure and, in particular, the structure and timing of conversion triggers.

Therefore, at this time, the Council recommends that contingent capital instruments remain an area for continued private sector innovation. The Council encourages the Federal Reserve and other financial regulators to continue to study the advantages and disadvantages of including contingent capital and bail-in instruments in their regulatory capital frameworks.

Appendix A

Section 115(c) of Dodd-Frank Act is set out below.

(c) CONTINGENT CAPITAL.—

(1) STUDY REQUIRED.—The Council shall conduct a study of the feasibility, benefits, costs, and structure of a contingent capital requirement for nonbank financial companies supervised by the Board of Governors and bank holding companies described in subsection (a), which study shall include—

(A) an evaluation of the degree to which such requirement would enhance the safety and soundness of companies subject to the requirement, promote the financial stability of the United States, and reduce risks to United States taxpayers;

(B) an evaluation of the characteristics and amounts of contingent capital that should be required;

(C) an analysis of potential prudential standards that should be used to determine whether the contingent capital of a company would be converted to equity in times of financial stress;

(D) an evaluation of the costs to companies, the effects on the structure and operation of credit and other financial markets, and other economic effects of requiring contingent capital;

(E) an evaluation of the effects of such requirement on the international competitiveness of companies subject to the requirement and the prospects for international coordination in establishing such requirement; and

(F) recommendations for implementing regulations.

(2) REPORT.—The Council shall submit a report to Congress regarding the study required by paragraph (1) not later than 2 years after the date of enactment of this Act.

(3) RECOMMENDATIONS.—

(A) IN GENERAL.—Subsequent to submitting a report to Congress under paragraph (2), the Council may make recommendations to the Board of Governors to require any nonbank financial company supervised by the Board of Governors and any bank holding company described in subsection (a) to maintain a minimum amount of contingent capital that is convertible to equity in times of financial stress.

(B) FACTORS TO CONSIDER.—In making recommendations under this subsection, the Council shall consider—

(i) an appropriate transition period for implementation of a conversion under this subsection;

(ii) the factors described in subsection (b)(3);

(iii) capital requirements applicable to a nonbank financial company supervised by the Board of Governors or a bank holding company described in subsection (a), and subsidiaries thereof;

(iv) results of the study required by paragraph (1); and

(v) any other factor that the Council deems appropriate.

Appendix B: International Developments

During the financial crisis that began in 2007, it became evident that banks globally held insufficient amounts of high-quality capital to absorb losses on a “going-concern” basis. Consequently, as losses mounted, a number of governments injected capital into their distressed banks. However, these actions protected investors in certain regulatory capital instruments (such as tier 2 subordinated debt and tier 1 hybrid securities) and those regulatory capital instruments did not absorb losses as may have been previously expected by regulators and market participants. Over the last few years, policymakers around the world have discussed various measures to strengthen the resilience of the banking sector, in order to avoid using taxpayer funds to rescue banks and to support sustainable economic growth. Discussion of these measures at the BCBS and the Financial Stability Board (FSB) has resulted in a number of recommendations on the usage of contingent capital and bail-in instruments. A number of major jurisdictions, such as the European Union, Switzerland, and the UK, have issued proposals to incorporate contingent capital and bail-in debt requirements in their regulatory regimes.

On January 11, 2010, the Group of Central Bank Governors and Heads of Supervision (GHOS), the oversight body of the BCBS, noted the possibility that contingent capital and convertible capital instruments could play a role in BCBS’s regulatory capital framework.¹³ More specifically, the BCBS was to consider possible entry criteria for such instruments in tier 1 or tier 2 capital to ensure loss absorbency, and also the possible role of contingent capital and convertible capital instruments more generally within the regulatory minimum and as buffers. The following June, G-20 Leaders lent their support to the BCBS’s work “to consider the role of contingent capital in strengthening market discipline and helping to bring about a financial system where the private sector fully bears the losses on their investments.”¹⁴

Regarding possible entry criteria for tier 1 or tier 2 capital to ensure loss absorbency at the time of financial stress, the BCBS proposed that “the contractual terms of such instruments would allow them at the option of the regulatory authority to be written off or converted to common shares in the event that a bank is unable to support itself in the private market in the absence of such conversions.”¹⁵ It argued that this proposal should help to reduce moral hazard, thereby reducing the likelihood of future crises.

¹³ Press Release, Bank for Int’l Settlements, Group of Central Bank Governors and Heads of Supervision reinforces Basel Committee reform package (Jan. 11, 2010), <http://www.bis.org/press/p100111.htm>.

¹⁴ G-20 Toronto Summit Declaration, Annex II: Financial Sector Reform, para. 13, June 27, 2010, <http://www.g20.utoronto.ca/2010/to-communicue.html>.

¹⁵ Press Release, Bank for Int’l Settlements, Basel Committee proposal to ensure the loss absorbency of regulatory capital at the point of non-viability (Aug. 19, 2010), <http://www.bis.org/press/p100819.htm>.

After extensive consultation on and comprehensive assessment of this proposal, in January 2011, the BCBS issued minimum requirements to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss.¹⁶ To accomplish this goal, regulatory capital instruments that are not common equity must convert to common equity or be written off at “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; and (2) 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.”¹⁷ The timing of this trigger event is designed to ensure that the capital provided by the public sector, if any, is not diluted. With respect to the scope, the terms and conditions of all non-common tier 1 and tier 2 instruments issued by an internationally active bank must have such a provision unless 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. With respect to the post-trigger instrument, any compensation paid to the instrument holders as a result of the write off must be paid immediately in the form of common stock (or its equivalent in the case of non-joint stock companies). In addition, the issuing bank must maintain at all times all prior authorizations necessary to immediately issue the relevant number of shares specified in the instrument’s terms and conditions should the trigger event occur. Under Basel III, convertible capital instruments are tier 1 or tier 2 eligible so long as the foregoing minimum requirements are met, and the other standards that apply to tier 1 or tier 2 capital instruments (respectively) are met.¹⁸

The BCBS also considered whether it would be appropriate for global systemically important banks (G-SIBs) to use contingent capital to meet their additional loss absorbency requirement.¹⁹ Based on a balance of pros and cons, it decided in July 2011 that neither low-trigger contingent capital (*i.e.*, bail-in debt and capital instruments that absorb losses at the point of nonviability), nor high-trigger contingent capital (*i.e.*, instruments designed to convert to common equity while the bank remains a going concern) were appropriate for this purpose, and therefore, that the

¹⁶ Press Release, Bank for Int’l Settlements, Final elements of the reforms to raise quality of regulatory capital issued by Basel Committee (Jan. 13, 2011), <http://www.bis.org/press/p110113.htm>.

¹⁷ *Id.* at Annex.

¹⁸ Sometimes these convertible capital instruments are referred to as a type of contingent capital. For example, in August 2011, the Office of the Superintendent of Financial Institutions (Canada) released its final advisory on non-viability contingent capital to implement the Basel III minimum requirements for tier 1 and tier 2 eligibility. OFFICE OF THE SUPERINTENDANT OF FIN. INST. CAN., ADVISORY: NON-VIABILITY CONTINGENT CAPITAL (Aug. 2011), http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/capital/advisorics/nvcc_e.pdf.

¹⁹ See BCBS, GLOBAL SYSTEMICALLY IMPORTANT BANKS: ASSESSMENT METHODOLOGY AND THE ADDITIONAL LOSS ABSORBENCY REQUIREMENT 16–20 (July 2011), <http://www.bis.org/publ/bcbs201.pdf>, BCBS, GLOBAL SYSTEMICALLY IMPORTANT BANKS: ASSESSMENT METHODOLOGY AND THE ADDITIONAL LOSS ABSORBENCY REQUIREMENT 16–20 (November 2011), <http://www.bis.org/publ/bcbs207.pdf>.

additional loss absorbency requirement should be met only with common equity tier 1. The GHOS and the BCBS indicated that they would continue to review contingent capital and that they “support the use of contingent capital to meet higher national loss absorbency requirements than the global requirement, as high-trigger contingent capital could help absorb losses on a going-concern basis.” Additionally, they proposed minimum requirements for going-concern contingent capital.²⁰

FSB Proposals on Bail-in

At the G-20 Summit in Toronto in June 2010, Leaders called upon the FSB to consider and develop concrete policy recommendations to effectively address problems associated with resolving systemically important institutions and explicitly directed the FSB to consider mechanisms to encourage market discipline such as contingent capital options.²¹

Responding in October 2010, the FSB proposed that global systemically important financial institutions should have loss absorption capacity beyond the minimum Basel III standards, and depending on national circumstances, this additional capacity could be drawn from a menu of viable alternatives including a capital surcharge, a quantitative requirement for contingent capital instruments, and a share of debt instruments or other liabilities represented by “bail-in-able” claims.²² This FSB report was endorsed at the Seoul Summit in November 2010 by G-20 Leaders, who urged continued development of a resolution framework and requirements for high loss-absorbing capacity for global systemically important financial institutions.

²⁰ The minimum criteria that contingent capital should meet if it is to merit consideration to meet the additional loss absorbency requirement for G-SIBs are: (1) fully convert to common equity tier 1 through a permanent write off or conversion to common shares when the common equity tier 1 of the banking group subject to the additional loss absorbency requirement falls below at least 7 percent of risk-weighted assets; (2) include in its contractual terms and conditions a cap on the number of new shares that can be issued when the trigger is activated and the issuing bank or banking group must maintain, at all times, all prior authorization necessary to immediately issue the relevant number of shares specified in its contractual terms and conditions should the trigger be activated; (3) meet or exceed all of the tier 2 entry criteria (including the point of non-viability trigger); (4) with respect to group treatment, irrespective of the group entity that issues the contingent capital instrument, the mechanism of permanent write off or conversion to common shares must create common equity in a form that will be fully recognized as common equity tier 1 of the banking group subject to the additional loss absorbency requirement; (5) with respect to the capital treatment for the issuer, contingent capital used to meet the additional loss absorbency requirement will not be eligible to meet any of the other regulatory capital requirements to which the bank is subject; and (6) with respect to the capital treatment for the investor, banks that invest in contingent capital are required to deduct such investments from their common equity tier 1 in accordance with the treatment of common stock investments under Basel III. BCBS, GLOBAL SYSTEMICALLY IMPORTANT BANKS: ASSESSMENT METHODOLOGY AND THE ADDITIONAL LOSS ABSORBENCY REQUIREMENT 26 (November 2011), <http://www.bis.org/publ/bcbs207.pdf>.

²¹ G-20 Toronto Summit Declaration, *supra* note 13, Annex II, para. 18.

²² Bail-in-able claims are capable of bearing loss at the point of nonviability and therefore enable creditor recapitalization and recovery whilst maintaining vital business functions. FSB, REDUCING THE MORAL HAZARD POSED BY SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS 3 (Oct. 20, 2010), http://www.financialstabilityboard.org/publications/r_101111a.pdf.

Within the FSB, the Resolution Steering Group (ReSG) was charged with developing proposals for an overall framework that would resolve financial institutions without causing systemic instability and exposing taxpayers to loss. Members discussed the feasibility of employing bail-in instruments in order to achieve these objectives. In December 2010, the FSB established a Working Group on Bail-in (Bail-in Group), which reported to ReSG, and mandated that the group specify the characteristics required for bail-in to serve as an effective loss-absorption and resolution tool in the overall framework being developed. The Bail-in Group examined the legal and operational aspects of both contractual and statutory bail-in mechanisms, and considered the market capacity and impact of such mechanisms. It included representatives from the relevant working groups at the BCBS, as well as regional and national authorities and it consulted with private-sector experts.

As a result of this work, in its July 2011 consultative document released for public comment, the FSB ReSG set out proposed essential elements of statutory powers for a special resolution procedure and possible contractual provisions to achieve a creditor-financed recapitalization of systemically vital functions of an ailing financial institution.²³ The document narrowed the application of the bail-in tool and described bail-in as an “additional resolution option that could be used in conjunction with other resolution tools,” noting that bail-in should be embedded within a national resolution regime, but that a statutory bail-in regime alone is not a substitute for an effective comprehensive resolution regime that includes arrangements for insolvency. To that end, it proposed that resolution authorities should have bail-in powers within resolution that “enable the resolution authority to write-down or convert into equity unsecured and uninsured claims, with a view to maintaining continuity of systemically vital functions, by either recapitalizing the entity providing these functions, or, alternatively, capitalizing a newly established entity or bridge institution to which these vital functions have been transferred following closure of the residual firm.”²⁴ An example of “bail-in within resolution” is the authority of the FDIC to effectuate a gone-concern restructuring of a firm under Title II of the Dodd-Frank Act by exchanging claims against the closed institution for equity in a bridge financial company. The consultative document opined that the existence of statutory bail-in within resolution tools does not prevent firms from issuing instruments that write off or convert contractually, nor do they prevent national authorities from requiring them.²⁵ It also noted that

²³ FSB, EFFECTIVE RESOLUTION OF SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS 11–13 (July 19, 2011), http://www.financialstabilityboard.org/publications/r_110719.pdf.

²⁴ *Id.* at 11–12.

²⁵ With regard to the mechanisms for contingent capital instruments, the FSB indicated: “Where, at the point of entry into resolution, an institution has contractual instruments with write-off or conversion features outstanding, a contractual instrument that had not been previously written-off or converted will be written-off or converted according to the contractual terms and conditions of the instrument upon entry into resolution but before the application of bail-in within resolution or other powers by the resolution authority.” *Id.* at 12.

bail-in powers could potentially create incentives for a firm to issue such contractual instruments which might reinforce the capacity of firms to recover from distress without going into resolution.

After consideration of responses to its public consultation, the FSB issued an international standard for resolution regimes.²⁶ The new standard, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, instructs jurisdictions to “ensure that they have designated resolution authorities with a broad range of powers to intervene and resolve a financial institution that is no longer viable, including through transfers of business and creditor-financed recapitalization (“bail-in within resolution”), that allocate losses to shareholders and unsecured and uninsured creditors in their order of seniority.”²⁷ The *Key Attributes* standard was endorsed by G-20 Leaders at their Cannes Summit in November 2011.²⁸

Importantly, in their coordinated work, the BCBS and the FSB reached complementary conclusions on the need for measures to avoid governments’ recourse to taxpayer funds to ensure banking stability. The GHOS, in its proposal on loss absorbency at the point of non-viability, “agreed that under certain conditions, including a peer review process and disclosure, the proposal’s objective could be met through a statutory resolution regime if it produces equivalent outcomes to the contractual approach.”²⁹ Therefore, banks would not be required to have such bail-in provisions embedded in their non-common tier 1 and tier 2 instrument contracts if their governing jurisdiction has in place laws that require tier 1 and tier 2 instruments to be written off upon the activation of a trigger or otherwise require such instruments to fully absorb losses before taxpayers are exposed to loss. A peer group would need to confirm that the jurisdiction has conforming laws; the regulator and the bank issuing such instruments would need to disclose to potential investors that such instruments are subject to these loss provisions.

Consistent with the BCBS’s recommendations for the use of contingent capital to meet higher national loss absorbency requirements than the global requirement, as well as the FSB’s *Key Attributes* resolution standards, several jurisdictions have pursued regulatory initiatives in this area and some are now in process of implementation, as discussed further below.

²⁶ Press Release, FSB, FSB issues International Standard for Resolution Regimes (Nov. 4, 2011), http://www.financialstabilityboard.org/press/pr_111104dd.pdf.

²⁷ *Id* at 1.

²⁸ Cannes G-20 Leaders Summit Final Communiqué, para. 13, Nov. 3–4, 2011, <http://www.g20-g8.com/g8-g20/g20/english/for-the-press/news-releases/g20-leaders-summit-final-communique.1554.html>.

²⁹ Bank for Int’l Settlements, *supra* note 12.

European Union Proposals

Various bodies in the European Union have proposed the use of contingent capital instruments and bail-in provisions. In July 2011, the European Commission proposed implementation of Basel III through the Capital Requirements Directive 4/Capital Requirements Regulation 1 (CRD4/CRR1), which includes a provision for “high trigger” going-concern loss absorption. Once fully implemented in 2019, the minimum capital requirement (tier 1 plus tier 2 capital) will be 8 percent of risk-weighted assets, composed of 4.5 percent common equity tier 1 (CET1) capital, 1.5 percent of additional tier 1 capital, and 2 percent of tier 2 capital. Banks will also be required to maintain a 2.5 percent capital conservation buffer and an institution-specific countercyclical buffer between zero percent and 2.5 percent; both buffers are to be composed of CET1. The proposed directive mandates that additional tier 1 capital is to be composed of contingent capital instruments that will be written down or converted into CET1 capital when the CET1 ratio falls below 5.125 percent.³⁰

Most recently, in June 2012, the Commission released its Proposal for a Directive on Recovery and Resolution (also known as the “Crisis Management Framework”) that includes both going and gone concern statutory bail-in provisions. Whereas CRD4/CRR1 does not address the resolution of a non-viable institution, the Crisis Management Framework requires resolution authorities to have powers to effect going-concern bail-in when the appropriate authority has made a determination that the institution meets the conditions for resolution or that the institution would no longer be viable without the exercise of the bail-in authority. Also, as in the United States, the Directive would require resolution authorities to have a gone-concern bail-in tool (*i.e.*, capitalization of a bridge bank through conversion of equity or reduction of principal amounts of debt instruments that are transferred to the bridge bank).

Switzerland and Britain

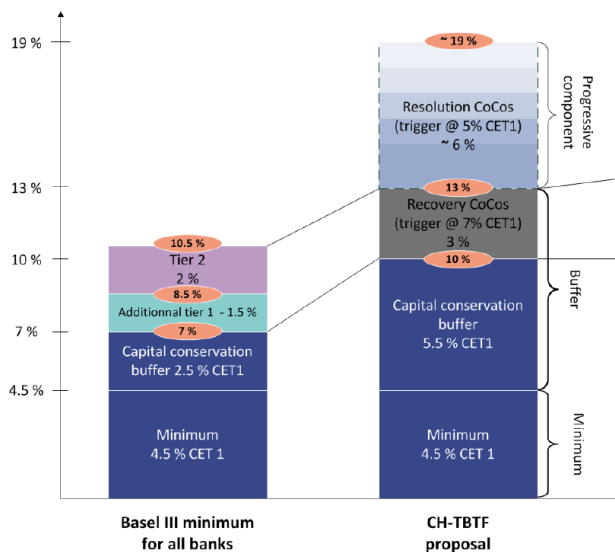
Switzerland and Britain are two major jurisdictions that have promulgated several regulatory proposals on contingent capital requirements and bail-in.

In June 2011, Switzerland proposed that the capitalization of systemically important banks be defined by three components of capital: (1) a baseline requirement that would be used as going-concern capital, (2) a buffer to help fend off crises, and (3) a surcharge that serves as a reserve to

³⁰ This percentage may be higher if so specified in the instrument. Where conversion is already specified in the terms of the instrument, this proposed regulation requires the terms to specify either the conversion ratio and a limit on the amount of permitted conversion, or a range within which the instrument will convert into common equity tier 1 instruments. *Proposal for a Regulation of the European Parliament and of the Council on Prudential Requirements for Credit Institutions and Investment Firms*, at 74–81, COM (2011) 452 final (July 20, 2011), [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SPLIT_COM:2011:0452\(01\):FIN:EN:PDF](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SPLIT_COM:2011:0452(01):FIN:EN:PDF).

restructure or resolve the bank. Under this proposal, a minimum of 10 percent of risk-weighted assets would be held as CET1, partly to satisfy the Basel III minimum (4.5 percent CET1) and partly to satisfy the required capital conservation buffer (see figure below). As much as 3 percent of risk-weighted assets of the capital conservation buffer can be composed of recovery contingent capital instruments (*i.e.*, contingent capital instruments with a 7 percent CET1 trigger) with the remainder CET1. On top of that buffer, the progressive systemic surcharge consists of two parts—a market share-based surcharge that takes into account a bank’s share in the Swiss domestic loan market and a size-based surcharge that considers the size of the bank’s balance sheet—resulting in additional capital requirements amounting to between 1 and 6 percent of risk-weighted assets. On June 1, 2012, the Swiss government adopted these capital rules for Swiss banks.

The Swiss Financial Market Supervisory Authority has published the following comparison of the Swiss proposed capital requirements to Basel III minimum capital requirements.³¹



In September 2011, the United Kingdom’s Independent Commission on Banking (commonly known as the “Vickers Commission” after its chair, economist Sir John Vickers) released its comprehensive study and recommendations to reform the British banking sector. In addition to its well-known recommendation to separate (“ring fence”) investment and retail banking operations, the Commission recommended that all banks hold more loss absorbing capital.

³¹ SWISS FIN. MKT. SUPERVISORY AUTH., ADDRESSING “TOO BIG TO FAIL”: THE SWISS SIFI POLICY 19 (June 23, 2011), <http://www.finma.ch/e/finma/publikationen/Documents/be-swiss-SIFI-policy-june-2011-summary-20110624-e.pdf>.

However, the Commission did not endorse the mandatory use of contingent capital instruments.³² It cited concerns about potentially destabilizing “death spirals” as a firm’s capital level reached the trigger point and the distributional impact on the holders of contingent capital.³³ The Commission did recommend the adoption of bail-in tools to facilitate resolution of a firm near the point of non-viability.

In a white paper published on June 14, Her Majesty’s Treasury stated that it will follow the Vickers Commission’s recommendation on higher loss absorbing capital.³⁴ The Commission recommended that the precise amount of “primary loss absorbing capacity” (PLAC) be held by UK-headquartered global systemically important banks (G-SIBs) should be based on the BCBS’s assessment of equity surcharges for G-SIBs.³⁵ Thus, UK G-SIBs with the maximum equity surcharge of 2.5 percent would be required to hold PLAC of at least 17 percent of risk-weighted assets (RWAs). If a given G-SIB is subject to a surcharge of less than 2.5 percent, then its PLAC would be set on a sliding scale from 10.5 percent to 17 percent of RWAs. The PLAC figure of 17 percent is composed of the Basel III common equity requirement (4.5 percent), the Basel III capital conservation buffer (2.5 percent), Basel III G-SIB surcharge (2.5 percent), non-equity Basel III capital (3.5 percent) and undefined additional PLAC that could be common equity, contingent capital, or bail-in bonds (3.5 percent).³⁶

There have been approximately a dozen issuances of either contingent capital instruments since January 2011. Some, but not all, of these issuances have been made in a manner that creates capital that is compliant with the new Basel III criteria. Many of the issuances also have features that seek to comply with specific national regimes. Depending on the regime, contingent capital and/or bail-in instruments can be tax-advantaged, so the potential buffers which they comprise may be less costly to build than solely through equity capital issuances or the retention of earnings. Trigger events have typically been based on the CET 1 ratio falling below a pre-specified threshold and/or a point of nonviability requirement.³⁷ Most of the instruments issued would convert to common shares upon the occurrence of the trigger event, but there have also been a few instruments issued that would employ a permanent write-off mechanism to generate

³² INDEP. COMM. ON BANKING, FINAL REPORT: RECOMMENDATIONS 103, para. 4.72 (2011), <http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf>.

³³ *Id.* at 102, para. 4.69, 4.70.

³⁴ This discussion focuses on the White Paper’s guidelines for UK-headquartered G-SIBs. HM TREASURY, BANKING REFORM: DELIVERING STABILITY AND SUPPORTING A SUSTAINABLE ECONOMY (2012), http://www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf

³⁵ INDEP. COMM. ON BANKING, *supra* note 31, at 238.

³⁶ HM TREASURY, *supra* note 33, at 33–34, 37–39, para. 3.4–3.9, 3.23–3.30.

³⁷ This trigger design is consistent with the minimum proposed requirements by the BCBS described above.

CET 1.³⁸ In some cases, an instrument was issued to existing investors as part of an exchange where a noncompliant instrument was substituted for a compliant instrument that contained a conversion to equity, or a write off, at the point of nonviability.

³⁸ For instruments that convert, issuers typically used conversion caps to limit the number of shares that would be issued should the trigger be activated.