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The implications of the amended capital requirements for banks

- Focusing on the effects for hybrid instrument inclusion

Master's thesis within Commercial and Tax Law

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Abstract

The financial crisis hit the capital market hard. Many banks were particularly affected and had severe troubles suffering through the losses why financial aid from the State was necessary to prevent defaults. Insufficient capitalization in banks required resources from the public sector to be used to keep institutions from failing. Funds that rightfully belonged to the taxpayers. To prevent such a scenario from happening again the EU together with the Basel Committee on Banking Supervision has presented the Capital Requirements Directive IV. This Directive aims at revising the definition and the quantity of high quality capital to assure institutions' ability to absorb losses without the need of a public bailout. Capital Requirements Directive IV amends the former capital requirements for credit institutions through imposing stricter rules regarding the inclusion of financial instruments in the highest quality capital. As previous capital requirements proved to be inadequate, the new provisions seeks to reduce the subscription of instruments with unsatisfactory loss-absorbency. These instruments are known as hybrid instruments and have both equity and debt features. Due to their character these instruments have been able to trigger regulatory requirements for banks, at the same time as they grant the issuer with benefits such as tax-deductible interest that are connected to debt instruments. Capital Requirements Directive II which is the predecessor of the new Directive permitted hybrid instruments to be accounted for as core capital. How the new provisions treat hybrid instruments is still somewhat uncertain.

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Abbreviations and definitions

AT 1 – Additional Tier 1

BCBS – Basel Committee on Banking Supervision

BIS – Bank for International Settlements. Serves the Central Banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for Central Banks. Sixty of the worlds Central Banks are members of BIS. Among these is the European Central Bank.

Total Capital Ratio – Calculated as: $\frac{\text{Tier 1} + \text{Tier 2}}{\text{RWA}}$

Call option – An option is a derivative providing with a right to sell (call).

CEBS – Committee of European Banking Supervisors. Now known as EBA.

CET 1 – Common Equity Tier 1

CRD – Capital Requirement Directive

Core capital – Constitutes the highest quality of capital.

Debt – Capital on which an external party has a claim, such as a bond (loan).

Derivative - A contract between two parties on the fluctuations of value for an underlying asset, e.g. stock, that specifies conditions (especially the dates, resulting values of the underlying variables, and notional amounts) under which payments, or payoffs, are to be made between the parties. Derivatives are divided into exchange traded derivatives and over-the-counter derivatives (OTC). Exchange derivatives are traded on a regulated market with fixed characteristics while OTC derivatives are customized bilateral contracts, why naturally, they impose higher risk.

EBA – European Banking Authority. Organ of the EU serving to safeguard public values such as the stability of the financial system.

EC- European Community

Equity – Assets in which the entity has full ownership over and where externals can make no rightful claim.

EU – European Union

FSA – Financial Services Authority

GDP – Gross Domestic Product

IASB- International Accounting Standard Board, responsible for publishing International Accounting Standards (IAS).

IFRS – International Financial Reporting Standards

Institution – An organization or establishment devoted to the promotion of a specific cause. In this thesis the usage of the concept will only refer to credit institutions.

MiFiD – Markets in Financial Instruments Directive

Own funds – Old reference to regulatory capital. Original own funds comprises Tier 1 capital.

Prospectus - Publication of information in relation to the issuance of securities. A prospectus must be published and disclose information regarding the product, the issuance and the issuer, where certain types of securities such as shares or derivatives either are offered to the public or are requested for admission on a regulated market.

Regulatory capital – Tier 1 and Tier 2 (Terminology of BCBS)

RWA – Risk-weighted assets. RWA is a risk-adjusted measurement of a bank's exposures, weighted according to the risk they contain. Some assets, such as corporate loans, are assigned a higher risk weight than others, such as cash or government bonds. The risk-weight is multiplied with the exposure value with adjustments for the type of risk. For assets in cash and exposures to organisations such as the EU, the RW is 0 percent.

SEC – US Securities and Exchange Commission

Security – A financial instrument. Divided into equity securities (common stock), debt securities (bonds) and derivatives (options).

SIB – Systematically Important Banks. These are deemed systematically important to the global economy in the sense that a failure could trigger a financial crisis.

TBTF – Too Big To Fail. Systematically Important Banks are Too Big To Fail.

I Introduction

I.1 Background

The year is 2012. Four years after the escalation of the financial crisis and the end of Lehman Brothers. The crisis is still adherent, now maybe more than ever. The reasons said to have caused the crisis are diverse and many, but no one can really pinpoint out the main reason for the crisis, only speculate.¹ Even so regulators, politicians, economists and organizations are trying to figure out ways to take us out of this turmoil and to prevent it from repeating itself. One of these ways is to secure and assure the survival of so called systematically important banks (SIB:s), whose failure would lead to a recession causing fatal global consequences even worse than the ones we are witnessing now. These banks are ultimately too big to fail (TBTF).² If one of these banks would default it wouldn't just end there. In an increasingly globalized world, banks all across the world today are correlated through the interbank market; connecting countries and banks globally through polygamous economic relationships. There is thus a severe risk of a domino effect of (bank)ruptcies, evolving from only one bank default.³ Such a scenario would without a doubt contribute to the increment of the financial crisis' detrimental impact on the world economy in a whole new dimension, portraying the current one as a subtle introduction. A crisis of such magnitude, that the world economy might not ever be able to fully recover from. To prevent this from happening there is a need to have a sufficient capital base in the banks, one that the the entire global market can depend on.

Capital serves as insurance for an institution's⁴ depositors, creditors and other counterparties that unanticipated losses or decreased earnings will not affect the institution's ability to fulfil its obligations to repay creditors or keep depositors' savings protected. The premium possessions of an institution's capital shall represent assets which the bank has no obligation to repay, or which no external party has a right to claim.⁵ Sufficient capitalization means that the institution has a buffer adequate enough to suffer declines in asset values,

¹ Nesvetailova, A, *The Crisis of Invented Money: Liquidity Illusion and the Global Credit Meltdown*, Theoretical Inquiries in Law, Vol. 11, Issue 1, 2010, p. 126-148.

² See the homepage of BIS, <http://www.bis.org/publ/bcbs201.htm> (12 May 2012).

³ Greenbaum, S, Thakor, A, *Contemporary Financial intermediation*, 2nd edition, 2007, p. 407-409.

³ Greenbaum, S, Thakor, A, *Contemporary Financial intermediation*, 2nd edition, 2007, p. 407-409.

⁴ Institution refers to credit institutions in this thesis.

⁵ Nesvetailova, A, p. 126-148.

without subjecting the bank to default or insolvency. This capital is typically sponsored through the owners or through earnings retained by the bank. This high quality capital (retained earnings and shares) is the first line of defence during times of financial losses, absorbing the losses, hence protecting depositors and creditors from loss. It is therefore essential that this kind of capital is immense enough in credit institutions. Capital instruments can vary in structure and their ability to absorb losses as well. Common equity in the form of stock is the purest form of capital as it has no repayment obligations such as a principal or dividends attached to it. Moreover it has the lowest priority in a bankruptcy and bears no maturity date. Debt instruments compared to common equity, are considered a weaker form of capital funding as they oblige payments of periodic interest payments as well as repayment of a principal at maturity. Debt capital also has an unsubordinated claim over common equity in bankruptcy. Some instruments may bear equity features such as long maturity, subordination in claims or the ability to defer claims; whilst defined as debt. These capital instruments are called hybrid instruments and have been used to meet regulatory capital standards.⁶

The European Union (EU) saw it as necessary to amend the current regulation of credit institutions' capitalization due to excessive risk of default. From 2007-2010 European credit institutions incurred losses of approximately EUR 1 trillion, which amounts to 8 percent of EU Gross Domestic Product (GDP).⁷ Because of insufficient capital regulations, the banks had no possibility to deal with these losses, why these costs have been conferred on state resources, which ultimately means that the taxpayers have been the ones responsible for bailing out the banks. The legislation regulating capital requirements for banks in EU exists in the form of Capital Requirements Directive II and III, deriving from the regulatory work of the Basel Committee on Banking Supervision (BCBS). BCBS publishes recommendations for credit institutions which national legislators can sign up to comply with. On July 20, 2011 the Commission released a new proposal for the further tackling of regulatory inadequacies related to credit institutions. The new capital requirements regime for credit institutions is known as the Capital Requirements Directive IV (CRD IV). Problems addressed were liquidity risk, capital insufficient in quality and quantity and counterparty cred-

⁶ The Dodd Frank Act is the implementation of Basel III in the United States. For the Act in fulltext see the homepage of the SEC: <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>, (8 May 2012).

⁷ Brussels, 20.7.2011, COM(2011) 452 final, 2011/0202 (COD), PROPOSAL FOR A REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on prudential requirements for credit institutions and investment firms PART I, p. 1. Referred to as CRD IV.

it risk. The proposal for CRD IV stems from the work in BCBS and is a duplicate of Basel III⁸, with 1 January 2013 as its implementation date.⁹ Through revising the definition of high quality capital the new provisions intend to segregate hybrid instruments from the definition of core capital. As debt featured instruments these should not be eligible to participate in a banks' first line of defence. Hybrid instruments provide the issuer and the holder with multiple benefits, therein tax deductions why these instruments have been issued and used extensively.¹⁰

1.2 Purpose

The past years financial turmoil has made it evident that many of the worlds leading banks, on which the public depend on, have insufficient capital to endure times of losses. For several of the world's leading banks, national governments had to step in with state aid to bail out these banks, with money raised from public funds. The taxpayers should not be the ones paying the bill for banks failure in raising quality capital, why regulators in the EU and independent organisations such as the BCBS have presented new proposals that hopefully will prevent this from happening again.

The new provisions in CRD IV aim to revise the quality and the quantity of capital. The new rules are supposed to exclude earlier accepted forms of highest quality capital; hybrid instruments from being eligible for core capital inclusion and through doing so alter the quality of core capital and alter CRD II.¹¹ The purpose of this thesis is to examine what the new provisions in CRD IV mean for the assortment of high quality funds in banks in comparison to the preceding requirements in CRD II.

1.3 Method and Material

CRD II addresses the same issues as CRD IV. Through revising the definitions in CRD IV and the work within the BCBS which has laid the foundation for the CRD the thesis will illustrate the amendments affecting the substances of a bank's capitalization in comparison

⁸ CRD IV, p. 2-3.

⁹ See opinions from UK governmental bodies, <http://www.hmrc.gov.uk/basel3/discussion.pdf>, (13 April 2012), p. 1.

¹⁰ See more under 2.3 below.

¹¹ Angsten, S: *Taxation of Basel III-Compliant Instruments*, Derivatives & Financial Instruments, Vol. 14 - No. 1, IBFD, 2012, p. 17-18.

to the former rules in CRD. For the reader to understand the constituents of a bank's capital and any problems arising when determining whether an instrument is suitable for core capital qualification, the International Financial Reporting Standards (IFRS) are referred to. IFRS does not constitute mandatory law, however in the absence of common provisions regarding defining a financial instrument, IFRS is applied. Most of the EU Member States apply IFRS why this is appropriate.¹² Through revising articles published from market participants, the reaction regarding the new provisions will be reviewed to demonstrate the implications that CRD IV could have on the capital market. Articles are foremostly publications found on IBFD, from the Bank for International Settlements' homepage (BIS) and opinions published by state organs. Other reliable sources from the internet have been used in the form of newspaper articles and published opinions from experts and banks. These are after all the ones that will be applying the provisions. After revising established law and articles interpreting the law, a conclusion as to whether the intentions of the regulators' and the institutions' application of the law are in convergence will be presented. This conclusion mirrors the implications of the new provisions.

Through examining EU hard law the thesis applies the traditional legal method emphasizing the highest source of law in this area constituting of the CRD. To be able to successfully establish the implications of the new provisions on banks capitalization, the former provisions in CRD II are compared to corresponding CRD IV provisions. The aftermath of the capital requirements in CRD II will be compared to the market's interpretation of CRD IV to appreciate any different practical implications for the banks. Thus is the traditional legal method overlapped with a comparative analysis.

1.4 Terminology

CRD IV enters into force 1 January 2013. Even though still in force, CRD II is referred to as the old provisions in this thesis. This is to facilitate the understanding for the reader. Furthermore is CRD IV a package comprising a Directive and a Regulation. The contents of the Directive lies outside the scope of this thesis and will thus not be touched upon. Even if the Regulation is principally what this thesis refers to, the mentioning of "CRD IV" applies to articles in the Regulation unless other is stated. The alternative would be to use

¹² Review of current practices for taxation of financial instruments, profits and remuneration of the financial sector, European Commission, Impact Assessment, vol. 4, SEC(2011) 1102 final, p. 59.

”CRR IV”, however CRD IV is the established concept for the capital requirements amendments.

The scope of this thesis lays in examining the legal aspects of the new capital requirements. This judicial area builds on financial terms and notions, which could aggravate the understanding of the contents for the reader. Therefore, the thesis comprises a list of abbreviations and definitions describing the key concepts related to this thesis to enhance the understanding for the reader. To read through this list could also be of help to comprehend the terminology, as the capital requirements in the EU stem from two regulations, the CRD and Basel. Even if these share the same capital requirements, the terminology differs. The terminology in CRD IV differs from CRD II and is similar to the terminology in the Basel Accords. The concepts in this thesis are therefore adjusted to the modern wording in CRD IV. The major concepts are presented in the list and should be reviewed before reading the thesis for thorough understanding.

1.5 Outline

Chapter 1 of this thesis introduces the topic through a background to the capital requirements regime and which issue the thesis addresses in the Purpose. The methodology in 1.3 describes how the purpose of the thesis will be fulfilled. Chapter 2 describes the old provisions in CRD II. CRD:s connection to Basel is introduced in 2.1, followed by the capital requirements in 2.2 and the definition of hybrid instruments with reference to law enforcements in 2.3. Chapter 3 entails the new provisions governing banks capitalization in CRD IV, presenting the findings or implications of the amendments, in Chapter 4. Under Chapter 4 are implications from the new definition of high quality capital presented and how the amendments affect hybrid instruments’ inclusion in the regulatory capital and effects on the banks as issuers. In the Analysis in Chapter 5 own thoughts and comments regarding the findings are presented, followed by a summary of the entire thesis in the Conclusion in Chapter 6. The reader can locate sections in the table of contents. Due to the fact that the thesis only contains one table, a table of figures has been left out.

1.6 Delimitations

CRD IV constitutes of a Directive and a Regulation.¹³ Only the Regulation will be discussed in this thesis as the Directive lies outside the scope of this paper. CRD III will not

¹³ CRD IV, p. 6.

be covered as it deals with remuneration and resecuritization, which also are issues outside the scope of this thesis. Cross-border taxation issues when defining and measuring financial instruments are also left out. Although the provisions in Basel have global effect the focus of this paper lays in examining the capital requirements in the EU through Basel provisions adopted as EU law. The thesis is thus written in the perspective of the EU. How to calculate risk-weighted assets and capital ratios are also left out. The reason for this is that these facts are unnecessary for fulfilling the purpose of this thesis.

2 The rise of the Capital Requirements Directive

2.1 Capital requirements in the EU

2.1.1 Provisions stemming from Basel Regulation

The Basel framework began in 1987 when the BCBS for the first time launched a proposal of their framework. Today BCBS consists of Central Bank Governors and Heads of Banking Supervision from 27 Member States.¹⁴ The original goal of the Committee was to achieve a strengthening in the capital resources of international banks, primarily SIB:s, to enhance the stability of the international banking market. Another purpose was to remove disparities among national supervisory regimes and thereby maintain convergence in the capital adequacy field and essentially, remove obstacles to international banking operations formed as a result of unequal competition. The G-10¹⁵ Central Bank Governors assigned BCBS to achieve common measures in the field of banks' capital adequacy and establish minimum standards when operating cross-border.¹⁶ The framework was presented to the national authorities of the G-10 countries, but also to others.

As negotiations regarding similar issues were ongoing within the European Community (EC), the BCBS saw it as important for the Basel Accords, to be compatible with the framework of the EC. This was also due to the fact that seven members of the Committee were Member States of the EC. The difference between the intent in Basel from the one in Brussels was that the EC targeted all credit institutions, while Basel only aimed internationally active banks. The aim of the Committee was to create sound recommendations that also regarded sovereign features. Countries committed to the Basel recommendations were given a transition time of 5 years, giving the national authorities time to adjust to the provisions. Moreover the Member States were in aspects of risk-weighting allowed to deviate from the minimum standards and impose stricter provisions. This meant that the Basel

¹⁴ 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, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States.

¹⁵ G-10 States are Belgim, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Swtizerland and the United States. G-10 participate in General Arrangements to Borrow (GAB) and their work is supervised by BIS and the European Commission.

¹⁶ BIS, Consultative Paper by Committee on Banking Regulations and Supervisory Practices, Proposals for international convergence of capital measurement and capital standards, 1987, p. 1.

Regulation only set out minimum requirements. This approach was said to cause only marginal discrepancies.¹⁷

The main issue for the initial Basel Report was not directly strengthening banks through capitalization. The goal was to reduce institutions' exposures to mainly credit risk (risk of counterparty failure) and also interest rate risk and investment risk in securities and through doing so enhance capital adequacy. The position of the BCBS was that capital ratios might imply a misleading strength for a bank as it is very independent with regards to the quality of the assets. A sufficient capital ratio might be portrayed falsely through capital not qualified to absorb losses when the bank defaults.¹⁸

All though aiming for convergent supervision, the Committee reckoned the fact that differences would arise due to fiscal treatment of tax issues which was an area not covered by the competence of the Committee. These tax issues would be reviewed but not taken into account in the regulatory work. The Committee further stated that these issues potentially could work against the Committee's aim to reduce inequality competition.¹⁹

2.1.2 Basel II

The framework of Basel II concerned the International Convergence of Capital Measurement and Capital Standards for internationally active banks and was published in June 2004 by the BCBS. The core target of Basel II was to diminish discrepancies in the regulation of internationally active banks and thereby impose consistency and equilibrium regarding competition.²⁰ Basel II similarly to Basel I only set minimum capital requirements for internationally active banks. Another reason for amending Basel I was to create a more risk-sensitive framework. BCBS introduced a three pillar system constituting of capital requirements, supervisory review and market discipline.²¹

¹⁷ BIS, Proposals for international convergence of capital measurement and capital standards, 1987, p. 2-3.

¹⁸ BIS, Proposals for international convergence of capital measurement and capital standards, 1987, p. 2-3.

¹⁹ BIS, Proposals for international convergence of capital measurement and capital standards, 1987, p. 4.

²⁰ Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, 2004, p. 2.

²¹ Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, 2004, p. 3.

2.1.3 The Regulatory Capital

Equity capital should be the focus when assuring the quality of the banks reserves. To facilitate supervision the Committee decided to divide regulatory capital in categories; two tiers. Equity capital and disclosed reserves forms core capital from post-tax retained earnings and should constitute at least 50 percent of a bank's capital base. The Committee also decided on a minimum capital ratio of 8 percent against a bank's risk-weighted assets (RWA).²² Out of this margin should 4 percent constitute core capital.²³ The core capital forms Tier 1.²⁴

Tier 1 capital is the highest quality of capital that serves to support a banking institution in the event of unexpected financial complications through the absorption of losses.²⁵ Tier 1 shall only include permanent shareholder's equity, which should be issued and fully paid common stock and permanent non-cumulative preference shares. Disclosed reserves created by retained earnings or other forms of surplus can also be eligible for Tier 1. Assets such as goodwill should be deducted from Tier 1 funds.²⁶

Tier 2 comprises so called supplementary capital and shall be of the same size as the core capital, thus 4 percent. Supplementary capital consist of undisclosed reserves. Tier 2 should also comprise loan-loss reserves, which are funds prepared for not yet identified losses.²⁷ Funds targeting identified losses are not freely available to absorb unexpected losses why such capital is not eligible for Tier 2 classification. Hybrid capital instruments and subordinated debt were other categories of the supplementary capital.²⁸

²² 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, art. 75 (a). Referred to as CRD II.

²³ BIS, Proposals for international convergence of capital measurement and capital standards, 1987, p. 13.

²⁴ BIS, Proposals for international convergence of capital measurement and capital standards, 1987, p. 4, 14-16.

²⁵ See the Dodd Frank Act, p. 1.

²⁶ BIS, Proposals for international convergence of capital measurement and capital standards, 1987, p. 14-15.

²⁷ Tier 2 capital is later on described as gone-concern capital.

²⁸ BIS, Proposals for international convergence of capital measurement and capital standards, 1987, p. 4.

Tier 3 covers capital instruments used to tackle market risk which lies outside the scope of this thesis why Tier 3 won't be discussed further.²⁹

2.1.4 The implementation of Basel II into EU law

The integration of the Basel Accords into EU legislation was formally adopted on 14 June 2006. The regulation was a consolidation concerning the taking up and pursuit of the business of credit institutions and the capital adequacy of investment firms and credit institutions jointly formed and named the Capital Requirement Directive (CRD I).³⁰ The objective of the first framework was to obtain a functioning Internal Market and to implement supervisory functionalities for banks within the EU.³¹ The CRD framework was a result of Basel II with the intention of devising risk-sensitive regulation with risk management in mind, but keeping the capital financing aspect unchanged. CRD II amending the first set of provisions in CRD, covers current capital requirements and will be presented in the following. CRD III is yet another amendment of the CRD and deals with issues relating to an institution's trading book, re-securitization and remuneration policies and had a final implementation deadline of 31 December 2011.³² CRD III lies outside the scope of this thesis why it won't be further mentioned.

2.2 The Capital Requirements Directive II

CRD II introduced a new qualification for capital to be eligible for Tier 1 subscription compared to previous EU provisions. The definition of core capital is originally described as “[an item that shall] *comprise all amounts, regardless of their actual designations, which, in accordance with legal structure of the institution concerned are regarded under national law as equity capital subscribed by the shareholders or the proprietors.*”³³ CRD II made an adjustment to the original defini-

²⁹ See the homepage of the EU, <http://www.eba.europa.eu/getdoc/06e25083-2f37-4146-90f3-9e9a40365117/hybrids.aspx>, (May 12 2012) p. 2.

³⁰ 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 and Directive 2006/49/ec of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions were the consolidation of CRD I. Referred to as CRD I.

³¹ Directive 2006/48/EC, p. 5.

³² Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading-book and re-securitisation, and the supervisory review of remuneration policies.

³³ Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, art 22. The part in *italics* stands for the additional wordings of CRD II in relation to Directive 2006/48/EC.

tion that these instruments also have to be “[...] *paid up, plus the related share premium accounts, it fully absorbs losses in going concern situations, and in the event of bankruptcy or liquidation ranks after all other claims*” to be regarded as core capital.³⁴ This additional wording has been criticized as potentially causing inconsistency in the interpretation.³⁵ Other than equity capital, CRD II also allows other items in the scope of Tier 1. Reserves, funds for general banking risks, revaluation reserves, certain value adjustments and other items are other capital forms eligible for Tier 1 inclusion.³⁶ A new provision was added through CRD II for instruments others than those originally intended for Tier 1. This provision mainly strikes the inclusion of hybrid instruments and states that:

“The instruments shall be undated or have an original maturity of at least 30 years. The instruments may include one or more call options at the sole discretion of the issuer, but they shall not be redeemed before 5 years after the date of issue. If the provisions governing undated instruments provide for a moderate incentive for the credit institution to redeem as determined by the competent authorities, such incentive shall not occur within 10 years of the date of issue. The provisions governing dated instruments shall not permit an incentive to redeem on a date other than the maturity date.”³⁷

2.2.1 Implementation Guidelines for Tier I capital

The Committee of European Banking Supervisors (CEBS, now known as EBA) was requested by the Commission to release implementation guidelines³⁸ to further ensure that the core capital in CRD II were capable of fully absorbing going-concern losses. CEBS’ work is not legally binding for the Member States, but national supervisors are expected to comply with EU law through observing CEBS Guidelines.³⁹ CEBS announced 10 criteria for core capital instruments to fulfill. These are presented below with a short description of each criterion.

³⁴ CRD II, art. 57 (a). The part in italics is the additional requirements imposed through CRD II.

³⁵ See the Joint Associations’ Response to European Commission Consultation on CRD Potential Changes, Hybrid Capital Instruments by BBA, LIBA, ISDA, ESF, <http://www.isda.org/speeches/pdf/CRD-Review-Joint-Association-response061008Hybrid-Capital-Instruments.pdf>, (12 February 2012) p. 5.

³⁶ CRD II, Art. 57 (a) – (f).

³⁷ CRD II, 63a, para 2.

³⁸ CEBS, Implementation Guidelines regarding Instruments referred to in Article 57(a) of Directive 2006/48/EC recast, 2010.

³⁹http://www.fsa.gov.uk/pubs/cp/cp09_29.pdf, (27 January 2012), p. 21.

Criterion 1

Any subscription to the capital instrument shall make the sponsor a shareholder or a proprietor of some kind. The applicable national insolvency law and accounting standards shall recognize the investor as a shareholder and the instrument as equity.

Common shares should be the benchmark when assessing whether capital is suitable for Tier 1. Other instruments than ordinary shares may be included but must absorb losses in the same manner as ordinary shares. Furthermore these instruments should be simple, clear to understand and able to absorb losses entirely in going-concern situations immediately when needed. These instruments should be of higher quality than hybrid instruments. No voting rights need to be attached to the instrument.⁴⁰ The amount paid must be accounted for as equity and not liability under domestic accounting standards to be accounted as subscribed capital. The capital must come from a shareholder or other proprietor of the institute. Injection to equity capital from external investors will therefore not qualify as Tier 1 capital. This is to prevent potential claims from creditors during times of distress, nor shall the creditor be able to petition for the issuer's insolvency.⁴¹

Criterion 2

Each instrument must be fully paid. When external capital is directly or indirectly injected, the instrument can not be considered as core capital. Core capital must always ensure an efficient permanent supply of capital.

An effective supply of permanently available and fully loss absorbing capital shall be aimed. This can't be ensured if the bank directly or indirectly through e.g. a group member provides capital to the shareholders to facilitate the subscription of capital. In cases of return to the shareholders surveillance must be ensured to prevent improper distribution of capital.⁴²

Criterion 3

The instrument shall be directly issued.

⁴⁰ CEBS, Implementation Guidelines, 2010, p. 7-8.

⁴¹ CEBS, Implementation Guidelines, 2010, p. 9.

⁴² CEBS, Implementation Guidelines, 2010, p. 9-10.

As the benchmark for assessing instruments are common shares, the instruments shall be directly issued by the institution and not through a Special Purpose Vehicle.⁴³

Criterion 4

The capital instrument shall be perpetual without any terms other than in liquidation or certain allowed repurchases under national law, enabling redemption by the issuer. A situation where the holder might require redemption shall be abolished.

For redemption and buy-backs approved by competent authorities, the estimated amount shall be deducted from the original own funds until effectively carried out.⁴⁴ Instruments should be undated and not redeemable for anything other than liquidation. The funds must always remain freely available within the institution. Competent authorities shall take the bank's financial situation into account when deciding whether redemption should be permitted.⁴⁵

Criterion 5

Neither contractual terms nor marketing conditions shall cause expectations that the capital instrument will be repurchased. For permission to repurchase is prior approval by the competent authority required.

Ordinary shares are allowed to be bought back by the issuer. Buy-backs are subject to prior approval by competent authorities. If the competent authorities find that the institution is not enough capitalized, buy-backs may be refused. Future pledge which could cause a major withdrawal of funds in times where there is a deficiency should be prevented why prior approval is required. An institution can not rely on a future payment due to a pledge to buy-back.⁴⁶

Criterion 6

The capital instrument shall not provide any right for the holders to claim a distribution.

Payments must be flexible, in the sense that the issuer has a discretion to decide if and how much he wishes to pay in dividends. This is to preserve the financial and solvency position of the institution. If the institution chooses not to pay out dividends, it shall not be an

⁴³ CEBS, Implementation Guidelines, 2010, p. 10.

⁴⁴ CEBS, Implementation Guidelines, 2010, p. 10.

⁴⁵ CEBS, Implementation Guidelines, 2010, p. 11.

⁴⁶ CEBS, Implementation Guidelines, 2010, p. 11-12.

event of default, or trigger an event of default. Further, there should not be any additional obligations connected to the payments, in other forms than cash or dividend pushers or dividend stoppers.⁴⁷

Criterion 7

The payments of dividends should come out of distributable items and should not be cumulative. The distribution should not be linked to the amount paid at issuance.

If other instruments than ordinary shares qualify as core capital, the dividends for these instruments should replicate the behavior of ordinary shares. For the payment of dividends to be possible there must be enough distributable items. As long as there are not enough distributable items the institution should not have to pay out dividends. There should not be any pre-indications as to the amount of dividends, to prevent any market expectations or obligations.⁴⁸

Criterion 8

In the occurrence of losses should the instrument take the first and proportional share of losses *pari passu* with other equivalent instruments.

Instruments should absorb losses that may arise to cause an undertaking to continue as a going concern. Share capital must be the first absorber of losses as they occur and rank below other capital in a liquidation. The instrument must be able to immediately and in its entirety absorb the loss. The absorption should occur automatically, proportionately and *pari passu* with other core capital instruments.⁴⁹

Criterion 9

Capital instruments must be *pari passu* among themselves and have the highest rank of claim in liquidation.

Other instruments than ordinary shares should have the same features as ordinary shares and have the lowest rank in liquidation and absorb losses *pari passu*. The holders of such

⁴⁷ CEBS, Implementation Guidelines, 2010, p. 13.

⁴⁸ CEBS, Implementation Guidelines, 2010, p. 14.

⁴⁹ CEBS, Implementation Guidelines, 2010, p. 16.

instruments shall therefore not have prioritized claims in liquidation or a fixed claim for their holding amount.⁵⁰

Criterion 10

The capital instruments shall not be accompanied with guarantees, pledges or credit enhancements that legally or economically enhances seniority compared to subordinated claims. Whenever an instrument is attached to a pledge for credit enhancement, or insurance through assets of the bank, it is immediately disqualified from eligibility for core capital.⁵¹

2.3 What are hybrid instruments?

Hybrid instruments have existed since the 16th century, when first used by English companies. Hybrids grew very popular as innovative ways for institutions to, in a cost-efficient way which was less dilutive than plain equity, qualify capital as regulatory. Following the development and expansion of the capital market and derivatives, the innovation and complexity of hybrids has evolved significantly. Hybrids are complex instruments with both equity and debt features, which often include classes of preference shares, convertible notes, capital protected equity loans, perpetual debt, equity swaps and others. Initially, the issuance of these instruments came about due to their hedging of risks, taxation and investor benefits. The first hybrid instruments were structured as preferred stock, representing ownership in the institution, just like equity, while providing fixed payments to the holder, like bonds. Now hybrid instruments are customized in numerous structures to satisfy the needs of the customer. Some instruments bear characteristics leaning more towards equity featuring longer maturity, while some more towards debt in the form of a periodic rate return on cash flow for the owner. Investors might prefer hybrid instruments rather than common shares as hybrids grant them better protection in the event of bankruptcy in comparison with equity. Investors of hybrid instruments are likely to be paid before ordinary shareholders in the event of bankruptcy. Additionally hybrids provide a higher rate of return compared to plain debt instruments. These are factors working as incentives for investors to choose hybrid instruments as their investment form. For investors seeking to maintain influence in an institution, the more preferable choice would be common shares,

⁵⁰ CEBS, Implementation Guidelines, 2010, p. 16.

⁵¹ CEBS, Implementation Guidelines, 2010, p. 17.

as hybrid instruments do not provide with any voting rights.⁵² Well-known hybrid instruments are preference shares, convertible notes, perpetual debt and silent participations.

Preference shares:

Preference shares have features which differ due to customization. Preference shares may be redeemable or not and convertible or non-convertible. Moreover the dividends can be cumulative or non-cumulative, but they are shares offering ownership in an entity. The possibility to redeem preferred shares strengthens the instrument's character as liability, as the purchase of common equity does not include regression rights. Further, where distributions are mandatory, the shares prevail a debt classification. However, if only the issuer of the non-redeemable shares is granted discretion on distribution, the shares may be considered equity. When the deferral of the distributions depend on participation in business growth, the shares will also enhance their character as equity.⁵³ Defining preference shares as equity or debt is therefore difficult.

Convertible notes and bonds:

Convertible notes are bonds that can be converted into common stock and hold a fixed interest rate. These notes often give the buyer a right to sell back the securities, through a call option.⁵⁴ However for convertible instruments to be eligible for Tier 1, can the call option or the right to redeem only occur at the initiative of the issuer.⁵⁵ A convertible bond is a contractual obligation to distribute payments in cash, or in another financial asset. For this reason the convertible bond will be classified as debt. Meanwhile, a convertible bond gives the holder of the instrument an option to require a conversion to common shares at a given time. This feature can give this hybrid instrument equity classification.⁵⁶

⁵² Aberbach, K, *Treatment of Hybrid Instruments*, IFC Bulletin No 29, 2009, p. 114. Found on <http://www.bis.org/ifc/publ/ifcb29n.pdf>, 9 April 2012.

⁵³ Canellos, C, P, Paul, L, D, *Contingency and the debt/equity Continuum*, Taxation of financial products/Fall, Heinonline, 2002.

⁵⁴ Woods, R, *The Taxation of Debt, Equity, and Hybrid Arrangements*, Canadian Tax Journal , Vol 47, No 1, 1999, p. 57.

⁵⁵ CRD II, art. 63a.

⁵⁶ IAS 32.29.

Silent participations:

Silent participations stem from the financing form of silent partnership. It is common in banks that do not have the legal form of a stock corporation, but a public-law body. These institutions are thus financed through external ownership. Silent participations are instruments that are very close to shareholding. It grants the silent partner with an internal partnership through the injection of equity, but without voting rights.⁵⁷

Perpetual debt:

Perpetual debt is a bond-like instrument with no maturity until being paid back. Thus, it never needs to be redeemed by the issuer and is continually subject to coupon interest payments until redeemed. For this reason it is very similar to preferred shares, as it has a subordinated claim, and can be non-cumulative in the distributions. The difference with preference shares is that perpetual debt usually can't be converted to common shares in the event of default. Another option in the event of default is that the debt can be written down.⁵⁸

Examples:

MM, a bank in Denmark issues preference shares at EUR 2 million par value 1 January 20X1. The shares have no redemption date attached and the terms allow MM to determine the level of distribution to the holders of the preference shares. The issue documentation mentions the possibility that distributions will terminate in a few years. This hybrid instrument will probably be classified as equity.

PP, a bank in Sweden issues 8 percent preference shares at EUR 1 million par value. The shares carry no redemption date and the preference shares are cumulative which means that if PP is not capable of making distributions of 8 percent of par value, the distribution liability is carried forward to a future year. PP has an option to defer, but not a right to cancel distributions why this hybrid will be considered as debt.⁵⁹

⁵⁷ Silent participations can qualify as Tier 1 capital in Germany. Many banks in Germany are financed through externals with these hybrids. A significant part of the capital injection constitutes of silent participations qualifying as Tier 1 capital. See Krause, M, *Basel III: The regulatory Framework*, Derivatives & Financial Instruments, Vol. 14 – No. 1, IBFD, 2012, p. 12 and 16.

⁵⁸ Olivier, C, *Catching the Capital Markets*, International Tax Review, p. 15-19, Heinonline, 1995, p. 16.

⁵⁹ Examples with modifications taken from Accounting for Financial instruments, <http://www.scribd.com/doc/67254587/109/Hybrid-instruments>, (16 April 2012), p. 239.

2.4 The importance of distinguishing between equity and debt

To distinguish between equity and liability is very important, as liabilities as well as the interest paid is tax-deductible, while equity and dividend payments on equity usually are not. This is mainly why hybrid instruments have become so popular, as they are considered debt for accounting purposes, whilst also can be accounted for as equity in the capital requirements regime. Besides granting tax benefits, many market participants also use hybrid instruments to conceive increased creditor rights, mandatory redemption and profit sharing.⁶⁰

According to the wording of International Financial Reporting Standards (IFRS), significant emphasis is put on the distributions of the instrument, in order to decide its character as equity or debt. Any financial instruments that with certainty or potentially, imposes an obligation for the bank to deliver cash or a financial asset will be accounted as a liability. When the options whether the settlement of payments shall occur in cash or in the exchange of shares is to be decided by either the issuer or the holder of the instrument, the instrument will principally be considered to be a liability.⁶¹ For the issuers of hybrid instruments, it is therefore very important to consider the distribution setup of the instrument, to enjoy debt classification. For financial liabilities any interest, dividends, profits or gains shall be recognised as income or loss in the profit or loss account of the credit institution.⁶²

2.5 Difficulties that may arise when distinguishing an instrument's character

The distinction between equity and debt has been of central interest for a long time for taxation issues. Taxation is not harmonized within the EU, why Member States have different rules regarding how to tax income. However the general principle within EU is that interest payments are deductible. For this reason the EU has established rules regarding the deductibility of interest in cross-border transactions to eliminate any favourable tax treat-

⁶⁰ Peter J. Connors & Glenn H.J. Woll, *Hybrid Instruments – Current Issues*, 553
PLI/TAX 175, 181, 2002. Other benefits or hybrid instrument issuance are not further discussed.

⁶¹ Technical summary of IAS 32, <http://www.iasb.org/NR/rdonlyres/0242B440-1174-4BED-B399-B5BA248D0D06/0/IAS32.pdf>, (5 April 2012).

⁶² Technical summary of IAS 32, <http://www.iasb.org/NR/rdonlyres/0242B440-1174-4BED-B399-B5BA248D0D06/0/IAS32.pdf>, (5 April 2012).

ment for companies operating only domestically.⁶³ For these transactions deductibility is granted if the payment is considered interest.⁶⁴ Interest is described as:

“Income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures; penalty charges for late payment shall not be regarded as interest”.⁶⁵

The Directive restricts deductibility for payments which are equivalent to dividends or principals.⁶⁶ To determine an instrument’s character as debt or equity is thus very important as one provides tax deductibility distributions while the other does not. Entities try to evade this through complex setups of instruments and embedded derivatives in attempts to enjoy interest treatment for dividends or principals which are not deductible, or vice versa.⁶⁷

Making this distinction has been a challenge for the authorities. There is no unified definition of the concepts of equity and debt in the EU which does not make it easier to take a clear stand. This imposes uncertainty for involved parties in the capital market in knowing precisely which instruments will be accounted for as equity, alternatively debt. In the rise of the issuing of derivatives and hybrid instruments, it certainly did not facilitate matters.⁶⁸ Moreover globalization has opened the way for regulatory arbitrage as companies take advantage of the insecurities when it comes to distinguishing equity from debt and the inconsistent definitions across the EU.⁶⁹ Regulatory arbitrage and double taxation stem from the

⁶³ See the Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States. Referred to as the Interest and Royalty Directive.

⁶⁴ For application of the Interest and Royalty Directive the companies should be associated and be situated in different Member States. The directive is used to illustrate how the EU relates to the distinction between interest and dividends.

⁶⁵ Art. 2 (a) of the Interest and Royalty Directive.

⁶⁶ Art. 4.1 of the Interest and Royalty Directive.

⁶⁷ Bundgaard, J, *Perpetual and SuperMaturity Debt Instruments in International Tax Law*, Derivatives and Financial Instruments, IBFD, 2008, p. 128.

⁶⁸ Review of current practices for taxation of financial instruments, profits and remuneration of the financial sector, European Commission, Impact Assessment, vol. 4, SEC(2011) 1102 final, p. 59. IASB has presented IFRS 9 Financial Instruments on the Classification and Measurement of Financial Assets, with the purpose to enhance the evaluation of financial instruments. IFRS 9 enters into force 1 January 2013, but has not yet been adopted by the EU.

⁶⁹ Woods, R, p. 51. IFRS is used in many Member States however how the guidelines are interpreted and translated is up to each Member State why inconsistencies exist.

issue of non-consistent definitions of these concepts and the EU is trying to battle this.⁷⁰ When it comes to risk, it is being argued in different directions whether equity instruments or debt instruments serve as the riskiest, but these capital instruments functionally perform similar financing roles. As debt instruments and the interest that follows allow tax deductibility, institutions have been keen on using these items extensively. When these advantageous items can be disguised as equity to fulfil capital requirements while providing the institution with benefits linked to debt classification, institutions will probably take advantage of this. While giving the banks a great tax relief through treating some hybrid instruments as equity, one can not disregard the fact that hybrid instruments de facto are debt. Debt will not serve the same protection as equity as it comes with a liability to pay the principal and interest. In times of financial distress these obligations to repay creditors will prevent the bank from absorbing losses to the fullest, why equity instruments are more useful in terms of reliable capital adequacy.⁷¹ Investors prefer hybrid instruments rather than common equity as hybrids grant them better protection in the event of bankruptcy and other benefits compared to equity (as mentioned above).⁷²

2.6 Regulation of hybrid instruments

2.6.1 Implemented through the Capital Requirements Directive II

After the implementation of the Basel provisions, banks found ways to generate Tier 1 regulatory capital through the issuance of innovative financial instruments and thereby comply with capital standards. These capital instruments complying with the basic criteria regarding regulatory capital were the earliest forms of hybrid capital. For Tier 1 capital there has been a big fraction of hybrid instruments compromising banks regulatory capital. At the end of 2006 before the regulation of hybrid instruments, almost 50 percent of the hybrid capital in Tier 1 for several EU Member States were dated innovative hybrid instruments. These are now excluded entirely from Tier 1.⁷³ The intention of CRD II was also for these instru-

⁷⁰ The Interest and Royalty also aims at combating double taxation.

⁷¹ See Woods, R, p. 51-52. The risk aspects of capital will not be further developed as it lies outside the scope of this paper.

⁷² Aberbach, K, p. 114.

⁷³ CEBS, Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA), 2007.

ments to be eligible for Tier 2,⁷⁴ but some of these instruments still fell under Tier 1. BCBS raised their concerns regarding this inclusion of instruments in the core capital and amended the requirements through the so called Sydney Press Release (SPR). These rules were implemented into EU law through CRD II and were assembled approximately 10 years after the SPR. The European Commission (Commission) saw it as a necessity to create a uniform treatment of hybrid instruments and equivalent standards for capital qualification in Tier 1.⁷⁵ On 28 March 2008 CEBS at the request from the Commission released a proposal for a common definition of hybrid capital within EU.⁷⁶

The proposal was to ensure the instrument's quality which is vital for core capital with the purpose of protecting the bank and the public from default occurring. The capital should first of all be measured against the benchmark of equity. Equity constitutes the highest quality of own funds, with the paramount ability to absorb losses with its permanence and the bank's capability to fully distribute over the funds. The key contents of core capital should be common stock, disclosed reserves or retained earnings as these absorb losses on an ongoing basis in the most efficient manner. This is due to the facts that creditors bear the utter most subordinated claim in bankruptcy with these equity instruments. Moreover common stock allows a bank to conserve resources and functions as market discipline trigger through the voting rights it provides, which hybrid instruments do not. To ensure that banks obey this limitation, an obligation for banks to release periodical reports disclosing the components of the Tier 1 capital was introduced.⁷⁷ The instrument should not only correspond to the legal requirements when doing an assessment of its applicability, it shall additionally have the desired effect of high quality capital. The risk of the instrument should be on the market rather than on the issuer, as a "substance over form" criterion.⁷⁸

⁷⁴ Basel II, p. 16, para 4.

⁷⁵ Own original funds corresponds to core capital and Tier 1 capital, and is the original terminology used by the EU. Own funds means regulatory capital which means Tier 1 and Tier 2.

⁷⁶ CEBS 2008, Proposal for a common EU definition of Tier 1 hybrids, <http://www.eba.europa.eu/getdoc/06e25083-2f37-4146-90f3-9e9a40365117/hybrids.aspx>, (17 Feb 2012).

⁷⁷ The Sydney Press Release, <http://www.bis.org/press/p981027.htm>, (16 Februari 2012).

⁷⁸ The principle of "substance over form" means that the financial reality of a transaction should be considered rather than the legal form. If distributions are called interest rates but reflect a level of business participation, the Substance over form principle will define it as dividends, hence taxed accordingly.

The hybrid must not only be able to absorb losses in times of distress but also on a going concern basis. This means in an institution's exercise of its daily commercial activity.⁷⁹

The instrument shall:

- *be issued and fully paid,*
- *have no cumulative obligation to pay dividends and come with a right for the competent authority to cancel such payments when the institution is suffering from major losses,*
- *be able to absorb losses on an ongoing basis,*
- *constitute subordinated debt for the bank,*
- *be permanent as to maturity,*
- *bear no legal arrangements in the form of subordinated debt, e.g. collateralization, that could lead to a potential claim from creditors,*
- *be pari passu to equity (absorb losses in the same manner as equity),*
- *be redeemable only after a certain amount of time with the permission from competent national authority.*

2.6.2 Requirement I: Duration of the instrument

The instrument shall either be undated or have an original maturity of 30 years. Call options may be included in the instrument at the sole discretion of the issuer, but shall not be redeemable within 5 years after the issue. For instruments with an incentive to be redeemed there is a qualifying period of 10 years. Such an incentive for redemption is called a step-up and increases the interest rate significantly if the issuer should choose not to redeem. Redemptions require prior consent from competent authorities. Exemption from the restriction to redeem may also be granted by the competent authorities, in the event of a change in the tax treatment of the instrument regarding the tax deductible payments (if payments are no longer considered interest but dividends). Where the issuer has no right to

⁷⁹ <http://www.eba.europa.eu/getdoc/06e25083-2f37-4146-90f3-9e9a40365117/hybrids.aspx>, p. 4.

redeem, the conversion to common stock might lead to high costs for the bank. If the financial situation has triggered a redemption, competent authorities are likely to permit it.⁸⁰

2.6.3 Requirement 2: Flexibility of Payment Obligations

The instrument shall allow the institution to cancel payments of dividends and interest for an unlimited time and on a non-cumulative basis, when necessary due to financial conditions. This cancellation shall take place when the institution has capital exceeding 8 percent of risk-exposure.⁸¹ Competent authorities can demand cancellation if they consider it vital for the bank to remain solvent. A substitution of the instrument shall come in the form of newly issued shares and offered directly to the holder of the hybrid.⁸²

2.6.4 Requirement 3: Absorption of losses

The capacity to absorb losses is the key feature for hybrid instruments to be eligible for Tier 1 capital. The principal, unpaid interests or dividends that constitute the value of liability for the credit institution, must bear such attributes that they can fully absorb losses and not hinder the recapitalization of the institution. A hinder could be mandatory payments to creditors for claims they have on the institution.⁸³ In the event of liquidation or bankruptcy, the instrument must rank lower than other regulatory instruments, such as Tier 2 capital.⁸⁴ Other hybrid instruments are entitled to Tier 2 inclusion, if the requirements are met.⁸⁵

A hybrid instrument is classified as a liability for accounting purposes. For it to still be recognized as core capital, it must endure principal loss absorption through a conversion to common equity at a pre-specified trigger point, where the financial situation of the bank no longer allows it to hold this capital as liability. The other option for the instrument to qualify, is through the requirement of a write-down mechanism, which allocates losses to the instrument at a pre-specified trigger point as well. By these means the instrument ensures that the value of the liability is written down, reducing the liability of the bank. This helps

⁸⁰ M, Hanten, Global Financial Markets, No 7, 2009, <http://www.gfinm.de/images/stories/workingpaper7.pdf>, (1 March 2012) p. 5.

⁸¹ Directive 2006/48/EC, art. 75.

⁸² M, Hanten, Global Financial Markets, No 7, 2009, <http://www.gfinm.de/images/stories/workingpaper7.pdf>, p. 5.

⁸³ CRD II, art. 63a, para 4.

⁸⁴ CRD II, art. 63a, para 5, referring to art. 63 para 2.

⁸⁵ See CRD II, art. 63, para 2 for details on the requirements.

the bank to have a reduced claim of the instrument in a potential liquidation, reduce the amount of repayments and reduce the payments of distributions affiliated with the instrument.⁸⁶ This triggered conversion or write-down does not increase the liquidity of the bank. What happens is that the high quality capital, the common equity of the bank is increased. When the conversion/write-off occurs, the bank becomes better equipped to withstand further losses. Ultimately the loss-absorbency is increased, while the liquidity is unchanged, but the potential for improving the liquidity in the future is increased. Even if the bank remains illiquid for a period of time, at least the likelihood of a public bailout is reduced.⁸⁷ To be able to compensate the instrument holders the bank can issue new common shares through the conversion. Through such a conversion the investors are compensated and the common equity is increased, why convertible instruments many times are considered as equity.⁸⁸

This trigger point must be at a point earlier than a decision from the national authority to support the bank through capital injection and at a point earlier than a decision from the national authority to write off liabilities. It is up to the national authorities to decide the exact circumstances triggering a conversion or a write-down.⁸⁹ A predetermined market variable or a regulatory ratio triggering conversion or a write-off was considered not to be a good idea. The argument was that it is impossible to know what will trigger a possible future crisis. Furthermore should not all credit institutions be aimed at being rescued; some banks are better off failing and entering normal insolvency procedures.⁹⁰

The developing hybrid instruments were not all of them fully serving the purpose of loss-absorbency in Tier 1, why restrictions limiting the inclusion of these instruments was incurred. CRD II imposed quantitative restrictions of hybrid instruments allowed in the total calculation of Tier 1 capital. For instruments which convert into items *pari passu* to common shares in emergency situations a permission to include 50 percent of these hybrids

⁸⁶ Basel III, p. 17, para. 11.

⁸⁷ Consultative Document, Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability, 2010, p. 13.

⁸⁸ Consultative Document, Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability, 2010, p. 5-7.

⁸⁹ Consultative Document, Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability, p. 5.

⁹⁰ Consultative Document, Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability, 2010, p. 12.

was laid down. For other hybrid instruments this percentage is 35 percent and for hybrids which will likely be redeemed due to contractual circumstances and dated instruments are limited to 15 percent.⁹¹ 31 December 2011 was the implementation deadline for CRD II.⁹²

Additional requirements said that the instrument's features must be easily understandable and that revenues must immediately be made available at a predetermined trigger point in terms of accessibility in the case of financial distress for the institution. Also the institution must have full discretion regarding the distribution of this capital.⁹³

Due to the fact that a remarkable issue stems from accounting principles and the definition of debt and equity, corporation law and tax law a harmonizing regulation is difficult as these linked issues lay within the competencies of the Member States.⁹⁴ A hybrid must meet corporate law requirements to be recognized as equity but must at the same time fulfil requirements for debt definition, in order to be granted deductibility of the financing costs of the instrument.⁹⁵

⁹¹ CRD II, art 66.1a.

⁹² [http://www.fsa.gov.uk/pages/about/what/international/pdf/crd%20\(pl\).pdf](http://www.fsa.gov.uk/pages/about/what/international/pdf/crd%20(pl).pdf), (21 March 2012).

⁹³ <http://www.bis.org/press/p981027.htm>, (16 Februari 2012).

⁹⁴ <http://www.eba.europa.eu/getdoc/06e25083-2f37-4146-90f3-9e9a40365117/hybrids.aspx>, p. 6. See also article from M, Hanten, p. 2.

⁹⁵ M, Hanten, p. 2.

3 Amendments to the Capital Requirements Directive

3.1 Background to the new provisions

These higher capital standards are part of what the BCBS has called the “*core of the global financial reform agenda*”. This agenda, commonly referred to as Basel III was introduced in December 2009 when BCBS published its consultative proposal for global capital and liquidity standards. On 26 July 2010, the Basel Committee reached a general agreement of the proposed capital and liquidity reforms. Even though it was endorsed by the G-20⁹⁶, Basel III will not be legally binding in itself. The Basel III standards will need to be implemented by the regulatory authorities of its members by statute or regulation. Member countries are expected to issue laws or provisions to implement Basel III by 1 January 2013, when the first benchmark in the phase-in period is scheduled to be achieved. CRD IV derives from Basel III and is principally a duplicated version. The need for a new set of capital rules in the EU stems from an insufficient harmonisation of quality capital definition as Member States have been taking significantly diversified approaches to excluding or including instruments with certain elements in institutions’ core capital. This diversified interpretation of what constitutes high quality capital was a catalyst for the financial situation seen today. Insufficient harmonisation in combination with regulatory ratios portraying a deceptive ability to absorb losses undermined the capacity of the market to assess accurately how capitalized the EU institutions were. As is now known, these facts amplified financial instability all across the EU. The EU wants to change this and prevent the crisis from repeating itself through revising the definition of high quality capital and the quantity.⁹⁷

CRD IV is a package comprising a Directive and a Regulation and replaces CRD II. The Regulation deals with prudential sanctions for credit institutions and also investment firms while the Directive⁹⁸ covers authorization for institutions, the supervisory review, the freedom of establishment and the free movement of services.⁹⁹ The reason for dividing CRD

⁹⁶ 19 of the world’s leading economies and the EU.

⁹⁷ CRD IV, Explanatory memorandum, p. 2.

⁹⁸ The Directive is not applicable to investment firms entirely as these issues are covered through Directive 2004/39, also called the ‘MiFiD’.

⁹⁹ COM(2011) 453 final, Proposal for a Directive of the European Parliament and the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary

IV in a Directive and a Regulation is essentially because a Directive needs to be transposed into national law to obtain regulatory effect, while a Regulation has direct effect. Thus must the Member States obey the prudential sanctions of the Regulation immediately on the implementation date.¹⁰⁰

For the integration of the new, more stringent rules in the CRD to be as smooth as possible, the new provisions in CRD are attached to a transition period between 1 January 2012 and 31 December 2021. This generous time frame has been enacted to ensure that the institutions have sufficient time to meet the amendments in what constitutes regulatory capital and to ease the imposition of prudential adjustments.¹⁰¹ For instrument currently qualifying as Tier 1 which might not continue to be eligible for inclusion, a phase out period of these instruments is admissible if the instrument was issued before 20 July 2011. This date is the publication date of the CRD proposal.¹⁰² This is referred to as “grandfathering” items in the CRD. For grandfathered items according to Basel, the date is set to 12 September 2010 which is Basel III’s publication date, hence contradicting the CRD. For each year between 2013 and 2019, the institution must grandfather these items according to a phase out schedule specified by percentage barriers given in the CRD.¹⁰³ So even though the Regulation has direct effect, the provisions in CRD permits transitional implementation, giving the banks some breathing space.¹⁰⁴

3.2 Capital Requirements Directive IV

3.2.1 Key amendments

The revised CRD contains several amendments. The most important amendments are those relating to liquidity risk, counter party risk, leverage risk, corporate governance and quality capital requirements. The aim of this thesis is to examine the amendments con-

supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, p. 10.

¹⁰⁰ CRD IV, Frequently asked questions, <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/527&type=HTML>, (24 April 2012).

¹⁰¹ CRD IV, para 80-81, p. 29.

¹⁰² CRD IV, art. 463.

¹⁰³ CRD IV, art 464. See the phase out schedule in 464(5).

¹⁰⁴ See CRD IV, art. 464-465.

ferred to quality capital, why this will be described more thoroughly in 3.3. Below follows a short description of the other key amendments in CRD IV.

3.2.1.1 Liquidity risk

As a result of the crisis, multiple banks could not answer to various short term demands due to insufficient liquid assets. Naturally, Member States did not want depositors, wishing to withdraw cash from their bank account to receive an error message from an ATM, why a bailout financed by the state and ultimately the taxpayers was inevitable.¹⁰⁵ To prevent a repeated future scenario the Commission has introduced rules targeting liquidity risk with the aim of covering short term liquidity needs. Institutions must always have and report liquidity assets that cover a bank's normal outflow of funds for a period of thirty days.¹⁰⁶

3.2.1.2 Counterparty risk

Due to the massive increase of trade with derivatives the past years, the Commission has decided to review the treatment of counterparty credit risk. Counterparty risk is especially evident in customized contracts for these financial instruments, known as OTC-derivatives, which are difficult to target for the legislator as they are extensively differentiated.¹⁰⁷ Through raising the level of regulatory capital requirements, the Commission believes that the high risk these contracts impose on the financial market will be reduced. The provisions targeting counterparty credit risk complement the proposal for a Regulation on OTC derivatives, central counterparties and trade repositories.¹⁰⁸

3.2.1.3 Leverage risk

Leverage is investment using debt instruments. Banks use leverage to avoid increasing their equity and through doing so maintain funds which they can reinvest freely. Leverage leads to a substantial increase of risk for the bank, why a new regulatory tool has been introduced that measures how an institution's funds are financed. This leverage ratio is a new, additional but necessary tool for supervisors according to the EU. Without the measurement of leverage in the elapse of the crisis, banks had to sufficiently reduce their leverage

¹⁰⁵ CRD IV, Explanatory Memorandum 1.1.1, p. 1.

¹⁰⁶ CRD IV, art. 405(c).

¹⁰⁷ Hybrid instruments are often customized like this.

¹⁰⁸ COM(2010) 484/1059, Commission Staff Working Document, Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories. See para 63-64, CRD IV, p. 27.

due to shortage of equity, which lead to desperately underpriced sales of assets, further increasing the losses of the banks.¹⁰⁹

3.2.1.4 Corporate governance

Weaknesses in corporate governance have lead to excessive risk-taking in credit institutions. One way to tackle this according to the Commission is to impose restrictions on variable remunerations. The new remuneration policy requires an explicit disclosure of the reasoning behind the size, the type (cash or stock e.g.) and the performance rationale of the remuneration.¹¹⁰

3.3 The new definition of high quality capital

Tier 1 capital functions in the institutions going concern business. This means that capital shall be able to absorb losses in the banks every day activities and prevent the bank from becoming insolvent. Tier 2 capital is of a gone concern basis, meaning that it shall be used when the financial institution is entering bankruptcy or is subject to liquidation.¹¹¹ Regulatory capital meaning Tier 1 and 2, must be capable of absorbing loss to be acknowledged. With the new rules all the regulatory instruments must absorb losses through either conversion to equity or a write-down.¹¹² The Commission wishes through CRD IV, to extensively limit hybrid instruments inclusion as primarily Tier 1 capital, but also seen to the regulatory capital in general. These instruments can according to the old provisions be included in Tier 1 due to their ability to convert into equity, hence loss-absorbent capital on an on-going basis. However this turned out to be inefficient in practice.¹¹³

The Tier 1 capital consists of the Common Equity Tier 1 (CET 1) capital and the Additional Tier 1 (AT 1) capital of a bank.¹¹⁴ CET 1 items are for e.g. capital instruments, retained earnings, other accumulated comprehensive income, reserves and funds for general

¹⁰⁹ CRD IV, para 64-65,68, p. 28 and art. 436.

¹¹⁰ CRD IV, para 77, p. 29, and art. 435.

¹¹¹ Den offentligrättsliga reaktionen på finanskrisen (II), [http://www.vinge.se/upload/bocker_artiklar/Den%20offentlig%C3%A4ttliga%20reaktionen%20p%C3%A5%20finanskrisen%20\(II\).pdf](http://www.vinge.se/upload/bocker_artiklar/Den%20offentlig%C3%A4ttliga%20reaktionen%20p%C3%A5%20finanskrisen%20(II).pdf), (21 January 2012).

¹¹² Consultative Document, Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability, 2010, p. 13.

¹¹³ Angsten, S, p. 17.

¹¹⁴ CRD IV, art. 23.

banking risk.¹¹⁵ AT 1 capital consists of other capital instruments and certain share premium accounts.¹¹⁶ The Tier 1 capital ratio must at all time be 6 percent for an institution to satisfy the new provisions of CRD and a total capital ratio of 8 percent.¹¹⁷ In this capital ratio the CET 1 must hold 4.5 percent. Would the CET 1 capital ratio sink to a level below 5.125 percent, or even at a higher level if the reason is originating from an instrument's specific features, a trigger event occurs. The trigger event causes an immediate write-off or a conversion from AT 1 to CET 1 capital.¹¹⁸ AT 1 capital is not given too much importance in CRD IV and is only required to an amount of 1.5 percent. The same goes for Tier 2 capital, which in total shall amount to 2 percent. The 4.5 percent CET 1 serves as a first layer of protection. Additionally a second layer of capital conservation buffer of 2.5 percent is obligatory and should constitute of CET 1 capital. This additional buffer aims at restricting payments of dividends, coupons and bonuses.¹¹⁹ A countercyclical buffer is also imposed to prevent the institution from harmful economic fluctuations through exceeded lending. Consequently another 2.5 percent capital requirement is imposed. It is however still uncertain whether the countercyclical buffer should constitute of CET 1 or AT 1 capital.¹²⁰

3.4 Tier I capital

3.4.1 Common Equity Tier I capital

For instruments to qualify as Common Equity Tier 1 capital the instrument must meet fourteen conditions. The instrument must have been issued directly (and not through a Special Purpose Vehicle) through the bank, while not purchased directly or indirectly through institutional funding. Therefore instruments owned by the owners of the institution can not be included and shall be deducted from CET 1 (see more below).¹²¹ The issuing entity must be defined as an institution by national law.¹²² Increases in equity deriving

¹¹⁵ CRD IV, art. 24.

¹¹⁶ CRD IV, art. 48.

¹¹⁷ CRD IV, art. 87.1.

¹¹⁸ CRD IV, art. 51.

¹¹⁹ CRD IV, para. 5.2, p. 12.

¹²⁰ M, Krause, p. 12.

¹²¹ CRD IV, art. 26(a)-(b).

¹²² CRD IV, 25.1(a).

from securitised assets and cash flow hedges are not permitted classification under CET 1.¹²³

The capital instrument shall according to national legislation be classified as equity capital subscribed by the shareholders or other proprietors and comprise all elements required. The requirements are hence cumulative in their character.¹²⁴

The instrument shall moreover be defined as equity according to accounting standards and national insolvency laws. An equity instrument is according to IFRS any contract that discloses residual interests in the assets of an entity after all the liabilities have been deducted.¹²⁵

Furthermore the financial statements of the institution shall be clearly and separately disclosed on the balance sheet, the instrument shall be infinite, the principal amount of the instruments may not be reduced or repaid, unless in the event of liquidation or corresponding occurrences. The instrument shall be equal to other CET 1 instruments in regards to preferential distribution when payment is actualised and not lead to prioritisation. The governance and distribution of the instruments must not be restricted nor conditioned in any way for the institution. Thus, failing to fulfil payments of the distribution should not lead to the institution's default. The instruments should absorb losses to the utmost extent as they occur. The ability to absorb losses shall be *pari passu* to other CET 1 items, that is common stock, and rank below all other claims in the event of insolvency. The instruments do not qualify in CET 1 if secured or guaranteed by a subsidiary, parent company or other. This is so far what is agreed on. Further details are up to the European Banking Authority (EBA) to develop by 1 January 2013.¹²⁶

The capital required to be deducted from CET 1 is comprised by assets, which represent no real value according to the regulator, such as intangible assets. Other than intangible assets, losses for the current financial year, deferred tax assets¹²⁷, certain expected losses, holdings of own CET 1 capital and also CET 1 capital holdings in other entities shall be

¹²³ CRD IV, art 29-30. Hedging the risk of shares or a derivative issued on the shares value e.g. can not be included in CET 1.

¹²⁴ Directive 86/635/EEC, art. 22 through CRD IV, art. 26(c)(i).

¹²⁵ IAS 32 para 11.

¹²⁶ CRD IV, Art. 26(d)-(l).

¹²⁷ Future income of tax assets due to for example net loss carryovers, which reduce the income tax expense. Deferred tax assets which constitute a claim on the state do not have to be deducted.

deducted. AT 1 capital exceeding the allowed quantity, RWA:s with high exposure and any tax charge relating to CET 1 instruments foreseeable at the point of calculation should also be deducted.¹²⁸ The more deduction-mandatory instruments from CET 1 the bank acquires, the more high quality capital does the bank have to comprise to reach the capital ratio of 4.5 percent for CET 1. All though the deductions decreases the institution's income tax base, it also impedes the banks ability to meet the requirements of the CRD. A positive effect of this should be that the banks have to limit their investments in risky projects as some of these investments have to be deducted. On the other hand is it possible that these provisions have an impact on banks' commercial activity, as they will choose not to engage in certain risky investments, and investments in risky instruments many times yield revenues. Decreased revenues and the increased capital requirements leave little room for distributable capital, thus might decrease commercial activity.¹²⁹

3.4.2 Additional Tier I capital

For an instrument to qualify as AT 1 capital the instrument must have been issued and paid for, it can further not have been purchased or funded by the institution, a subsidiary, or another entity where the institution's ownership exceeds 20 percent. In the event of insolvency must AT 1 capital rank below Tier 2 capital. The instrument shall not be guaranteed or secured, nor bear any contractual liability that enhances the seniority of a claim during times of insolvency or liquidation. Additionally the instrument must be perpetual, hence undated and include no incentive for the institution to redeem the instrument (step-ups). An option to call may only be exercised by the issuer. Redemptions, repurchases and calls may only occur 5 years after the date of the issuance. Distributions stemming from the instruments must be paid with distributable funds. When necessary the institution must have discretion to cancel payments for the instrument during an unlimited period and on a non-cumulative basis. The instrument shall not contribute to increasing the institutions liabilities in relation to its assets and shall not hinder the recapitalisation of the institution.¹³⁰

¹²⁸ CRD IV, art. 33.

¹²⁹ M, Krause, p. 11.

¹³⁰ CRD IV, art. 49.

3.4.3 Tier 2 capital

Tier 2 items are certain capital instruments, related share premium accounts, specific credit risk adjustments and gross tax effects. The conditions for capital to qualify as Tier 2 capital is similarly to Tier 1, that the capital should be issued and paid for, not purchased or funded by the institution or a subsidiary or entity where the institution has more than 20 percent voting rights or capital and not secured or guaranteed by another related entity. Furthermore the instruments should have an original maturity of 5 years.¹³¹

¹³¹ CRD IV, art. 60.

4 Implications for the high quality capital

4.1 High quality capital according to the Capital Requirements Directive IV

4.1.1 Overall amendments

With CRD IV the overall Tier 1 capital requirement increases from 4 percent to 6 percent out of which 4.5 percent must be equivalent to common stock and 1.5 percent additional capital. These figures are calculated on the RWA of the institution and after mandatory deductions have been made. Along with this, capital buffers amounting to 5 percent (conservation and countercyclical) with equity featured instruments becomes mandatory as well. In total this means that banks must maintain 11 percent equity instruments and a total capital ratio of 13 percent including Tier 2.¹³² These figures can be compared to the previous requirement of 8 percent total capital ratio out of only 2 percent was deemed to be equity. This increase is for the sake of capital conservation. Previous provisions constituted minimum requirements with the possibility for Member States to impose higher requirements, which was said to only lead to marginal discrepancies.¹³³ To hinder the widespread of implementation among Member States the new provisions preclude excessive requirements.¹³⁴ All though banks are imposed with a phase out period where non-qualified instruments issued prior 20 July 2011 will be phased out 10 percent per year between 2013 and 2019, completely new instruments must be issued and acquired from this date for the bank to be able to reach the new core capital ratio by 2013. A new leverage ratio requirement of 3 percent of the bank's gross capital will be adopted in 2019. Banks which are extensively financed through debt capital must thus deleverage to be able to meet this requirement. Options, futures and other debt instruments must therefore be converted, these derivatives are often embedded in hybrid instruments.¹³⁵ Furthermore a new liquidity coverage ratio will be adopted from 2015, meaning that there must be high quality liquid assets enduring one month of cash outflow in times when a bank is suffering from financial distress.

These ratios intend to prevent banks from failing and reduce banks' freely distributable funds significantly. A possible negative impact of this could be that banks will compensate

¹³² M, Krause, p. 12.

¹³³ See 2.1.1 above.

¹³⁴ CRD IV, art. 87.

¹³⁵ Larking, B, *Overview of National Taxation of the Financial Sector*, Derivatives & Financial Instruments, Vol. 14 – No. 2, IBFD, 2012, para 3.3.

declining turnovers through making it considerably harder and much more expensive for individuals to lend money. Another potential impact due to limited distributable funds could be that banks no longer will be able to lend money to each other to the same extent. This is how the banking industry works and how banks are financed why overall limited lending risk hindering commercial activity and in the end, risks to deteriorate the capital market.¹³⁶

4.1.2 Amendments concerning Tier 1 capital

The strict requirements of what constitutes CET 1 should remove any chances for hybrid capital to fall in this category.¹³⁷ The most material criteria introduced by CRD IV are that instruments should be classified as equity according to accounting purposes, be perpetual, bear no right to redemption nor preferential payments. Furthermore the distributions shall not be cumulative and the amount and occurrence of distributions payment is for the issuer to decide. The level of distributions shall not be determined based on the amount for which the instrument was purchased (thus not interest).¹³⁸ The instrument shall have the utter most subordinated claim in the event of insolvency or liquidation and its ability to absorb losses shall be *pari passu* to common shares.¹³⁹ Assets which have no real value or could reduce the quality of an institution's capital shall be deducted from CET 1.¹⁴⁰ For AT 1, instruments must bear corresponding features with the difference regarding redemption, which is allowed but constrained, and without a requirement for equity classification. Step-ups are not allowed for any Tier 1 instruments. At the occurrence of a trigger event motioned by financial difficulty, the instrument shall be converted to CET 1 or the principal amount be written-down.¹⁴¹ The instruments' conversion to common shares at the point of non-viability is enforced for both Tier 1 and Tier 2 capital.¹⁴²

¹³⁶ M, Krause, p. 11.

¹³⁷ Angsten, S, p. 17.

¹³⁸ These requirements are characteristics of dividends and should enhance the distributions character as dividends. The distributions of interest are usually determined on the principal amount paid for the issuing. See CRD IV, art. 26 (h).

¹³⁹ CRD IV, art. 26 (i)-(j).

¹⁴⁰ CRD IV, art. 33.

¹⁴¹ CRD IV, art. 49.1.

¹⁴² CRD IV, art. 51.

4.2 Out with the old and in with the new?

4.2.1 The new provisions versus the old

CRD II like CRD IV, recognizes common shares as the unquestionably highest quality of capital.¹⁴³ Nevertheless does CRD II allow for other instruments than common shares to be eligible for core capital.¹⁴⁴ CRD IV does not explicitly set out a prerequisite of common stock¹⁴⁵ but with the fourteen rigid, cumulative criteria it ought to be difficult for other instruments to qualify. CRD IV requires instruments to be perpetual for CET 1 which in comparison to CRD II could be 30 years for specific items, therein hybrids. Although there are hybrids with perpetual maturity, CET 1 disallows preferred distributions (crossing perpetual preferred shares of the eligibility list).¹⁴⁶ For the designation of distributions there is therefore a limited area for interest rather than dividends to be paid for CET 1 instruments. This does not only disrupt the inclusion of hybrids but the right to tax-deductible interest as well.¹⁴⁷ For the loss-absorbency the instruments are expected to manage losses in the same manner as common shares. CRD II required the highest quality capital to be able to absorb losses and be subordinated in comparison with *other instruments*.¹⁴⁸ Through this vague wording in CRD II the regulators cleared the way for hybrid instruments such as preference shares to be accounted for as high quality capital. Preference shares are de facto ordinary shares, but due to the owner's senior claim they are principally considered as hybrids, ultimately debt. Preference shares thus have a restricted ability to absorb losses as they are less subordinated. Preference shares are though more absorbent than "other instruments" such as plain bonds, making them comply with the definition of core capital in CRD II. CRD IV changes this through requiring loss-absorbency with equivalent capacity as common shares.¹⁴⁹

¹⁴³ CRD II, art. 57 (a), and CRD IV, art. 26 (c). Differs from the wording of Basel III which can be interpreted as exclusively permitting common stock., para 52, Basel III.

¹⁴⁴ "Other items" can constitute Tier 1, CRD II, art. 57(f).

¹⁴⁵ CRD IV differs in this sense from Basel III where the instruments should constitute common shares, para. 52, p. 13.

¹⁴⁶ CRD IV, art. 26 (h).

¹⁴⁷ There ought to be a debt-claim for interest to be conducted. See the Interest and Royalty Directive, art. 2 (a).

¹⁴⁸ CRD II, art. 57 (a).

¹⁴⁹ CRD IV, art. 26 (i).

CRD IV and the requirements for CET 1 must thus be said to eliminate any chances for hybrid instruments to be accounted as the core capital of an institution. The rules for AT 1 almost correspond to the criteria for CET 1, except for the redemption right and the definition of equity, thus slightly less rigid.

CRD II was quite vaguely formulated and allowed Member States to make their own interpretations as to what high quality capital should constitute of. The definition of core capital in CRD II was claimed as potentially causing inconsistency in the interpretation, and the widespread of instruments in the core capital of institutions proves that it did.¹⁵⁰ CEBS clarified further which characteristics high quality capital should have through setting up 10 criteria. If one would look at these guidelines affiliated with the emergence of CRD II, the differences with the new provisions CRD IV are not as blatant.

4.2.2 The old provisions through the eyes of CEBS

Regarding the right to preferential distributions, Criterion 1 allows such for other items than ordinary shares.¹⁵¹ According to CRD IV preferential distributions should be equal among the instruments. Preference shares were thus not considered sufficient as core capital prior to CRD IV too, as they are indeed ordinary shares, with the difference in preferential distributions. Meanwhile it is stated in Criterion 8 that the instrument should absorb losses in the same manner as common shares. Instruments such as preference shares were thus not to be accepted considering their inadequate loss-absorbency as well, as they are less subordinated than other shares in the event of default. This wording should definitely be interpreted as more stringent than the one in CRD II and is in line with requirement of CRD IV. The other criteria set up by CEBS regarding for e.g. the issuance and the payment also correspond to the ones in CRD IV. CRD IV totally precludes the right to redemption and step-ups and so does Criterion 4 in CEBS Guidelines. Criterion 7 of the guidelines assures that distributions should constitute dividends rather than interest. It was therefore known prior to CRD IV which features high quality capital should have, why the definition of high quality capital stays unchanged. CRD II allowed other instruments to qualify as core capital but the criteria for these other instruments left little room for instruments of lesser quality to be eligible. CRD II just like CRD IV distinguishes core capital from other instruments, such as hybrids. The inclusion of hybrid instruments in Tier 1 was permissible

¹⁵⁰ See 2.1.4 above.

¹⁵¹ CEBS, Implementation Guidelines, 2010.

but not for core capital classification. If the effect of CRD IV on high quality capital is that hybrid instruments no longer qualify, they should not have qualified according to CRD II either.

It is argued that hybrid instruments are banned from CET 1 through the requirement that the instrument must be paid-in share capital.¹⁵² The earlier provisions required the instrument to be paid-in equity capital and the acquirer to be a shareholder, which should mean the same thing. The 14 criteria representing core capital can consequently not be said to exclude hybrid instruments from the classification of core capital as it was not categorized as such prior to CRD IV either. Criterion 1 of CEBS' Guidelines explicitly states that core capital should be of higher quality than hybrid instruments and that instruments should be defined as equity with accounting standards.¹⁵³ This should mean that no debt instruments should qualify as core capital, hence should no core capital instruments trigger tax deductibility. Yet, hybrid instruments have been included in institutions core capital.¹⁵⁴

4.3 Implications of the amendments

4.3.1 What are the effects on hybrid instruments?

The SPR was a response to the immense issuing of innovative hybrid instruments made to trigger regulatory capital. Approximately 10 years after the SPR, the EU made an effort to incorporate the rules regarding the inclusion of hybrid instruments in core capital into EU law. However the original intention concerning hybrids was Tier 2 inclusion, that is instruments for gone-concern losses.¹⁵⁵

The SPR focused on the duration of the instrument, the flexibility of payment obligations and the ability to absorb losses. The instrument should be undated or have an original maturity of 30 years.¹⁵⁶ Furthermore the instrument must be as loss-absorbent as equity, which is the key feature for hybrids to qualify as core capital. Redemption is only permitted by the issuer after 5 years and the claim shall be subordinated in relation to non-subordinated

¹⁵² Art. 26.1 (a)-(b). See Angsten, S, p. 17.

¹⁵³ Certainly the criterion of equity definition gets a little tricky with hybrid convertibles as they transform from debt to equity.

¹⁵⁴ Angsten, S, p. 18.

¹⁵⁵ BIS, Proposals for international convergence of capital measurement and capital standards, 1987, p. 4.

¹⁵⁶ Instruments with a maturity of 30 years are regarded as equity due to their long maturity. See Angsten, S, p. 18.

creditors. Step-up are permitted according to CRD II, but only if such takes place after 10 years.¹⁵⁷ Even if the aim for hybrid instruments was Tier 2 inclusion, Member States have still allowed these instruments to be included in Tier 1 for their equity features. The major difference between the regulated characteristics for hybrid instruments and those for core capital regards redemption which is slightly less rigid for hybrids, whilst entirely prohibited for core capital.¹⁵⁸ Even so instruments redeemed after 10 years have been accounted as core capital.¹⁵⁹

As the most important feature for hybrids is loss-absorbency, Member States must have found hybrids *pari passu* to equity to include them in the core capital. This in turn stems from the fact that there is no uniform classification of equity within the EU and a wide-spread of the definition. Many Member States permitted the inclusion of perpetual preferred shares, because of the vague wording in CRD II on preferential distributions, which CEBS acknowledged.¹⁶⁰ Preference shares are considered debt¹⁶¹, why they also should result in deductible interest. As shares are “preferred” the creditors have a senior claim compared to shareholders of common stock. This prioritized claim should limit the instrument’s ability to absorb losses why these instruments are not *pari passu* to equity. To include these instruments in the core capital of an institution has thus been wrong. Step-ups are no longer permitted for hybrid instruments, not even for AT 1 capital. This has changed as CRD II allowed step-ups for hybrid instruments.¹⁶²

Hybrids should not stand a fighting chance against the requirements of CET 1, just like they should not have stood a fighting chance against the core capital of CRD II. Even so some of these instruments were acknowledged as core capital.¹⁶³ AT 1 ought to be the appropriate forum for hybrid instruments. These rules are similar to CET 1, with the main

¹⁵⁷ CRD II, art. 63.2 and 63a.

¹⁵⁸ Restriction to redeem within 5 years, or 10 years if the instrument carries a step up clause, CRD II, art. 63a.2.

¹⁵⁹ Angsten, S, p. 18.

¹⁶⁰ CEBS Implementation Guidelines, 2010, p. 6, para. 25.

¹⁶¹ Preference shares are excluded completely from core capital with the new capital requirements.

¹⁶² CRD II, art. 63a.2.

¹⁶³ It is stated in the Basel Accord that hybrid instruments can qualify as Tier 2 capital. The intention of the provisions was thus not to include them in Tier 1. See <http://www.bis.org/publ/bcbs128b.pdf>, (30 April 2012).

difference regarding redemptions and no equity classification requirement. The right to redemption is a key feature for the recognition of hybrid instruments and should thus play a significant role when deciding whether the instrument should be granted tax-deductibility in the form of debt. However the right to redemption is still relatively reduced why these instruments' have no guarantee in being accounted as debt.¹⁶⁴ CRD II distinguished core capital from hybrid instruments in Tier 1, just like CRD IV does. As one of the problems addressed in CRD II was the inclusion of hybrid instruments in institutions core capital (see above), one might ask why the regulators did not make a bigger effort to stop this problem.

Amendments have been incurred. Tier 1 is from now on divided into CET 1 and AT 1 with the total capital ratio of 6 percent. The former rules required a total capital ratio of 8 percent out of which 2 percent should have constituted core capital. AT 1 can only constitute 1.5 percent of the institutions RWA and has, together with Tier 2 capital, been given limited significance with the new provisions.¹⁶⁵ This narrow scope is to ensure the capital's ability to absorb losses on a going concern basis, for which the previous Tier 1 capital proved to be insufficient during the elapse of the crisis. This was especially the case with hybrid instruments, which were proven unsuccessful in absorbing losses when they occur.¹⁶⁶ During the financial crisis, the issuers of hybrids were expected to use their early redemption option and thereby decrease the liability to pay distributions to the investors (market expectations can arise through statements in the prospectus). Many issuers chose not to do this, because the redemption alternative was too burdensome. Moreover redemptions send negative signals to investors and may in the end be detrimental to an institution's reputation. Instead of redemptions the step-ups received effect, increasing the institution's liability towards the creditors.¹⁶⁷ This is something the regulators want to prevent, why step-ups are prohibited for Tier 1 instruments in CRD IV.

The definition of high quality capital can be said to remain unchanged whilst the amount of core capital required increases significantly with 2.5 percent. The new rules do not "force"

¹⁶⁴ See the position of the Government of the UK in the matter, <http://www.hmrc.gov.uk/basel3/discussion.pdf>, (8 May 2012).

¹⁶⁵ Krause, M, p. 12.

¹⁶⁶ CRD IV, Explanatory Memorandum, p. 2.

¹⁶⁷ See publication from the rating agency Morrison Foerster, <http://www.mofo.com/files/Uploads/Images/100801Hybrids.pdf>, (15 april 2012).

hybrid instruments out of the core capital definition, as they never were part of the definition. As before, they are still eligible for Tier 1. In the former Tier 1, core capital was also distinguished from hybrid instruments. This is no different from CRD IV that distinguishes these categories in CET1 and AT1. The effects that the new capital ratios will have on hybrid instruments is that 1.5 percent of the RWA is left for hybrid instruments' inclusion in Tier 1. Moreover institutions are allowed to have 2 percent Tier 2 capital. The new provisions limit hybrids to 25 percent instead of 50 percent of Tier 1, if they are convertible. Other hybrid instruments of lesser quality are completely banned from Tier 1. By imposing these capital ratios the regulators are changing positions completely. The initial opinion on capital ratios was that they could be misleading indicators of the financial situation in a bank and portray false images of a bank.¹⁶⁸

Old: Type of capital			New: Type of capital	% of RWA
	Equity capital		Common equity capital (CET1)	4.5
+	Hybrid equity capital	+	Additional Tier 1 capital (AT1)	1.5
+	Innovative hybrid equity capital		Not applicable (n/a)	
=	Tier 1 capital	=	Tier 1 capital (T1)	6.0
+	Upper Tier 2 capital	+	Tier 2 capital (T2)	2.0
+	Lower Tier 2 capital		n/a	
=	Tier 1 + Tier 2 capital		n/a	
+	Tier 3 capital		n/a	
=	Total capital	=	Total capital	8.0
		+	Capital conservation buffer	2.5
		+	Counter-cyclical buffer up to	2.5
		=	Total capital + buffers	13.0

An overview of how the old capital classifications are transposed into the new in CRD IV with the capital ratios.

¹⁶⁸ See 2.1.1 above.

4.3.2 How the amendments affect the banks

Consequently the definition of high quality capital remains the same but how will the increased demands of capital affect the institutions? The new capital ratio requires the banks to more than double their subscription of core capital.

The new rules are interpreted as excluding hybrid instruments from core capital and so should the old provisions also have been.¹⁶⁹ Now, with all the eyes on the financial industry it might be harder for the Member States and the institutions to disregard the requirements for core capital. The effects of the new rules merely affect the quantity of the capital. What used to be a requirement of 2 percent core capital is now 4.5 percent. Those 2 percent may additionally have consisted of non-permissible instruments. If the supervision is sharpened, as it appears with the reactions caused by CRD IV, institutions may have some new issues and instrument conversions to arrange.

The effects of the new capital requirements are thus that banks need to increase their common stock and retained earnings. To clarify, this should be the effect. As the capital requirements formerly have not been obeyed to the fullest, the effect will be that banks need to alter their capital as well, as they interpret the new rules as stricter, when certain instruments should not have been issued for core capital purposes to begin with.¹⁷⁰ The problem does effectively not lay with the institutions that issued non-suitable instruments, but the Member States permitting the subscription of these instruments as core capital.

Ultimately institutions must replace any hybrid instruments that lack conversion rights, which have been included in Tier 1 in the foregoing, before the grandfathering period runs out. AT 1 capital will probably allow hybrid instruments inclusion, however it is uncertain whether these types of hybrids will in fact be considered debt for tax purposes. No general implication can be held as it is up to the Member States to decide whether an instrument as such constitutes debt or equity.¹⁷¹ The fact that these instruments will convert into common shares at a trigger point decided by competent authority, speaks for treating such instruments as equity. On the other hand is it possible for redemption under certain circumstances with AT 1, which speaks for debt classification. Whether rights to redemption

¹⁶⁹ Krause, M, p. 12.

¹⁷⁰ Angsten, S, p. 17.

¹⁷¹ Member States differ significantly in this sense; Swedish legislators will recognize just about any hybrid instrument as Angsten, S, p. 17 and Dahlberg, M, *Ränta eller Kapitalvinst – Grundproblem i kapitalinkomstbeskatningen – särskilt vad gäller finansiella instrument i gränslandet mellan lånekapital och eget kapital*, 2011, p. 570.

without the right to step-ups is considered debt is unclear. However to claim that step-ups used to be permissible under the old provisions can be discussed as hybrid instruments were also required to be perpetual in their existence. A step-up clause inflicts an instruments permanence and should therefore not be considered perpetual, hence impermissible according to CRD II as well.¹⁷² The requirements for AT 1 corresponds to the previous categorization of hybrid capital without the inclusion of innovative instruments. There are however mixed interpretations of the definition of CET 1, AT 1 and Tier 1 instruments in general why it is hard to foresee the exact treatments of these.¹⁷³ As it ultimately is up to the Member States to decide whether to treat these instruments as equity or debt, discrepancies across the EU can arise. Member States decide on the specifics of the provisions and classify instruments according to their own parameters. This can deteriorate the harmonization the EU strives to obtain and could potentially also lead to regulatory arbitrage. The widespread of applying the provisions may have a detrimental effect on the Internal Market. Economically equivalent financial transactions should receive functionally equivalent tax treatments, and should not be distorted by taxation issues.¹⁷⁴

This uncertainty as to the constituents of Tier 1 and how they should be taxed comprises a major issue for many banks, especially German banks, whom according to current provisions permits the inclusion of silent partnerships in core capital. In Germany these types of hybrids have been accepted as Tier 1 capital, leading to some banks raising 30 to sometimes as much as 50 percent of the Tier 1 capital. These banks will encounter great problems if the verdict from the EU encloses the instruments' future exclusion from the core capital definition.¹⁷⁵ As it has been showed in the previous, the criteria are the same for

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[http://danskeanalyse.danskebank.dk/abo/CreditUpdateHybridCapital190810/\\$file/CreditUpdate_HybridCapital_190810.pdf](http://danskeanalyse.danskebank.dk/abo/CreditUpdateHybridCapital190810/$file/CreditUpdate_HybridCapital_190810.pdf), (10 May 2012).

¹⁷³ M, Krause, p. 12. This is also a consequence of the fact that there is no unitary definition in EU of what constitutes debt and equity.

¹⁷⁴ Woods, R 1999, p. 52.

¹⁷⁵ <http://www.bloomberg.com/news/2011-04-07/eu-stress-tests-must-focus-on-high-quality-capital-enri-says.html> (17 January 2012). For the German "Landesbank Hessen-Thüringen" silent partnerships accounted for 50 percent of the Tier 1 capital at the end of 2010. Another example is Germany's second largest bank "Commerzbank", whom during the financial crisis were in the need of state support and issued these hybrids to a value of EUR 14 billion for the government to fund. Commerzbank has converted a large share of this amount to common shares, improving its capital quality and reducing its state liability, <http://www.ft.com/intl/cms/s/0/b44410e0-6010-11e0-abba-00144feab49a.html#axzz1qD3nNZPX> (January 18 2012).

core capital subscription, why silent participations should be eligible for core capital according to CRD IV if they were eligible according to CRD II. However Criterion 1 in the CEBS Guidelines excludes instruments financed through external capital from being included. Thus should silent participations not have been eligible for core capital in the foregoing. Even if the requirements for core capital are the same, there are ongoing discussions as to whether silent participations should be considered as core capital with the new provisions. The impression of the new provisions is apparently that the scope of core capital has been narrowed, or maybe it is fear that the supervision has been sharpened.¹⁷⁶

However the Member States and the banks choose to interpret the new provisions and however they interpreted the old, one thing is certain; a large fraction of capital must be converted into instruments allowing the banks to reach the increased capital ratios. For Member States interpreting the CRD IV differently from CRD II, institutions will have a difficult time as they have to substitute former eligible Tier 1 instruments.¹⁷⁷ That Tier 1 instruments have adequate loss-absorbency capacity is significantly important, as the new provisions mainly target Tier 1. Tier 2 is limited to only 2 percent. This means that when a bank has gone concern, there is not much resources to help it recover, as this is the task of Tier 2. One can not just say simply that hybrids lack ability to absorb losses. Certain Member States might define mainly equity featured instruments as hybrid instruments to grant institutions with tax relief. How each Member State chooses to handle its tax base is up to that Member State. It is however when banks are being granted core capital subscription for instruments that lack loss-absorbency ability just for the sake of supervisory satisfaction this becomes a global problem.

4.3.3 The future of hybrid instruments

The inclusion of hybrid instruments is being limited to 25 percent of Tier 1 in CRD IV. Hybrids which have been included in an institution's core capital must be replaced with common shares. As CRD IV enters into force there is limited space for hybrid instruments in Tier 1, as the permitted quantity is reduced to half. Moreover, only convertible hybrid

¹⁷⁶ Krause, M, p. 12.

¹⁷⁷ This could be the case in Germany. German bank Commerzbank suffering from significant losses, had to convert a large share of its hybrid instruments to common shares, <http://www.finanznachrichten.de/nachrichten-2012-03/22923055-soffin-converts-silent-participations-of-eur-230-8-mln-into-commerzbank-shares-020.htm>, (3 May 2012).

instrument will qualify, and it is uncertain whether these will be treated as debt and granted the tax advantages debt instruments obtain.

The hybrid instruments must for Tier 1 be perpetual in their existence. It is hard to imagine a bond (loan), which runs eternally, without a date to be paid back to be considered a liability. Can this instrument really be seen as debt? Big emphasis is put on the maturity of an instruments when deciding how to tax it. Hybrid instruments with perpetual maturity therefore run a risk of being taxed as equity.¹⁷⁸ Limited indication as to how to classify convertible instruments is given by the regulators, other than that they should be treated as convertible debt.¹⁷⁹ The term convertible debt can have various meanings, depending on the civic definition, the tax definition and the issue regarding capitalization for banks. Other than the permanence requirement, step up-options are abolished and in no way can the institution cause expectations that the instrument will be redeemed.¹⁸⁰

As equity and debt fulfil the same role in financing, it is not a surprise that institutions have used the type of instruments providing the most benefits. Investors in hybrid instruments are likely to be paid before shareholders in the event of bankruptcy. Additionally hybrids provide a higher rate of return compared to plain debt instruments. These are factors working as strong incentives for investors to choose hybrids as their investments.¹⁸¹

If Tier 1 instruments shall be accepted in the form of debt or equity is not for CRD IV or the EU to decide. As there is no common definition of equity or debt within EU, it is for the Member States to decide on the classification of hybrid instruments. This could continue to cause a widespread of the tax treatment of Tier 1 instruments within EU. The EU acknowledged during the initial phase of the CRD that tax issues could work against their aim to reduce inequality competition. Not much can be said to be done to prevent this from happening.¹⁸² With a liberal approach, capital adequacy and the civic and taxation de-

¹⁷⁸ Review of current practices for taxation of financial instruments, profits and remuneration of the financial sector, European Commission, Impact Assessment, vol. 4, SEC(2011) 1102 final, p. 59.

¹⁷⁹ Consultative Document by BCBS, Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability, 2011, p. 12.

¹⁸⁰ During the financial crisis many issues of hybrid instruments were expected to be redeemed, according to mandatory issuance documentation (prospectus). The institutions chose not to make use of this option as it was considered too expensive. The regulators want to prevent market expectations which can portray institutions as more capitalized than they really are.

¹⁸¹ Aberbach, K, p. 114.

¹⁸² See 2.1.1 above.

definition of an instrument constitutes two different things, why an instrument may be equity for capitalization issues and debt for taxation issues.¹⁸³ In Denmark for e.g. a hybrid instrument will be considered for debt eligible for Tier 1 if the debtor is the state or another credit institution.¹⁸⁴ With a conservative approach, a convertible hybrid instrument will have no chance in qualifying as debt, thus disqualify tax deductible distributions completely from Tier 1.¹⁸⁵ A new type of instrument is currently being tested on the market, contingent convertibles known as "Cocos". This is a new type of hybrid instrument with a few modifications, converting to common shares during times of financial distress at the initiative of the issuer instead of the holder. Cocos bear no repayment of principal and the payment of distributions is as well, converted from cash to shares when the institution is suffering from losses. The hope is that these hybrids will qualify as core capital. It is however uncertain whether these instruments can and should be treated as debt for tax purposes.¹⁸⁶

¹⁸³ As the situation is in France. See section on France in *"Tax treatment of Tier 1 following Basel III"* by Perrot, T, Linklaters, 2011.

¹⁸⁴ Munch, A, David, *Taxation of Basel III- Compliant Instruments*, Derivatives & Financial Instruments, Vol. 14 – No. 1 – 2012, IBFD, p. 20.

¹⁸⁵ The Belgian approach. See section on Belgium in *"Tax treatment of Tier 1 following Basel III"* by Vanhulle, H, Linklaters, 2011.

¹⁸⁶ Krause, M, *Tax Treatment on Contingent Convertible Bonds*, Derivatives & Financial Instruments, Vol. 13 – No. 3, IBFD, 2011.

5 Analysis

One of the main intentions of the new provisions for capital adequacy was to revise the quantity and quality of capital. The previous chapter of this thesis has made it evident that the definition of quality capital stays unchanged. The characteristics of high quality capital presented in CRD IV are exactly the same as the criteria presented by CEBS for the implementation of CRD II. So what is all the fuss about CRD IV then?

The problem has not been that hybrids have been included in institutions former Tier 1. The problem was that the amount of highest quality capital required has been too low, not being enough to suffer the losses. Therefore hybrid instruments had to be used as a first line of defense together with common shares instead of the second line of defence during the financial crisis. It ought not to be a chock that the nature of hybrids as debt-featured instruments were not capable of absorbing losses with exhaustive capacity.

To sum up, the effects of the new provisions do not mean that hybrid instruments are excluded from the definition of high quality capital. The processor to CRD IV, CRD II also distinguished between high quality Tier 1 and lower quality Tier 1. Hybrid instruments were not intended for core capital Tier 1 eligibility. The same system is applied in CRD IV that has provided us with two categories of Tier 1 capital. CET 1 constitutes core capital Tier 1 and AT 1 represent lower quality Tier 1. Arguments claiming that the new provisions exclude hybrid instruments from the definition of core capital are therefore misplaced as hybrid instruments were not effectively defined as such according to CRD II. Even though the regulators' ambition was to keep lower quality instruments like hybrids away from the first line of defense, why the SPR was implemented into CRD II, they continued to close their eyes when institutions subscribed hybrid instruments as core capital. Soon enough, when the damage was already done, CRD IV came. CRD IV does not change the prerequisites for core capital, but it seems as if this is the perception of CRD IV.

Banks have been exploiting the blurry distinction between equity and debt to trigger regulatory capital requirements and used it to their advantage but to the people's disadvantage. This has been done through the usage of hybrid instruments. Only 2 percent of the total capital according to CRD II had to constitute reliable loss-absorbent capital in the form of common shares. The remaining requirement for Tier 1 capital could constitute of whichever combination of Tier 1 instruments the institution preferred.

CRD IV has imposed rules on various new capital ratios for the banks to fulfill as an indication for the supervisor to acknowledge the accurate financial situation in the institution. CRD IV thus revises the required quantity of capital. A liquidity ratio is imposed to safeguard that banks always have freely distributable capital to survive 30 days cash outflow. Moreover a leverage ratio to control that banks are not exceedingly financed through debt is enacted and capital ratios for CET 1 and AT 1 capital. CET 1 capital shall account for 75 percent of Tier 1 capital and AT 1 for 25 percent. CRD II permitted convertible instruments to account for 2 percent out of the total Tier 1 capital (4 percent). The regulators expressed themselves in a very vague way in CRD II which apparently was interpreted as accepting hybrid instruments as core capital. The CEBS clarified the intention of core capital and developed the criteria. However it seems as if Member States ignored the guidelines and focused on the vague wording of CRD II as there was a need to alter the definition of high quality capital, resulting in CRD IV. Nonetheless CRD IV does not alter the requirements for quality capital, only the quantity.

To issue new common shares eligible for CET 1 to be able to reach the 4.5 percent threshold will be a costly procedure for banks. As the supervisors can be said to have had a somewhat relaxed approach to subscribing instruments as core capital, is it probable that institutions must convert hybrid instruments previously accepted as core capital to common stock when the new provisions enter into force. The supervisors seem determined to "clean up" any misplaced instruments. This should mean no more deductible instruments or distributions on the instruments as these lack features of core capital, which probably will reduce the banks revenues.

Will this affect banks' commercial activity? Unfortunately it might. Banks will in the future have a limited playing field when it comes to issuing risky but remunerative instruments. Limited resources due to the capital ratios enforces significantly restrained funds that are freely distributable. Hopefully does restrained resources not mean that the prices for normal banking services such as financial advise, lending and depositing will shoot through the roof. This would be an undue consequence of the new provisions as the definition of high quality capital is not something new to the banks. The banks have earlier circumvented the expensive maintenance of necessary high quality capital, with the consent from supervisors. It would not be fair if the price for CRD IV was conferred to the people. The taxpayers would then again be the ones paying for the banks; not wrong-doing this time, but for their right-doing. With the new leverage ratio and the CET 1 capital ratio banks have to deleve-

rage and replace a large fraction of their financing through debt with equity financing. The issuance of hybrid instruments is thus under significant surveillance. To be able to meet the requirements set up in the EU in time banks have to act now. During these times of financial cut-backs deleveraging should mean selling instruments below market price. It is therefore reasonable to think that revenues will be reduced even further. Are the supervisors strangling banking business by limiting their turnovers in their way to save the banks? Are the new capital requirements a race to the top, increasing banks trustworthiness and capitalization, or is it in fact a race to the bottom, resulting in insolvent banks not being able to meet exceedingly demanding requirements?

A bank is different from a normal corporation. It does not only have it as a sole purpose to generate income. It is fundamentally an institution established for the benefit of people; the safe deposits and investments of people's capital and savings. A world without banks would not be the functioning world as we know it today. People depend on banks and their existence. This is mainly the reason why governments have been so generous with injecting capital in banks on the verge of default during the crisis. Reserves that effectively belong to the taxpayers. Another important reason to make sure that a bank is rescued is the interconnected banking industry. The default of a SIB could mean the default of many others as they depend on each other. SIB:s have to be extra careful when blending capital adequacy with measures to increase revenues. The failure when doing so will not only have a deteriorating effect on the entity as such, but on the global market. Through exploiting blurred definitions of equity and debt and shaping hybrid instruments to maintain benefits from each concept, the banks have been blending two ingredients in a recipe for disaster.

Even though the banks should be responsible as quasi-public establishments for taking actions in everyone's best interest, it is up to the supervisors to make sure that they do so. What constitutes high quality capital has been known by these, before the existence of CRD IV. Hybrid instruments were not intended for core capital qualification. Even after it became evident that banks exploited the least painful way of complying with former capital standards, which could be seen as circumventing their better good, the supervisors allowed it. They let it pass against what should have been their better judgment. The supervisors have been acting according to 'what is', when they saw issued hybrid instruments constituting core capital and adjusted their rules accordingly. CRD II addressed the problem of hybrid instruments being included in the core capital and the legislators restricted it, but accepted it through a lacking effort. Instead they should have acted according to 'what if', as

in what if financial distress would occur. 'What if' reflects the composition of the new provisions.

Banks did reach the capital requirements according to CRD II, not using unlawful methods, but by using unrightful ones. CRD IV did not reveal what constitutes loss-absorbent capital, the features of such capital was presented after CRD II through the CEBS. As issuers and creators of the hybrid instruments the banks surely must have known that these instruments lacked loss-absorbency capacity. In the end they are nothing but debt instruments designed to look like equity. It would be reasonable to say that banks have been circumventing high quality capital rules, with the consent from the supervisors. So why should the supervisors stop looking through their fingers when banks continue to design hybrid instruments with convincing equity features? Simply because they have to now. During these times of financial crisis, all eyes are on the banks and the financial market. It is no longer about a difference in the balance sheet, it is a difference for the global economy. Not to say that the capital adequacy of banks was the reason for the crisis, but with the interconnected global market we live in with banks in the core central, each issue affect one another. The consequences of having a SIB default are too severe to risk. Moreover another capital injection subscribed by the taxpayers would diminish people's trust for the banking industry. Surely it is also a matter of being pointed out as a villain working against the resolution of the crisis, which no one wants. The pressure on the supervisors to show that changes have been made is just too immense for them to ignore. The crisis has had a significantly detrimental effect on the global market, and so far the banks have been manageable to be rescued. If a SIB would be too injured to be rescued, the damage should be considerably worse. It is hard to imagine that it can get even worse than this, but if this is true then SIB:s are indeed *too big to fail*.

Consequently CRD IV does not revise the definition of quality capital, only amend the capital quantity. So how does this change affect hybrid instruments? The Tier 1 capital ratio is increased from 4 percent to 6. More importantly for hybrid instruments, their genuine possible inclusion in Tier 1 is decreased from 50 percent to 25. These 25 percent can only constitute of hybrid instruments that convert to common shares at the point of non-viability and leave no room for other types of hybrids. As the share of hybrids is reduced to half, and it is likely that some of the former hybrids are innovative hybrids (depending on how the Member State treats Tier 1 capital), institutions have some conversions to take care of. Banks must therefore reduce their possession of hybrid instruments and replace

these with equity instruments. Tax-deductible capital could thus be replaced with tax-obligatory capital and deductible distributions are replaced with non-deductible distributions. Banks are imposed with a dual burden. Banks have to replace a huge amount of their capital, therein hybrid instruments classified under their former core capital with rightful common shares. Secondly they have to enhance the amount of tax liable equity, while reducing the tax dispensable debt.

The amount depends entirely on how Member States categorize hybrid instruments, so the effect this will have on banks will vary across the EU. Whether the hybrids that qualify as Tier 1 will be treated as debt or equity depends on how they interpret the instrument. In many Member States, competent authorities are keen on granting instruments debt classification to provide the institution with tax reliefs. The new set of rules, as has been shown in this thesis principally require the same features for instruments to fall under Tier 1 as before. This means that the instruments that were considered debt earlier should continue to be treated in this manner. Whether AT 1 instruments subscribes tax deductible interest should therefore depend on how the Member State treated the same instrument under CRD II. That is if they classified the instrument accordingly. For the sake of deducting distributions this is of course of great important for banks. As has been presented in the foregoing, is it hard for the regulators to determine the character of a hybrid instrument because of their complex setups. Although the most important issue for banks and for competent authorities should not be the settlement of an instrument's character as debt or equity. It should rather be if the instrument can absorb losses in a sufficient manner, thus prevent endangering the existence of SIB:s again. Inconsistent regulation of CRD IV bears a risk of this happening. If certain Member States allow less loss-absorbent instruments in Tier 1, no matter if the instrument is classified as equity or debt, the effect is not bank-internal nor domestic, it is global.

Another unwanted effect of different treatments of instruments across the EU with some Member States granting tax advantages and some not might be intensified regulatory arbitrage. The institutions will recognize which Member State that is eligible to treat hybrid instruments the most favourable, thus allows tax-deductible distributions. Institutions will make sure to design transactions in a way for the distributions of the instrument to be taxed in the most beneficial jurisdiction, through utilizing the Interest and Royalty Directive.

Important for the supervisors with the new provisions is not to materialize whether a hybrid instrument should be debt or equity for capital adequacy purposes. The banks will try their best to exploit the uncertainty when declaring an instrument equity or debt to receive the tax advantages stemming from debt classification. What is material for the supervisors is whether an instrument is loss-absorbent enough for Tier 1 inclusion, as mentioned above. However debt classification should indicate an undermined ability to absorb losses. Ability to absorb losses is after all what banks rely on to endure times of financial setbacks. At least if this is going to happen without capital support stemming from taxpayers, which was a primary aim of the new provisions. During the financial crisis and this time of need, the buffer placed to save banks from default could preferably have gone to create new job opportunities.

Whether the wrongful application of hybrid instruments in the banks' capitalization should be blamed on the supervisors or the practitioners is hard to determine. It is natural for an entity to convey each lawful measure to increase revenues; banks are no different. It is therefore particularly important for the regulatory sanctions and supervision to make sure that the banks' exploitation of measures to increase revenues does not intervene with the capital adequacy needed for a bank to survive.

The provisions governing the inclusion of hybrid instruments in entities' quality capital effectively serves as a buffer against loss. If the phenomena of hybrid instruments is endangering the loss absorbency of an entity, the restriction governing including such instruments as high quality should not only apply to banks, but also to systematically important corporations. Should a multinational corporation have inadequate loss-absorbency capacity, would it also have an effect on the world economy. Just like it would with SIB:s. If such an entity would become insolvent, numerous persons would lose their jobs and smaller entities that rely on the corporation as their main customer would have troubles surviving this scenario. Moreover corporations of these sizes bear loans of such magnitude that, if unpaid, the banks could once again encounter financial difficulties. The capital market is our financial ecosystem, all the pieces are connected. Corporations with the potential of causing such a serious effect to the capital market are insurance companies. Surely the request for hybrid instruments won't decrease. Maybe for investments in banks, but as hybrids provide benefits such as preferential distributions and enhanced creditor protection in comparison to equity instruments, creditors will be seeking to invest in these contracts. As the issuer, in this case the insurance company also obtains advantages in the form of tax deductions and

preventing influence to the creditor as these receive no voting rights, the subscription of these instruments will remain popular. If these instruments sincerely lack loss-absorbency qualities, problems will arise the day an insurance company suffers from losses. How would the world economy tackle the default of insurance companies? Probably not too good. Insurance companies and multinational corporations are ultimately also TBTF. CRD IV might prevent hybrid instruments from causing a new financial crisis for banks, but if these instruments have insufficient capacity to absorb loss, hybrid instruments might play a new role in the next financial crisis with an insurance company playing the lead role.

6 Conclusion

With a growing globalization grew a need for regulating internationally active banks to achieve a strengthening in the capital resources of international banks and enhance the stability of the international banking market. This framework started in the Basel Committee on Banking Supervision with Member States from all across the world. The Basel report was first drafted in 1987. With the publication of Basel II in 2004, the BCBS second set of provisions regulating credit institutions, the capital requirements were incorporated into EU legislation. This is known as the Capital Requirements Directive (CRD). CRD II entered into force in 2009 and further regulated which instruments that can be eligible as institutions' high quality capital. This high quality capital is categorized as Tier 1 and capital of lower quality as Tier 2. For an instrument to be eligible for Tier 1 it should constitute common shares. However other instruments can qualify if defined as equity, if they have an ability to absorb losses in a thorough manner and they do not lead to amplified liabilities for the institution. With the requirements of CRD II was a possibility to include hybrid instruments in the regulatory capital of an institution, that is Tier 1 and Tier 2. Hybrid instruments have features of both debt and equity embedded in the same instrument. Hybrids have been used as a method for institutions to reach capital requirements and at the same time enjoy benefits such as tax-deductible distributions. Moreover do hybrid instruments benefit investors in among others fixed payments instead of incidental dividends and increased creditor rights. To define a hybrid instrument is difficult. One must look at the features of the instrument to determine its character as debt or equity. An instrument with short maturity will be considered debt while a convertible instrument transforming to common shares at a trigger point will be eligible as equity. The quantity of these instruments allowed in Tier 1 is limited.

The recent financial crisis had a major impact on banks whom suffered from significant losses. Many internationally important banks lacked ability to absorb these losses and were on the verge of insolvency why the State had to interfere with capital injection. The funds used to save the banks came from state aid, thus financed by taxpayers. To prevent such an event from being repeated the EU put together a new set of rules in Capital Requirements Directive IV (CRD IV). CRD IV amends CRD II and revises the definition of high quality capital and the quantity. That these banks which are systematically important stay solvent is essential for the functioning of the capital market. To assure that this happens in a way

where public bailout is prevented the capital regime for these institutions must be strengthened.

It became evident during the crisis that hybrid instruments that were expected to absorb losses were not able to. For this reason the EU set new boundaries to capital eligible to core capital inclusion to prevent hybrids from being accounted. The new provisions categorized Tier 1 capital into Common Equity Tier 1 (CET 1) and Additional Tier 1 (AT 1). CET 1 only leaves room for common shares and capital of equivalence and should constitute 4.5 percent of an institution's risk-weighted assets. This is an increase with 2.5 percent for this type of capital. AT 1 capital shall comprise 1.5 percent and require principally the same features as CET 1. The difference is no requirement for equity definition and a slightly less rigid approach in the right to redeem an instrument. CET 1 totally precludes it while AT 1 opens up the possibility. Inclusion in AT 1 should be accessible for hybrid instruments, but only for hybrids with the capacity to convert into common shares. The aim is to exclude hybrid instruments from core capital definition and the regulators and the banks are convinced that this is the implication of the new provisions. However the requirements for core capital in CRD IV correspond to the requirements in CRD II, why this should mean that hybrids should not have been included in the foregoing as well. Now it seems as if the supervisors and the institutions are keen on doing it right, as doing it wrong evidently had severe consequences. Doing it wrong means including instruments that the banks as issuers recognizes as less loss-absorbent, as core capital through innovative setups of hybrid instruments. Systematically important banks have to restrain themselves in using riskful methods to increase their turnover, as the default of such an entity will have an impact on the world economy. Through using hybrid instruments which are debt in equity package to enjoy tax-deductible distributions as a way to circumvent costly capitalization, banks are putting a lot at risk. The supervisors have to make a better job at ensuring that this does not happen. Hopefully will the provisions in CRD IV prevent this from happening.

CRD IV can not be said to revise the definition of quality capital as it remains the same. It does however increase the quantity of quality capital required. Even though the requirements for core capital remains unchanged, the attitude towards the inclusion of instruments in core capital seemed to have changed.

The increased capital ratios regarding liquidity, leverage and capitalization in the event of loss will be a challenge for institutions to meet when CRD IV enters into force 1 January

2013. With restrained distributable funds, an unwanted effect of the new provisions would be a negative effect on banks' commercial activity. With restrained resources the banks might have to increase the costs for normal banking services such as lending and financial advice. It will not only impede on the banks ability to lend to people but also to other banks. Banks are able to answer to unexpected demands through lending from each other, that is how the banking industry works, why their ability to do so is vital. Instead of the people paying for the banks wrong-doing as happened during the elapse of the crisis the people would again be paying for the banks' right-doing.

CRD IV means that banks have to maintain higher levels of pure equity capital. Therefore banks have to issue new shares and convert hybrid instruments to common shares as the new regime for capitalization leaves little room for these instruments to be used. Thus will the new provisions governing Tier 1 leave little room for debt instruments with tax-deductible distributions to be eligible. AT 1 capital is given limited significance in CRD IV and AT 1 ought to be the appropriate category for hybrid instruments to fall under. Only hybrid instruments possible to be converted into common shares can be included in AT 1. Whether these instruments will be considered equity or debt is up to each Member State to decide as this lies within the competencies of the Member States. However instruments converting to common shares may be considered equity, hence diminishing any tax benefits entirely from Tier 1.

If hybrid instruments effectively are jeopardising entities loss absorbency, large multinational corporations and insurance companies should perhaps be incurred with similar restriction on their use of hybrids as well. A default of such an entity is comparable to the default of a systematically important bank.

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Appendix