GLOBAL riskupdate

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The Myth about Exchange Traded Deriviatives

Also in this issue

Contingent Capital Instruments – What is the future likely to hold?

In this article, Dennis Cox, CEO, Risk Reward Ltd, asks if bond issuance, its high regulatory and financial costs, and impact on economic stability ultimately makes sense as Tier 1 or Tier 2 Capital equivalents.

At present there is a trend operating within the banking community to develop new types of capital instrument to meet the demands of regulators. Of course the objective is to design instruments that would count as Tier 1 capital – that is would be considered akin to equity capital.

Contingent capital instruments act as bonds for the majority of their life but transform into equity instruments upon the occurrence of a trigger event. They are described within Basel 3 documentation and are already being issued by prominent institutions.

The Regulatory Environment

The final regulations which will specify what will be required of a contingent capital instrument to ensure that it counts as Tier 1 for capital purposes has not at this stage been finalised. In Europe you start with the Bank for International Settlements Basel 3 guidance and then look towards CRD4. After this you need to consider whether the European Banking Authority (EBA) might wish to provide greater clarity and then finally the guidance needs to be transposed into local regulation and legislation in compliance with taxation rules.

We do not have the final rules for any country so at this stage it would be brave to judge that any of the instruments currently issued would actually meet the detailed requirements of a set of rules which at present have not been produced. However it is possible to think through whether such an instrument could actually be effective and what the impacts are likely to be.

If the objective is for the banks to have capital that is both robust and provides customers and other institutions with confidence will contingent capital instruments meet this challenge?

The Problem with the Instrument

The idea is that the contingent capital instrument will become an equity instrument if a trigger event occurs. Such a trigger event needs to be ahead of any action that might potentially be taken by a regulator and therefore becomes difficult to set within the Basel 3 environment. That is because that capital requirements set within Basel 3 at present change every year. Accordingly the actual conversion trigger would be likely to vary over the life of an instrument if it were based on these capital rules. But this is perhaps the least of the problems. To understand the real concerns you need to start to consider investor impacts and the nature of the media.

How will the Instrument Operate?

Initially the intention is that the contingent capital instrument would operate as a bond. In common with all bonds it will have tenure and a coupon. However due to the uncertainty resulting from the potential for a conversion into equity the return that will be requested by the investor community will be higher than that for an equivalent bond. Therefore contingent capital instruments will be an expensive source of funding for the issuing firm.

This margin looks like it could be in the region of 3% to 5% but we will need to monitor this as more instruments are issued.

From a regulatory point of view things are even worse. Remember that these instruments have the right to be converted in an equity instrument – and they will not return to being bonds. If you are the holder of such an investment taking the enhanced returns that will exist prior to conversion, would you be happy to have these instruments convert into equities without any return? Our expectation is that the holder of such an investment will seek to unload the instrument if there is any increased likelihood of conversion. So just as the CDS rate increasing can cause a concern on a firm you will now also have bonds which are being sold en masse causing a transparent problem for the firm.

Rather than creating stability in the market these instruments could actually cause instability exacerbating what is in effect a worsening situation and causing a sell-off in all bond markets resulting in the firm effectively being excluded from funding markets. This is of course the effect that is intended to be avoided by the new rules.

Many countries will prohibit the use of contingent capital instruments as Tier 1 or Tier 2 capital. That does not result in the conclusion that they should not be issued by firms if there is an appetite for such an instrument then they will achieve liquidity objectives. However we believe that such instruments will be both expensive and potentially dangerous and therefore that firms should think twice before deciding that such bond issuance makes sense.

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