

### BANKS' HYBRID CAPITAL INSTRUMENTS: FINANCIAL STABILITY IMPLICATIONS

The purpose of banks' core capital is to absorb unexpected losses in order to safeguard the solvency of the institution and to enable it to continue operating as a business. Regulatory core capital consists of an unlimited amount of equity and a limited amount of other instruments that may include certain types of financial instruments known as hybrids.<sup>1</sup> Generally speaking, hybrid instruments have both equity and debt characteristics. For example, one type of hybrid may pay a regular dividend based on a par value (just like a bond coupon), but may be treated in a similar way to equity for regulatory purposes in that it can also be used for absorbing unexpected losses.<sup>2</sup> For euro area banks, a significant amount of these instruments are now included in Tier 1 capital and are increasingly being used as non-core capital funding for further lending or financing acquisitions. This reflects the development of this market globally as well as increased issuance by non-financial firms. This Box concentrates on the increasing use of this type of capital instrument by banks, and the possible financial stability implications.

Banks can issue hybrids for various reasons. Firstly, there may be cyclical explanations. Expansion of risk-weighted assets (RWAs) made it necessary for banks to find additional sources of longer-term capital. Given their debt-like characteristics, declines in long-term interest rates coupled with increasing investor appetite for higher yielding securities supported increased issuance of hybrids after 1999 (see Chart B13.1). Secondly, there may have been structural reasons for stronger issuance, as issuing these instruments provides a cost-efficient way of raising high-quality (loss-absorbing) capital for banks. In most European countries, dividends on equity are paid out of post-tax profit, whereas the coupon payments on bonds are tax-deductible. Therefore, if a bank can structure a security transaction so that it is treated as debt for tax purposes (and equity for regulatory purposes), then it is more cost-efficient than direct issuance of preferred stock.<sup>3</sup> Thirdly, hybrid capital instruments have become attractive to a wider range of investors since the introduction of the euro eliminated a major source of foreign exchange risk. This has the advantage of broadening a bank's capital base through access to different groups of investors, thereby diversifying its sources of capital funding. Furthermore, it may support banks' in their asset and liability management. Issuance in a non-euro currency (i.e. USD) also provides a hedge for RWA exposures against adverse movements in exchange rates when these exposures are denominated in the same currency as the hybrid instrument. Finally, recent changes in the way that rating agencies rate hybrids has also encouraged issuance by banks, as well as insurers and non-financial corporates. Essentially,

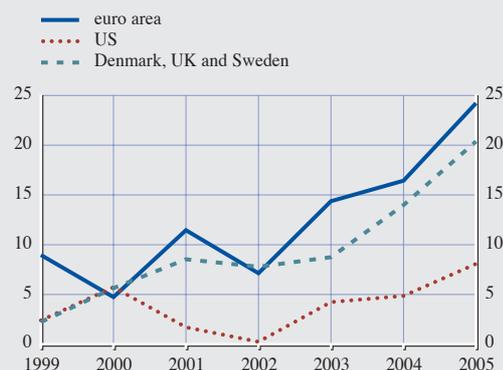
1 Briefly, as outlined in the Basel II accord, bank regulatory capital consists of three tiers: Tier 1, Tier 2 and Tier 3. The most important component in terms of its loss-absorbing capacity is Tier 1. Its capital consists of shareholder equity such as common stock, preferred stock (non-cumulative and non-redeemable) and retained earnings. Hybrid instruments – referred to as innovative capital – can be part of Tier 1 but are currently limited to 15% of total Tier 1 capital for individual institutions, as outlined in the Basel Committee Press Release of October 1998 (the so-called Sydney Release). Debt-like hybrids can also be part of Tier 2 if they are subordinated. Tier 3 capital covers market, foreign exchange and commodities risk, and does not usually contain hybrids. In the EU, Basel II is being implemented under the Capital Requirements Directive, in which core capital is essentially defined as original, additional and ancillary own funds. These roughly correspond to Tier 1, 2 and 3 respectively, but with certain technical differences. A survey of the implementation of own funds across Member States has been carried out by the Committee of European Banking Supervisors (CEBS). The results of this survey, together with the technical advice provided by the CEBS, are available on the CEBS website at [www.c-ebs.org](http://www.c-ebs.org).

2 Common stock by contrast pays a dividend that may vary with the banks' earnings. Another example of a hybrid security is a bond convertible into equity.

3 One example is the issuance of Trust Preferred Securities (TPS) by US and European institutions.

**Chart B13.1 Gross issuance of hybrid instruments by banks**

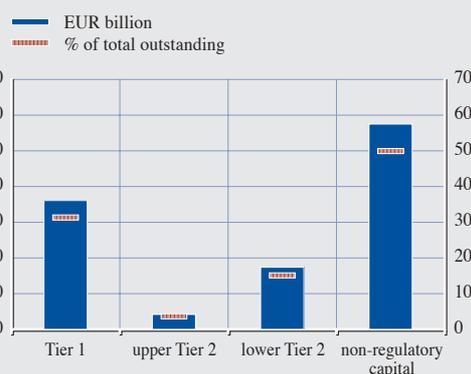
(EUR billions)



Sources: Bondware and ECB calculations.  
Note: Data are hybrid issues by public and private banks (and their associated financing vehicles). Data are in euro-equivalent amounts.

**Chart B13.2 Euro area bank hybrid issuance, by purpose**

(1999 - 2005)



Sources: Bondware and ECB calculations.  
Note: Tier 1, upper and lower Tier 2 are hybrid issues identified on the basis of the individual security data in Bondware. These data are non-called issues outstanding on 31 December 2005. These data include non-domestic issues and issues by funding vehicles. Data are in euro-equivalent amounts.

the overall result of this is more favourable treatment by rating agencies regarding the equity-like component of these securities for banks.<sup>4</sup>

Hybrid capital instruments that are part of banks' capital structure have become comparatively important as capital instruments since 1999 (see Chart B13.2). Given the cost-efficient advantage over equity, banks may be encouraged to include more of this type of capital instrument in regulatory capital. Their inclusion depends on the decision of the local regulator concerning the loss absorption capacity and the permanence of the instrument. If it is deemed to be equity then it can be included in Tier 1; while if it is deemed to be more debt-like, it will be placed in Tier 2.

From a financial stability viewpoint, it is preferable that these securities behave like equity in that they should be capable of absorbing losses and providing a practically permanent source of capital. Some market participants have argued that in the case of an episode of financial turbulence that was sufficiently strong to push a bank into distress, the inbuilt flexibility of hybrids could make it easier for the bank to trade its way out of difficulty by deferring payments, normally subject to regulatory approval, for several years of dividends on trust-preferred securities. However, deferral of payments can have a negative impact on a bank's reputation, which may have an adverse bearing on its future ability to raise funds in this and other debt markets.<sup>5</sup>

4 See, for example, Moody's (2005), "Refinements to Moody's Tool Kit: Evolutionary, Not Revolutionary, Rating Methodology", February; and Fitch Ratings (2005), "Bank Hybrid and Preferred Securities: Evaluating Their Role in Capital Analysis", Criteria Report, July. There are also some accounting-related reasons why banks may issue hybrids; however, these implications lie outside the scope of this Box.

5 There are also some divergent views among regulators on how exactly bank hybrids should be treated when it comes to core capital. In the US, for example, the Federal Deposit Insurance Corporation (FDIC) and the Board of Governors of the Federal Reserve have different views on whether they should be included in Tier 1 or not (see the letter to Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System from Donald E. Powell, Chair of FDIC, dated 2 July 2004).

Overall, while investor appetite may exhibit some signs of the hunt for yield phenomenon in the corporate hybrid market generally, the bank-issued hybrid debt market is comparatively well-established. This, combined with regulatory and rating agency oversight, means that the quality of banks' capital funding is unlikely to be compromised given the current market conventions and regulations.