US capital markets
Morrison & Foerster
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Contingent capital instruments

Since the outbreak of the subprime crisis in mid 2007, the world's financial markets have suffered unprecedented turmoil. Many banks, even large institutions that had previously been considered icons of stability, failed or had to be rescued or nationalised by their governments. The financial crisis has prompted regulators in the US and Europe to reexamine how much capital is enough capital for banks. Regulators generally agree that banks were too highly leveraged and that, in the future, banks should be required to have more capital. Discussion has turned to contingent capital (another form of hybrid capital) as a necessary component of capital going forward.

Contingent capital instruments are intended to provide a buffer for the financial institution issuers during times of stress. Commentators note that traditional hybrid securities, which were important financing tools for banks during the last decade, failed to absorb losses effectively during the crisis. Moreover, during times of stress, banks and other financial institutions found it difficult to access the market in order to bolster regulatory capital levels. Contingent capital instruments are intended to have loss-absorbing features. These instruments may take a variety of forms.

So far though, we have seen only one form, the Lloyd's Enhanced Capital Notes. The Lloyds instruments are debt securities that convert into equity if certain capital ratio levels are breached. Presumably the trigger would be low so that the instrument would convert early on in a crisis, mitigating the need for state intervention. In the Lloyds offering, the contingent capital instruments were offered as part of an exchange. So it is not clear how a new offering of contingent capital instruments would be received by investors and the yield that investors would exact in exchange for being subordinated (to equity) during a crisis.

There are a number of other open issues relating to contingent capital instruments. Regulators in the US and Europe are still formulating their views regarding the components of regulatory capital. Treatment accorded to contingent capital instruments will surely be a factor in these debates. Tax, accounting and rating agency treatment also will be important determinants that affect the future market for these products. As ever, the devil is in the details.