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Tear down this hybrid capital wall

Tracy Alloway Author alerts Sep 09 2009 08:56

The crackdown on hybrid capital begins and the Basel Committee on banking supervision is on the case.

From the FT:

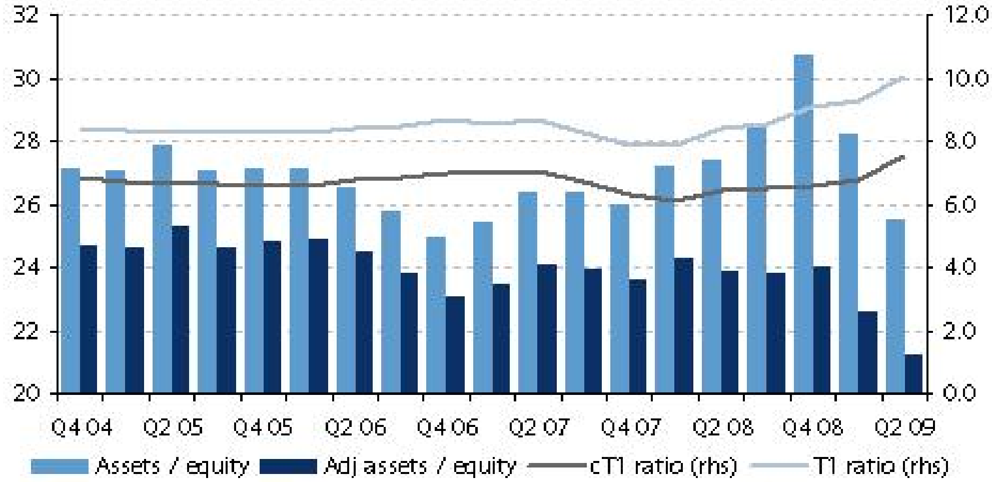
> The rules will force banks to substantially improve the quality and extent of the capital buffers they hold to absorb shocks. **At least half of the capital cushion must comprise common equity and retained earnings** under measures agreed by the powerful Basel committee of central bank governors and regulators, say people familiar with the discussions.
>
> The committee, whose meeting coincided with the G20, also agreed to put "hard" limits on how much banks can borrow. **It is likely to set a ceiling on borrowings of 25 times assets**. There will be no exceptions for less risky assets.

While the Basel Committee's proposals apply to banks in various regions, it's generally believed that Europe's financial institutions will be hardest hit given their higher exposure to the already beleaguered market for hybrid capital.

As a reminder, hybrid capital has qualities of both debt and equity and makes up banks' Tier 1 and Tier 2 regulatory under current Basel rules. Its inclusion in the capital, however, is and always has been rather controversial. The financial crisis has only worsened hybrids' reputation as the capital-type showed a remarkable inability to actually absorb losses. Hence, the European Commission forcing pain on hybrid bondholders via its `burden-sharing'.

Nevertheless, a number of banks have rushed to issue the hybrid stuff, which is still fairly cheap equity and non-dilutive to boot, in recent months — notably Deutsche Bank, Standard Chartered and Credit Agricole.

How then will Basel's new proposals affect banks? To start with, here's a useful chart from BarCap, showing European banks' (ex-UK) capital and leverage:



Asset/equity is a basic measure of leverage. According to BarCap the multiple has reduced significantly to about 25 times (left axis) over the past two quarters. Europe's banks are deleveraging and have, it would appear, already reached the Basel Committee's new leverage target.

The dark grey line corresponds to **core Tier 1 capital**, which is the common equity and retained earnings mentioned by the Committee, and excludes hybrids. European banks' core Tier 1 capital, then, is the highest it has ever been over the past four and a half years. The light grey line is **Tier 1**.

The weight of hybrids in European banks' capital bases (the difference between the two lines on the chart) has widened from 20 per cent at the end of 2004 to **25 per cent** in the second-quarter of 2009, BarCap says — though it's reduced slightly from about 28 per cent at the end of last year.

While Europe's banks have gone some way towards raising their core Tier 1 ratios and reducing their leverage, then, they have much further to go in terms of reducing the amount of hybrid debt in their capital base. If Basel decides to go all-out in its war against hybrid capital, something else will have to replace it.

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