Asian Bank Hybrid Capital

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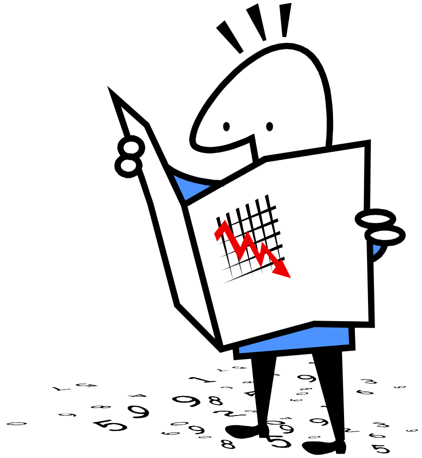
Where have all the investors gone?



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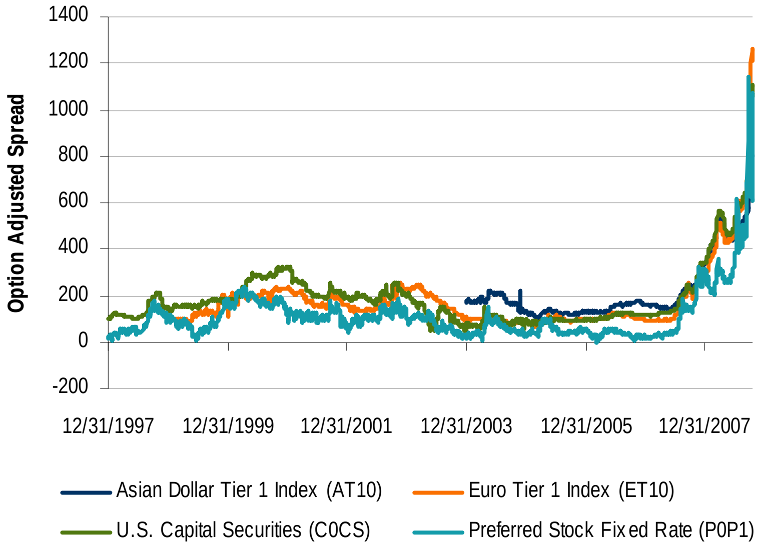
Overview

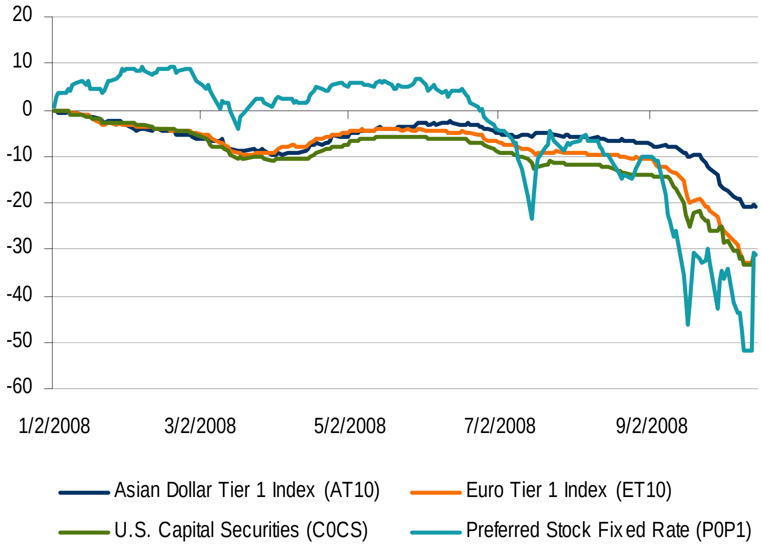
- A look at global hybrid tier 1 markets
- What has happened to investors of tier 1?
- How has this impacted Asian tier 1 markets?
- A look at the evolution of hybrid tier 1 securities in Asia
- What structural features do investors focus on when assessing value?
- What are the advantages of hybrid tier 1 for banks?
- How do ratings play a role? Could this change?

Globally, T1 is stressed & distressed

Spreads hit all-time wide levels



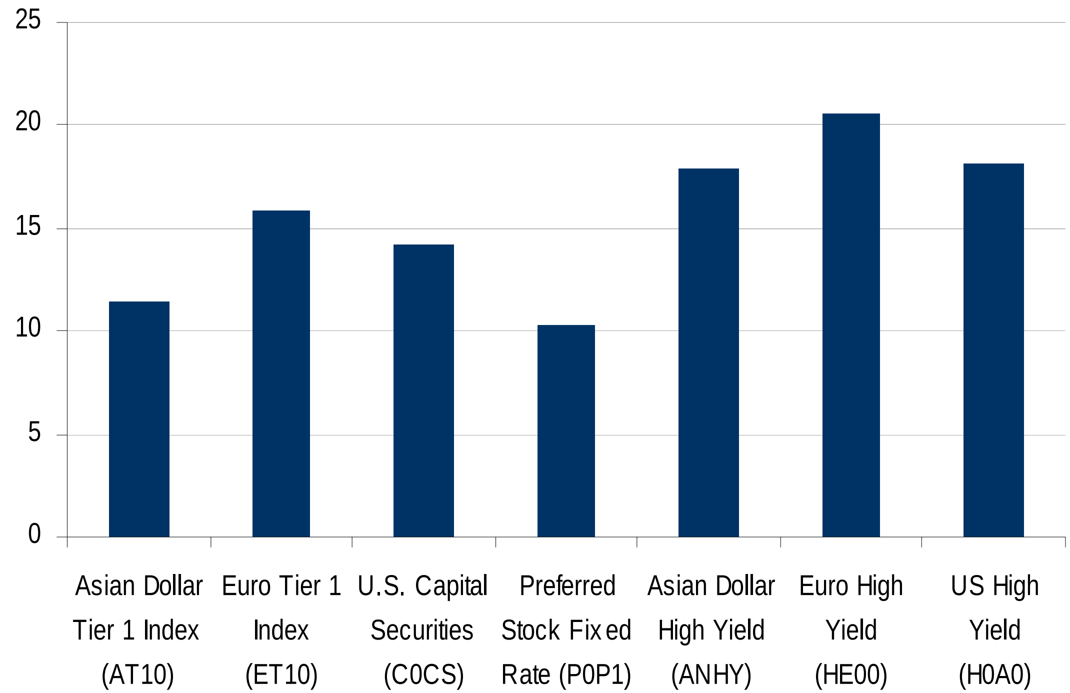
Excess returns worst ever



Source: Merrill Lynch

High grade ratings with “high yields”

Effective yields on par with HY bonds



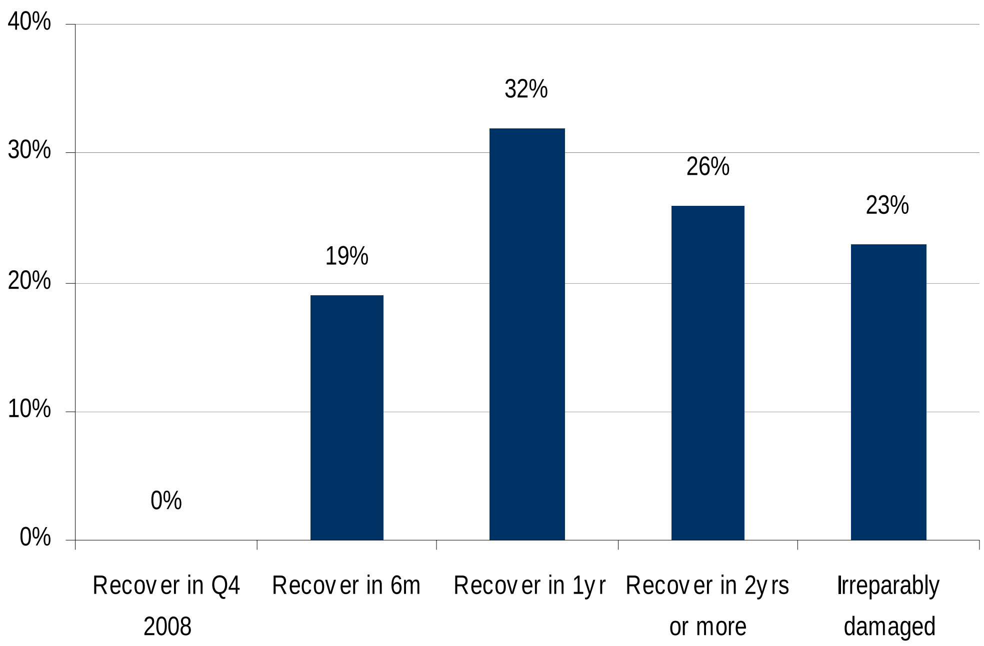
Source: Merrill Lynch

If T1 is cheap, where are the buyers?

- Still on strike…deferral risk a focus for investors, but more concerned about principal
- Impact of nationalizations/bankruptcies on preferred instrument holders:
  - Principal losses for investors in US institutions: Lehman, Fannie Mae, Freddie Mac, Wachovia, WaMu and investors in AIG preferred securities subordinated by line of credit, residual recovery value uncertain
  - Principal losses for investors in European banks: Bradford & Bingley, Icelandic banks, Roskilde and some preferred securities of Northern Rock
  - Some concern that government recapitalizations could result in the non-payment of hybrid tier 1 coupons; while more details still trickling out, it would appear that most government securities will rank pari passu with existing preferred instruments
- Mark-to-market – it's been a very painful ride down for institutional investors! Cash prices averaging about 65 cents (70-75 cents in Asia)
- Retail were buyers earlier this year but feeling the pain of falling stock markets (margin calls?)
- Return of investor confidence with Central Banks re-capitalizing the major banks? So far, cash prices up modestly but still few buyers and no issuance

Long time for recovery of T1 market?

Most European investors think it will take more than a year for the Euro T1 market to recover*

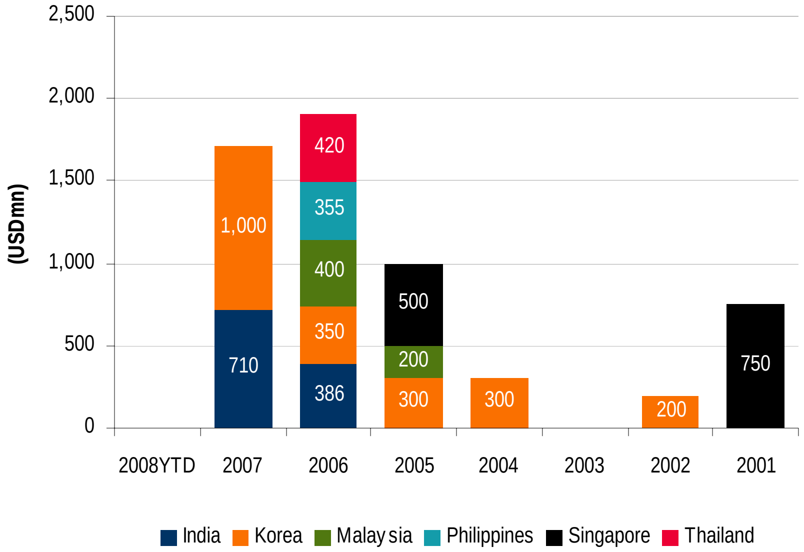


Source: Merrill Lynch

*Answer when asked “What do you think the prospects are for the Euro Bank T1 market? In our Credit Investor Survey: Life after defaults published 2 October 2008 by our European Credit Strategy Team

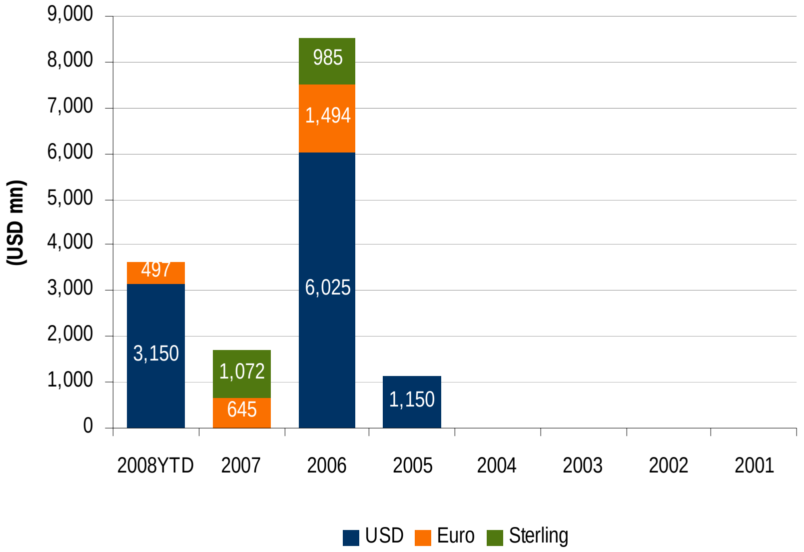
Asian T1 issuance (foreign currency)

Asia ex-Japan



Total outstanding: $5,871mn

Japan



Total outstanding: $15,018mn

Source: Bloomberg, Merrill Lynch

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Domestic markets an alternative?

- As spreads have widened in international markets, banks have turned to the local markets to raise T1
  - India: ICICI, Punjab Nat. Bk, Union Bk of India
  - Japan: Mizuho, MTFG
  - Korea: Shinhan, Woori
  - Malaysia: CIMB, Maybank
  - Philippines: BDO (Ps5bn convertible preferred shares)
  - Singapore: DBS, UOB, OCBC, Maybank
- Contagion from loss of confidence in global financial institutions has undermined local market issuance post Lehman bankruptcy
- Depth of domestic investor base uncertain

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The rise of bank capital in Asia

- Underlying credit fundamentals for Asian banks improved and ratings were on an upward trend between 2003 and early 2008
- Investors became more comfortable buying bank capital due to improving credit fundaments combined with the need for yield as credit spreads tightened
- Regulators created guidelines on hybrid tier 1 allowing banks access to new avenues of capital raising that would not lead to shareholder dilution and one that offers (or used to) a cheaper source of capital compared to equity

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Japan: Evolution of HT1

- Japan is the only Asian member of the Basel Committee and has had the longest experience with Hybrid Tier I in the region
  - — March 1998: allowed hybrid capital prior to Basel Committee agreement (so-called "OpCo" securities which had no mandatory deferral feature)
  - — Dec 1998: first Basel country to issue revised regulations based on the Basel Committee agreement
  - — 1998 - 2005: Yen private placements of Hybrid Tier I exceeding JPY 2.2 trillion (approx. US$22 billion)
  - — 2005: Resona Bank issued first international hybrid Tier I securities under post 1998 rules
  - — Japan has both 15% and 25% baskets for Hybrid Tier I: any Tier I with a step-up is limited to 15% of total Tier I, and Tier I issued with a pure call option and no step-up is limited to 25% of total Tier I

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Thailand: Evolution of HT1

- Thai banks first raised T1 in 1999 but the structure fell short of what is defined as hybrid tier 1 instruments today
  - March 1999: Bank of Thailand allowed commercial banks to include subordinated-cum-preferred shares and subordinated debentures for up to 1/3rd of their total Tier 1
  - 1999 onwards: Banks issued "SLIPS" and "CAPS" of about Bt90bn in total
  - June 1999: Bank of Thailand lowered the ceiling for any newly issued hybrid Tier 1 capital to 25% of total Tier 1
  - February 2006: Issues revised capital rules tightening hybrid definitions and lowering the hybrid Tier 1 limit to 15%
  - April 2006: TMB Bank raises first T1 bond under the newly revised capital guidelines
  - June 2006: The BOT issued clarification to the guidelines allowing a bank with retained earnings but a current loss (payment limitation condition) the ability (with regulatory approval) to pay the coupons

Hybrid Tier 1 in other Asian countries

- Singapore and Korea: Introduced regulations permitting SPV and direct-issue Hybrid Tier I
  - Singapore banks have only issued SPV Hybrid Tier I (first in 2001)
  - Korean banks have issued SPV and direct-issue Hybrid Tier I (first in 2001)
- Hong Kong and Taiwan regulators have issued rules allowing Hybrid Tier I securities but there has been no issuance
- Recent Malaysian regulations on innovative Tier I essentially follow Asian precedents but go one step further by allowing possibility of stock–settled distributions which have only been used by European banks. This allows an issuer to cumulate any deferred coupon and pay in the future in the form of an issuance of common stock, so the security is cumulative from the investor's perspective (first international in 2005)
- Philippine and Indian banks first raised T1 in 2006
- Singapore, Korea, Taiwan, and Hong Kong do not allow Hybrid Tier I beyond the 15% limitation while Malaysia recently issued a circular allowing banks to raise non-innovative Hybrid Tier 1 (non-step) of up to 35% of core capital

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How do investors assess value for T1?

- Investors will look at dividend stopper language, step-ups and structural features
- Areas of focus on structure include: whether coupon is cumulative or non-cumulative, mandatory deferral, mandatory conversion/substitution, replacement language, stock settlement and priority of claims
- A key focus for pricing is mandatory deferral language
  - How strong are the underlying fundamentals of the bank?
  - How easy is it to trigger the mandatory deferral?
- Step-ups could become more important as we get closer to call dates – generally the greater the step-up, the better for investors
  - Indian and Thai banks allowed max 100bps step-up by regulator
  - Currently all Asian T1 is trading wide of their back-end spreads
- There has been little focus on other loss absorption features but this may change as the Committee of European Banking Supervisors has been proposing less bondholder friendly features for future T1 securities

Mandatory deferral language

- Australia requires deferral on T1 if the bank has insufficient earnings (after-tax) in a financial year to cover distributions on T1 capital instruments (i.e. net loss)
- In Thailand the regulator requires mandatory deferral if no retained earnings and net loss; regulatory approval required if the bank has a net loss
- Japan, Malaysia, Philippine and Singapore require mandatory deferrals on T1 if they have no retained earnings or distributable profits (breach of CAR for Japan, Philippines and Singapore as well)
- Indian requires mandatory deferral if the banks breach CAR, regulatory approval required to pay if net loss (P&L definition)
- Mandatory deferral for Korean banks if they are classified as non-performing financial institutions

Easier to trigger deferral

Harder to trigger deferral

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Clarity of language is important!

- There can be confusion around mandatory deferrals as the result of vague regulatory/bond documentation language
- Bonds in the Philippines, Thailand and Malaysia use the language 'no obligation to pay' and 'shall not be liable to pay' which suggest an optional deferral where the Regulators infer mandatory deferral for coupon payments
- Example: TMB Bank T1 bonds were issued April 2006
  - Deferral language stating that the bank will not be obligated to make an interest payment if it does not meet the payment limitation condition. Investors assumed this was an optional deferral for the bank
  - On 1 June 2006 the BOT issued clarification to the guidelines which they viewed as a relaxation of the original guidelines by allowing a bank with retained earnings but a current loss (payment limitation condition) the ability (with regulatory approval) to pay the coupons
  - THAIML was given regulatory forbearance in January 2007 for payment of 1st coupon (IAS39) but was required to defer in July and December 2007

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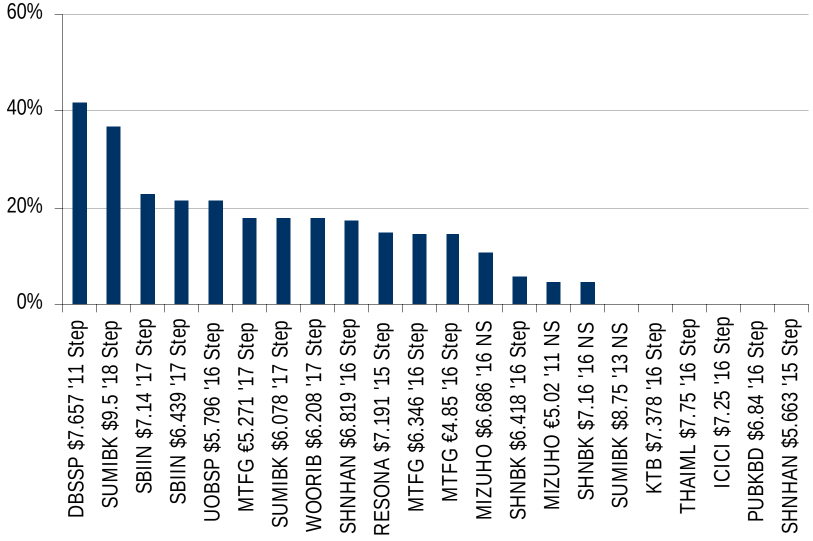
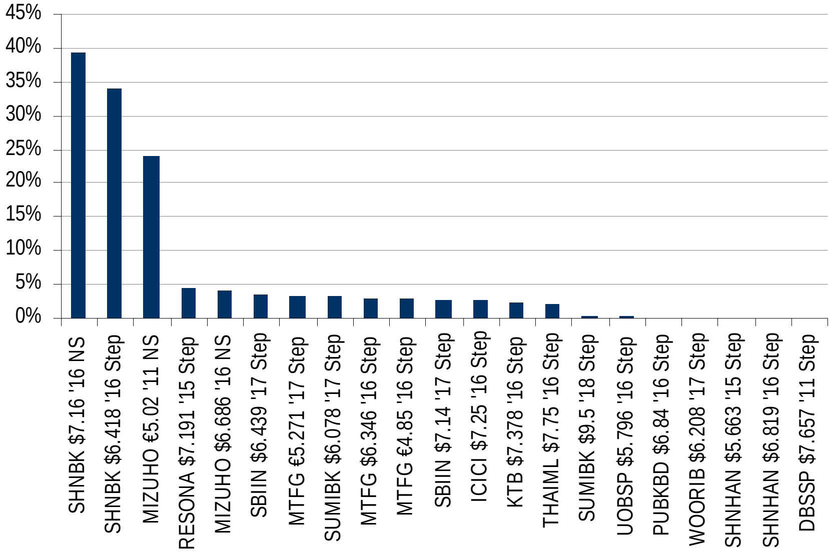
Will they or won't they call?

First call probabilities*



Probability of true perpetual*



Source: Merrill Lynch

*Using a ML proprietary non-step valuation model based on a Monte Carlo simulation of future spread paths under 300 scenarios. Assumes an economic call decision, when refinancing spreads are wider than the back-end spread under a given scenario. Model was run 17 September 2008.

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Big back-ends are favorable

Tier 1 bonds	Back-end (over Libor)	Current Spread (bid z-spread)	Difference
DBSSP $7.657 '11 Step	320	354	34
ICICI $7.25 '16 Step	294	1,666	1,372
KTB $7.378 '16 Step	327	1,364	1,037
MIZUHO $6.686 '16 NS	145.2	1,216	1,071
MIZUHO €5.02 '11 NS	147	1,237	1,090
MTFG $6.346 '16 Step	207	810	603
MTFG €4.85 '16 Step	205	993	788
MTFG €5.271 '17 Step	207	916	709
PUBKBD $6.84 '16 Step	230	612	382
RESONA $7.191 '15 Step	376	1,425	1,049
SBIIN $6.439 '17 Step	220	959	739
SBIIN $7.14 '17 Step	237	909	672
SHNBK $6.418 '16 Step	222	4,436	4,214
SHNBK $7.16 '16 NS	187	4,744	4,557
SHNHAN $5.663 '15 Step	199	927	728
SHNHAN $6.819 '16 Step	252	913	661
SUMIBK $6.078 '17 Step	205	744	539
SUMIBK $9.5 '18 Step	589	713	124
THAIML $7.75 '16 Step	313	2,167	1,854
UOBSP $5.796 '16 Step	174.5	465	290
WOORIB $6.208 '17 Step	204.4	1,159	955

Source: Merrill Lynch (Z-spread data as at 15 Oct 08)

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Call considerations

- Regulatory approval:
  - Banks require regulatory approval to call their T1 bonds
  - Regulators will consider strength of banks' capital positions in allowing bonds to be called back / may require replacement with higher quality capital
- Investor expectations:
  - **Non-step:** Decision to call is economic; bond spreads tend to be more volatile as interest rates move up and down
  - **Step:** Until recently, market has expected banks to call bonds even if uneconomic to do so in order to maintain access to the markets; Low back-ends and wide spreads increase uncertainty in the market re: extension risk
- Other considerations:
  - Government ownership (US/Europe); argument to keep outstanding bonds in place until public funds are re-paid
  - Redemption of non-step bonds may improve the overall quality of the capital remaining so why not call them?
  - Will banks need this weaker form of capital if we see an overall rise in T1 levels?

More focus on loss absorption?

- In recent years, language of institutional perpetuals in Europe have seen a steady drift away from bondholder friendly structures and language
  - UK and Swiss T1 now generally carries language that coupon payment is at the 'absolute discretion' of the bank or its board, meaning that coupons are treated more like distributions than fixed payments
  - French and Italian T1 now all have explicit loss absorption languages (all Nordic banks too as Roskilde illustrated)
- How does Asia stack up? Only Australia, HK, Malaysia, Singapore and Taiwan have other loss absorption features aside from deferral options
  - **Australia:** mandatory conversion to ordinary shares or non-cumulative irredeemable preference shares upon breach of capital ratios, regulatory directive or negative retained earnings
  - **HK, Singapore, Taiwan:** Mandatory conversion to non-cumulative preference shares upon breach of capital ratios
  - **Malaysia:** Write-down of instrument (direct issued) or mandatory conversion to equity (SPV issued) upon breach of capital ratios, regulatory event or winding up

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Why banks issue Hybrid Tier I

Hybrid Tier 1

- Fixed coupon payments (subject to suspension)
- Coupons senior to dividends on ordinary shares
- Coupons could be structured to be tax-deductible
- Fixed and pre-determined redemption/liquidation values (par)
- No shareholder meeting required to redeem (but regulatory approval)
- In liquidation, senior to ordinary shares
- **No voting rights (in most cases)**
- **Non-dilutive**
- **Can be denominated in foreign currency**

Ordinary Shares

- Variable dividends based on available distributable profits. Strict participation in profits
- No liquidation claim
- Dividends not tax-deductible
- Shareholder meeting required to redeem
- Subordinated in liquidation to all other securities and obligations
- **Voting rights**
- **Dilutive**
- **Only denominated in the home currency**

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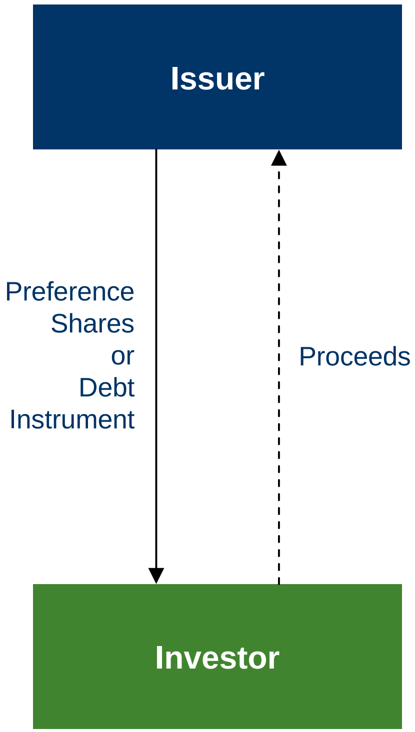
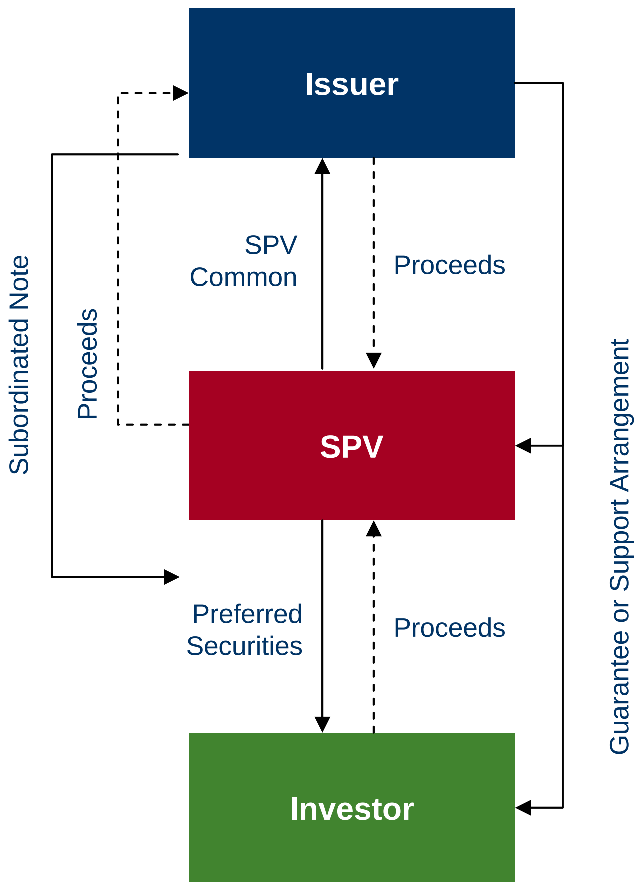
Direct issued securities

- **Security:** Direct issue of perpetual non-cumulative preference shares or perpetual debt instruments structured to meet applicable tax, regulatory and corporate law requirements
  - Could be treated as debt or equity on the Issuer's balance sheet depending on the terms of the securities and the relevant accounting standard
  - Bank regulators in many countries now allow Tier 1 treatment for debt securities if the loss absorption and other conditions provide sufficient equity-like features



SPV issued securities

- **Security:** SPV issued perpetual non-cumulative preferred securities or shares
  - Originally structured so that the Issuer would consolidate the SPV and Issuer's consolidated balance sheet would present the preferred securities as "minority interest"
  - Depending on the features of the instrument held by investors and the relevant accounting standard, the instrument would be classified as equity or debt in the consolidated balance sheet of the Issuer
- **Vehicles:** Cayman Companies, Jersey Partnerships, Jersey Companies, REITs, US Limited Liability Companies, US Trusts, US Partnerships
  - Tax efficiency is usually a key factor in choosing the vehicle



SPV vs direct structures - Malaysia

- AmBank and Southern Bank (now CIMB Bank) issued T1 via SPV while Public Bank issued its T1 directly
- Key structural differences include:
  - **Maturity:** Direct structure dated, SPV structure perpetual
  - **Coupon:** Coupon for direct structure is cumulative subject to deferral limit (50% of principal) and written approval of BNM, non-cumulative for SPV structure
  - **Mandatory deferral:** None for direct structure; SPV structure has mandatory deferral based on insufficient distributable reserves
  - **Substitution/loss absorption:** Direct structure could see bonds cancelled while SPV structure has mandatory conversion feature (into equity) on breach of capital ratios, regulatory event or winding up
  - **Stock settlement:** Direct structure has principal/interest stock settlement features while SPV structure does not
  - **Replacement language:** Direct structure has none, SPV structure does
- Features of direct issue T1 more debt-like due to tax considerations

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Rating agency notching for T1

Notching guidelines below senior unsecured ratings

Moody's	S&P	Fitch
BFSR C- or better: *+2 notches*	Investment grade: *+2 notches*	Individual rating A to C: *0 notches*
BFSR D or below: *+3 notches*	Non-investment grade: *+3 notches*	Individual rating C/D: *+1 notch*
		Individual rating D: *+2 or more notches*
		Individual rating D/E: *+3 or more notches*
		Individual rating E: *+4 or more notches*

- Notching can change if the potential for deferral rises
  - Japanese OPCO securities were, at one point, as much as 5 notches below senior ratings
  - TMB Bank's T1 securities were rated 4 notches below the senior rating by Fitch (currently 3), 5 notches by Moody's and 7 notches by S&P (currently 3) after the deferral
- Potential for updated notching guidelines as regulators/governments have taken a very harsh line on bank capital in the US and Europe

Getting equity credit from agencies

- Moody's puts securities in baskets A (most debt-like) to E (most equity-like) which infers the amount of equity credit that the securities will be given
  - Banks' capital levels are assessed using Tangible Common Equity + Hybrid Equity Credits to Risk-Weighted Assets
  - Most Asian HT1 falls into the B bucket (more debt-like) with some in C bucket (Singapore)
- S&P could infer a certain amount of equity credit for HT1 securities on a high, intermediate and minimal basis but is limited
  - Up to 50% of HT1 will be incorporated into their "ATE Ratio"
- In the US market, instruments getting higher equity credit from the rating agencies (usually Moody's) have been used for capital management purposes (buying back shares) at the bank holding company level

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Features of Asian Bank Hybrid Tier I Instruments

	Australia	Hong Kong[1]	India	Japan (Current)	Japan (OPCO)[2]
Issue Format	SPV preference shares	SPV preference shares	Direct-issue debt	SPV preference shares	SPV preference shares
Minimum maturity	Perpetual	Perpetual	Perpetual	Perpetual	Perpetual
Subordination	Senior to ordinary shares, pari passu with preference shares	Senior to ordinary shares, pari passu with preference shares	Senior to preference and ordinary shares	Senior to ordinary shares, pari passu with preference shares	Senior to ordinary shares, pari passu with preference shares
Maximum step-up	100bps or half of initial credit spread	100bps or half of initial credit spread	100bps	100bps or half of initial credit spread	Varies
Mimimum interval before step-up	10 years	10 years	10 years	10 years	10 years
Cumulative/Non-cumulative coupon	Non-cumulative	Non-cumulative	Non-cumulative	Non-cumulative	Non-cumulative
Optional coupon deferral	If no dividends on equity (or parity securities)	If no dividends on equity (or parity securities)	None	If no dividends on equity (or parity securities)	If no dividends on equity (or parity securities)
Mandatory coupon deferral	Insufficient earnings (after-tax) in a financial year to cover distributions on Tier I capital instruments related to that financial year (ie, no distributions out of retained earnings)	Insufficient distributable reserves	Mandatory deferral if in breach of capital ratio; regulatory approval needed to pay coupon if net loss (current) but in compliance with capital ratios	Non-payment of preference share dividends, insufficient distributable reserves, breach of capital ratio, insolvency, or liquidation	None
Other loss absorption features	Mandatory conversion to ordinary shares or non-cumulative irredeemable preference shares upon breach of capital ratios, regulatory directive, or negative retained earnings	Mandatory conversion to non-cumulative preference shares upon breach of capital ratios	None	None	None

Source: Central Banks and other various sources; 1 No HT1 precedents outstanding, 2 Four Japanese banks issued US$ HT1 in 1998 prior to current regulations

	Korea	Philippines	Malaysia	Singapore	Thailand	Taiwan[1]
Issue Format	SPV preference shares or Direct-issue debt	Direct-issue debt	SPV preference shares or direct-issue debt	SPV preference shares or direct-issue debt	Direct-issue debt	Direct-issue debt
Minimum maturity	Perpetual (30 year rolling)	Perpetual	Perpetual	Perpetual	Perpetual	Perpetual
Subordination	Senior to ordinary shares, pari passu with T1 preference shares	Senior to ordinary shares, pari passu with most senior class or classes of issued preference shares	Senior only to all equity shareholders	Senior to ordinary shares, pari passu with preference shares	Senior only to ordinary shareholders, subordinated to all T2 and other debt	Senior to ordinary shares, pari passu with preference shares
Maximum step-up	100bps or half of initial credit spread	100bps or half of initial credit spread	100bps, less the swap spread between the initial index basis and the stepped-up index basis or half of initial credit spread	100bps or half of initial credit spread	100bps	100bps or half of initial credit spread
Mimimum interval before step-up	10 years	10 years	10 years	10 years	10 years	10 years
Cumulative/Non-cumulative coupon	Non-cumulative	Non-cumulative	Non-cumulative although interest/dividends cumulative in the form of stock settlement may be considered on a case-by-case basis	Non-cumulative	Non-cumulative	Non-cumulative
Optional coupon deferral	If no dividends on equity (or parity securities)	If no dividends on common stock	If no dividends on equity (or parity securities)	If no dividends on equity (or parity securities)	None	If not dividends on equity (or parity securities)
Mandatory coupon deferral	FSC classification as non-performing financial institution or certain other regulatory measures	Mandatory deferral if breach of capital ratio or insufficient distributable reserves	Insufficient distributable reserves (retained earnings)	Breach of capital ratio, other regulatory restriction, or insufficient distributable reserves	Mandatory deferral if net loss and retained loss; regulatory approval to pay coupon if net loss	If no earnings in prior fiscal year and no dividend paid on ordinary shares
Other loss absorption features	None	None	Write-down of instrument; or mandatory conversion to equity upon breach of capital ratios, regulatory event or winding up	For SPV issuance, mandatory conversion to non-cumulative preference shares upon breach of capital ratios	None	Mandatory conversion to non-cumulative preference shares upon breach of captial ratios