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Briefing note

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A capital outcome: CoCos can be redeemed

The Court of Appeal has decided that, on the interpretation of the relevant terms, a bank is entitled to redeem convertible contingent securities if those securities cease to help the bank to pass the Prudential Regulation Authority's stress tests. In reaching this conclusion, the Court drew heavily on the function of regulatory capital and the changing rules surrounding capital, rejecting the argument that these complex matters were beyond the knowledge of retail investors. Regulatory capital instruments are for sophisticated investors only, who are presumed to understand the function of the instruments they buy and to be able to correct obvious mistakes in the terms and conditions.

LBG Capital No 1 plc v BNY Mellon Corporate Trustee Services Ltd [2015] EWCA Civ 1257 posed a common problem: how should contractual terms drafted against a particular regulatory or other background be construed when that background changes? In particular, bank capital requirements have continually evolved since the global financial crisis, though always in the direction of greater strictness. What constitutes a valuable form of capital instrument at one time may be less attractive later as requirements change.

The question in *LBG Capital* was whether the changes in the capital regime were sufficient, as a matter of interpretation, to trigger a right of redemption of the capital instruments. Could the bank redeem the instruments, avoiding their high cost when they that had ceased to meet the bank's needs? Or were the investors entitled to continue to receive the high yield paid on the instruments?

The Court of Appeal was satisfied that the commercial purpose of any capital issue was essential to understanding how the terms of the notes would be understood, even if, as in *LBG Capital*, the wording of the notes had gone awry. The commercial purpose of the instruments had disappeared as a result of changes in the regulatory regime and so, on the wording, the bank could redeem the instruments.

Background

In 2009, the bank issued Enhanced Capital Notes to a large number of investors, including retail investors. Under the regulations then applicable, these ECNs constituted lower tier 2 capital on issue, but they converted into the top tier of capital, core tier 1, if the bank's core tier 1 ratio fell to 5% (ie if the ratio of the bank's core tier 1 capital to its risk weighted assets was below 5%). Banks were at that time required to have a core tier 1 ratio of at least 4%. As a result, the ECNs helped the bank pass the regulator's stress tests because if the bank's core tier 1 ratio fell below 5% in the test, the ECNs were treated for the purposes of the test as having been converted and thus boosted the level of the bank's core tier 1 capital.

The terms of the ECNs recognised that the regulatory environment might change and that the ECNs might no longer provide this cushion. As a result, if a Capital Disqualification Event occurred, the bank could redeem the ECNs. The definition of this Event is set out in the Box on this

Key issues

- CoCos can be redeemed despite a mistake in the drafting
- CoCos are not taken into account on stress tests if they no longer help pass the tests
- Investors are treated as sophisticated because the offering memorandum said that only sophisticated investors should buy

page, but, in summary, under the second limb of the definition, the bank could redeem the ECNs if they ceased to be "taken into account" for the purposes of a stress test.

Regulatory capital requirements in 2015 are significantly stricter than they were in 2009 as a result of the Third Basel Accord, translated into EU law by the Capital Requirements Regulation (EU/575/2013). For example, core tier 1 capital has been replaced by the more limited common equity tier 1 capital; the common equity tier 1 equity ratio must be at least 4.5% and Additional Tier 1 capital has been introduced. AT1 must convert to common equity tier 1 if the common equity tier 1 ratio falls below 5.125%.

Capital Disqualification Event

- a "Capital Disqualification Event" is deemed to have occurred (1) if at any time [the bank] is required under Regulatory Capital Requirements to have regulatory capital, the ECNs would no longer be eligible to qualify... for inclusion in the Lower Tier 2 Capital of [the bank]... or (2) if as a result of any changes to the Regulatory Capital Requirements... the ECNs shall cease to be taken into account in whole or in part... for the purposes of any "stress test" applied by the FSA in respect of the Consolidated Core Tier I Ratio.
- "Core Tier 1 Capital" means core tier one capital as defined by the FSA as in effect and applied... as at 1 May 2009.
- "Regulatory Capital Requirements" means any applicable requirement specified by the FSA in relation to minimum margin of solvency or minimum capital resources or capital.

In addition, the ECNs were expensive for the bank. A voluntary exchange of some £5 billion of the ECNs into AT1 capital took place in 2014, but £3.3 billion of the ECNs remained outstanding. These ECNs paid an average interest rate of 10.33%, far above what the bank would have to pay in 2015 to obtain comparable capital.

In December 2014, the bank's regulator, the PRA, undertook a common equity tier 1 stress test. The ECNs had no impact on the outcome of that test for two reasons. First, because of the changes in the definitions, a 4.5% common equity tier 1 ratio works out at higher than a 5% core tier 1 ratio. As a result, the bank's common equity tier 1 ratio could fall to 4.5% but the ECNs would not at that point convert into equity to boost the ratio. Secondly, the bank's common equity tier 1 ratio did not in fact fall in the stress tests to a level equivalent to a 5% core tier 1 ratio under the old regulations that would have triggered the conversion of the ECNs.

In these circumstances, the bank understandably contended that a Capital Disqualification Event had occurred and, as a result, that the bank was entitled to redeem the ECNs. Equally understandably, the trustee of the ECNs, on behalf of the noteholders, contended that a Capital Disqualification Event had not occurred. At first instance ([2015] EWHC 1560 (Ch)), the Chancellor of the High Court agreed with the noteholders, but the Court of Appeal has overturned his decision, deciding that the bank is entitled to redeem the ECNs.

The case raised two principal points on the interpretation of the terms applicable to the ECNs: first, whether the PRA's December 2014 stress test was a stress test within the meaning of the definition of Capital Disqualification Event; and, secondly, whether the ECNs had ceased to be "taken into account" in that stress test.

When is a stress test not a stress test?

The trustee's argument was that the definition of Capital Disqualification Event required a stress test "in respect of Consolidated Core Tier 1 Capital", which was defined by reference to core tier 1 capital in effect on 1 May 2009. The PRA's December 2014 stress test was not in respect of core tier 1 capital but was in respect of common equity tier 1 capital. As a result, the PRA's stress test was not relevant.

Both the Chancellor and the Court of Appeal agreed that, on the literal wording of the ECNs' terms, the trustee's argument was correct. However, they considered this to be an obvious mistake in the drafting, which they corrected as a matter of interpretation.

The courts can correct drafting mistakes through the process of interpretation (as opposed to rectification) if it is clear that something has gone wrong with the language and it is also clear what a reasonable person would have understood the parties to have meant (*Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38).

In this case, at the time of issue of the ECNs it was common knowledge that the regulators were going strengthen the capital requirements for banks, which might include changing the definition of the highest tier of capital. The ECNs were long-dated notes, and the redemption right cannot conceivably have been intended to be available only while the 2009 definition of core tier 1 capital remained in effect. The drafting mistake was the use of the definition of Core Tier 1 Capital. This definition provided the noteholders with certainty as to when the ECNs would convert automatically into equity, but it was a mistake to use it in the definition of Capital Disqualification Event.

As a result of this mistake, the Court of Appeal, like the Chancellor, interpreted the Capital Disqualification Event as referring not to a stress test applied in respect of the Consolidated Tier 1 Ratio but to a stress test of the top tier of loss absorbing capital (as defined by the regulator from time to time).

Legally or practically taken into account?

The issue upon which the Court of Appeal disagreed with the Chancellor was as to what it meant for the ECNs to "be taken into account" for the purposes of a stress test. The Chancellor considered that the ECNs would only cease to be taken into account if they were disallowed in principle, which was not the case. The ECNs were not relevant to the PRA's stress test because the bank's ratio did not reduce to a level at which the ECNs converted, but that factual scenario was not enough to trigger the right of redemption.

Having reviewed at length the regulatory environment from 2008 to 2015, the Court of Appeal concluded that the ECNs ceased to be taken into account for the purposes of a stress test if the ECNs ceased to be capable of contributing to the bank's ability to meet the relevant ratio in the stress test. The Court of Appeal considered that it was clear from various regulatory statements and from the offering memorandum for the ECNs that clearing the relevant hurdle – whether the core tier 1 ratio or the common equity tier 1 ratio – was critically important to the bank in order to avoid costly action to satisfy the regulators. The prime function of the ECNs was to enable the bank to do this.

"A potential investor should not invest in ECNs unless it has the expertise,,, to evaluate how the ECNs will perform under changing conditions."

This was reinforced by first limb of the definition of Capital Disqualification Event, which referred to the ECNs ceasing to be "eligible" for capital purposes. This contrasted with the ECNs ceasing to be "taken into account" under the second limb. The changes in the regulatory requirements meant that the bank could never rely on the ECNs in order to avoid breaching the relevant ratio, and thus they ceased to be taken into account for that purpose, even though they remained eligible.

The Court of Appeal also rejected the argument that the holders of the ECNs, who included retail investors, could not reasonably be expected to have understood the complexities of the regulatory capital regime and thus take it into account when seeking to interpret the terms of the ECNs.

The offering memorandum was clear that the ECNs were highly sophisticated and complex financial instruments, and that a decision to invest should only be taken after informed and detailed consideration of the risks surrounding the investment, including how the ECNs would perform under changing conditions. The reasonable reader of the ECNs – in whose shoes the courts seek to interpret the ECNs – should be taken to be someone having an informed understanding, whether on his own or with the assistance of a financial adviser, of the working of the relevant markets, the regulatory background, the use of stress tests and the function that the ECNs were intended to fulfil. (The FCA has since prohibited the sale of instruments such as the ECNs to retail investors.)

With that knowledge, the reader of the definition of Capital Disqualification Event would have understood that it intended to allow redemption of the ECNs if the ECNs no longer helped the bank to meet the required capital ratio and therefore to pass the stress test.

Conclusion

The Court of Appeal's judgment runs to 53 pages (Gloster LJ's judgment filling 52 of those pages), of which well over half is devoted to reciting the regulatory situation before and at the time of the issue of the ECNs and its subsequent evolution up to the December 2014 stress tests. It is only once this "voluminous and technical background detail has been trawled through", in the words of Briggs LJ, that the question for the court could be understood and answered: must the ECNs play a part in enabling the bank to pass regulatory stress tests (which they did not); or is it sufficient that the ECNs are taken into account for some purpose in the stress tests (which they were).

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Briggs LJ said that he had vacillated as to the correct answer, but all three members of the Court of Appeal ultimately considered that the sophisticated investors who purchased the ECNs would have understood, both from the wording of terms and from the background, that the purpose of the ECNs was to help the bank to pass its stress tests. When the ECNs ceased to fulfil that function, the bank could redeem them.

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