



Hybrid Tier 1 Capital – Opportunities for Indonesia

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Hybrid Tier 1 Overview

Origins of Hybrid Tier 1 Capital

- Historically, bank Tier 1 capital was mainly comprised of
 - ▶ common equity and retained earnings
 - ▶ preference shares
 - ▶ minority interest
- Hybrid Tier 1 developed as a core Tier 1 alternative that is treated as Tier 1 capital for regulatory purposes but has certain features of debt securities
 - ▶ Non-voting / Non-dilutive
 - ▶ Issuers may achieve a lower cost of capital or other benefits
- Prior to June 1998 there was no international consensus on hybrid capital, but certain countries began to allow it to be treated as Tier 1 capital on a case-by-case basis
- In June 1998, the Basel Committee on Banking Supervision published guidelines allowing certain hybrid securities to qualify as Tier 1 capital
 - ▶ However, each country has its own regulations and there is variation in the interpretation of the guidelines

Comparison of Hybrid T1 & Ordinary Shares

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
- In liquidation, senior to Ordinary Shares
- No voting rights
- 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

Regulatory Capital Spectrum – Basel Standard

Lower Tier 2

- **Dated** - 5 year minimum maturity - amortisation of benefit 5 years prior to maturity
- Coupon deferral - not required, non-payment of coupons (and/or principal) constitutes event of default
- Loss absorption - subordination
- Ranking in liquidation - coupon payments and principal redemption are **subordinated** to senior creditors
- Issuer's option to call securities with prior approval of the bank regulator (no approval required at maturity)
- Step Up limited

Upper Tier 2

- **Perpetual** typically
- Coupon deferral - Issuer has **option to defer coupon** payments if Issuer does not pay dividends on its junior securities, preference or ordinary shares; **deferred interest accumulates**
- Loss absorption - subordination; coupon deferral
- Ranking in liquidation - principal redemption and coupon payments **subordinated** to senior creditors and Lower Tier 2 in most countries
- Issuer's option to call securities with prior approval of the bank regulator
- Step Up limited

Hybrid Tier 1

- **Perpetual**
- Coupon deferral - Issuer has option to forego payments if Parent Bank does not pay dividends on its common stock; coupons are **non-cumulative**
- Loss absorption - subordination; coupons may be missed
- Ranking in liquidation, principal redemption and dividend payments **subordinated to all creditors, including Upper and Lower Tier 2**, but senior to ordinary shares
- Issuer's option to call securities with prior approval of the bank regulator
- Step Up limited

Key Equity Features of Hybrid Tier 1

Feature	Description
“Deeply subordinated”	<ul style="list-style-type: none">• Senior to ordinary shares but subordinated to all debt, including Tier 2• Depositor protection: subordinated to all depositors
“No maturity”	<ul style="list-style-type: none">• Perpetual securities
“Loss absorption”	<ul style="list-style-type: none">• Going concern: Able to absorb losses of the bank (ability to suspend dividends or coupons)• Liquidation: Deep subordination
“Non-cumulative”	<ul style="list-style-type: none">• Suspended dividends or coupons are not paid in the future

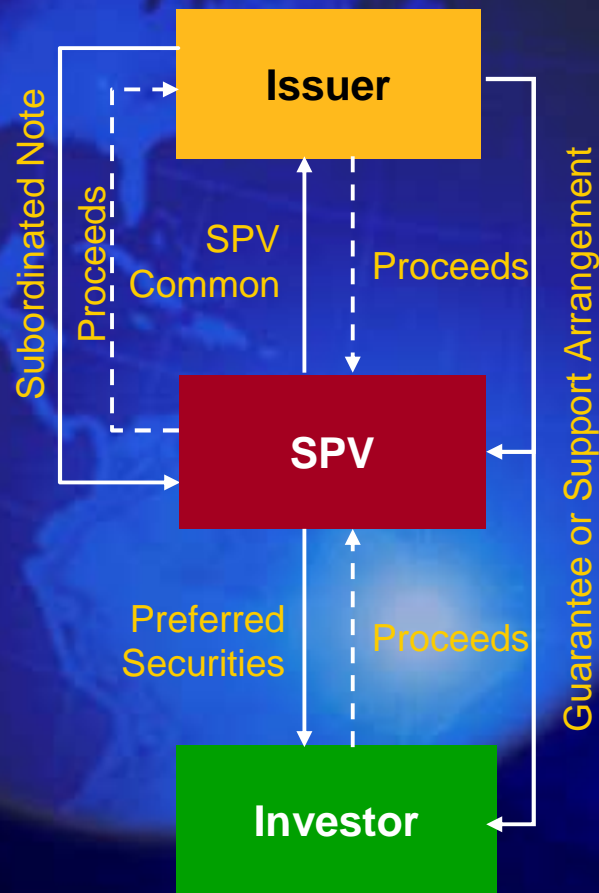
“No maturity”

- Call options are allowed, usually beginning 5 or 10 years after issuance
 - ▶ Regulatory approval is typically required for redemption
- Coupon “step-up” is allowed with certain restrictions
 - ▶ 1998 Basel Guidelines explicitly allowed step-ups
 - ▶ At least 10 years from initial issuance
 - ▶ No more than 100 basis points or $\frac{1}{2}$ the initial credit spread (in each case on a swap-adjusted basis)
 - ▶ Hybrid Tier 1 with a step-up may not exceed 15% of total Tier 1
 - ▶ Economic incentive for issuer to redeem securities at the first call date, since higher cost if not redeemed
 - ▶ Institutional investors in Hybrid Tier 1 securities typically require an expected redemption date
- Note some exceptions: German “silent partnership” Tier 1 may have a fixed maturity date and US bank holding companies are able to issue Tier 1 cumulative trust preferred securities with a 30 year fixed maturity (within certain limits), although a step-up is not allowed

“Non-Cumulative”

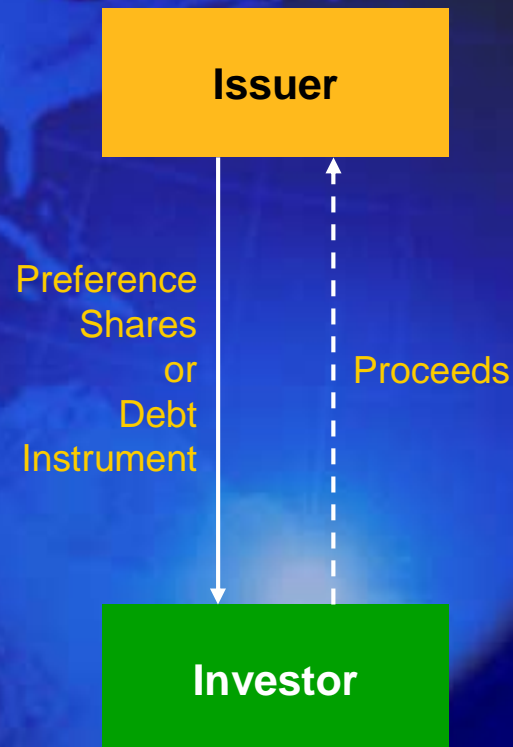
- Hybrid Tier 1 securities typically allow non-cumulative suspension of coupons / dividends in certain situations
 - ▶ “optional” suspension is usually allowed if common stock dividends are stopped
 - ▶ “mandatory” suspension is usually required for failing to meet capital ratios or certain other regulatory standards
- “Cumulative” stock settled deferred distributions (also called “alternative coupon settlement mechanism”):
 - ▶ Allows an issuer to cumulate any deferred coupon and pay in the future in the form of an issuance of common stock
 - ▶ Cumulative from investor perspective
 - ▶ Non-depletive to capital from regulatory perspective
 - ▶ bank has full discretion to stop cash outflow (“non-cumulative”)
- Stock settled distributions are allowed in UK, Netherlands and Belgium
 - ▶ Note: necessary in direct issued debt structures to be respected as debt and to achieve deductibility in many countries

SPV Issued Structure



- 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

Direct Issue Structure



- 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

Accounting Considerations - IFRS

A perpetual security is treated as either debt or equity

- IAS 32 “Financial Instruments” provides the accounting criteria
True or False: The issuer has an “unconditional right to avoid paying cash or financial assets to settle the obligation”:

True:	Equity
False:	Debt

- Additional criterion: The holder of equity must have a residual interest in the assets of the issuer after deducting all liabilities
- Regulators, rating agencies and tax authorities can have different criteria so classification can differ for different purposes

Under IAS 39, hedge accounting only applies to Debt instruments

- Banks typically view debt accounting as more advantageous for hybrid Tier 1

Hybrid Tier 1 in Asia

- Japan is the only Asian member of the Basel Committee and has had the longest experience with Hybrid Tier 1
 - ▶ March 1998: allowed hybrid capital prior to Basel Committee agreement (so-called “OpCo” securities)
 - ▶ Dec 1998: first Basel country to issue revised regulations based on the Basel Committee agreement
 - ▶ 1998 ~ 2005: Yen private placements of Hybrid Tier 1 exceeding JPY 2.2 trillion (approx. US\$22 billion)
 - ▶ 2005~2006: International hybrid Tier 1 securities under post 1998 rules (Resona, Shinsei, Mizuho, MUFG)
- Japan has both 15% and 25% baskets for hybrid Tier 1: any Tier 1 with a step-up is limited to 15% of total Tier 1, and Hybrid Tier 1 issued through a SPV is limited to 25% of total Tier 1

Hybrid Tier 1 in Asia

- Singapore, Korea, Malaysia: introduced regulations permitting SPV and/or direct-issue Hybrid Tier 1
 - ▶ Singapore banks have only issued SPV Hybrid Tier 1
 - ▶ Korean banks have issued SPV and direct-issue Hybrid Tier 1
 - ▶ Malaysian banks have issued SPV Hybrid Tier 1
- Hong Kong and Taiwan have introduced rules allowing Hybrid Tier 1 securities but there has been no issuance
- Recently, Thailand and India have introduced Hybrid T1 regulations but there have not been any issuances to date
- Singapore, Korea, Malaysia, Hong Kong, Taiwan, Thailand and India do not allow hybrid Tier 1 beyond the 15% limitation



Issuance Opportunities

Institutional Markets

Investor Profile

- The institutional investor base typically requires a “synthetic maturity” in the form of a step-up in the coupon rate after 10 years.
- This gives institutional investors some comfort that the securities will be redeemed, so the security is priced using the 10-year bond as a benchmark.
- To ensure that the step-up is based on then-current interest rates, the security is typically structured as fixed rate for 10 years and, if not redeemed, then as a floating rate at the higher step-up spread thereafter.
- The institutions active in this market are located in the US, Europe and Asia.

Offering Features

- Perpetual, NC-10 with step-up
- Priced on 10yr benchmark
- Reg S [for larger issues, 144A]

Institutionally Targeted Distribution

March 9, 2006

\$2,300,000,000
 €750,000,000
 ¥120,000,000,000



MUFG

Mitsubishi UFJ Financial Group

6.346% PerpNC10 Step-up Preferred Securities

4.850% PerpNC10 Step-up Preferred Securities

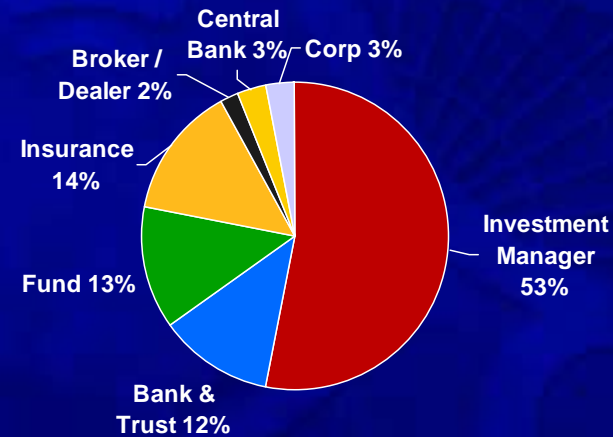
2.680% PerpNC5 Step-up Preferred Securities

Note Price 100%

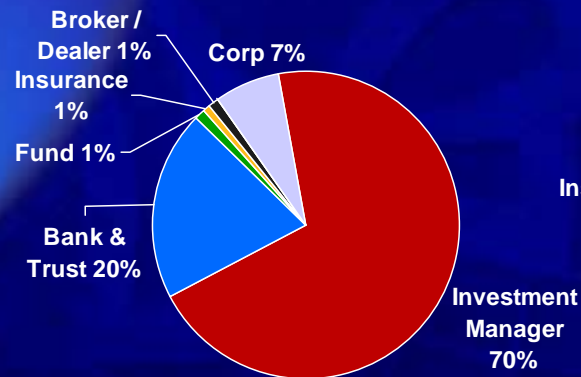
Global Coordinator
 Joint Bookrunner



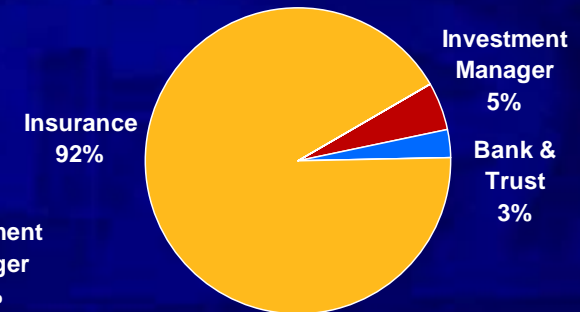
USD



EUR



JPY



Retail Markets

Investor Profile

- Retail investors do not require a step-up in interest rate and will purchase perpetual instruments with purely fixed coupons if the yield is attractive.
- There are active retail markets in both US and Europe (but US market requires SEC registration and European market mainly local issuers)
- Over the last few years, a new Asian retail market has developed which is focused on high-net-worth individual investors accessed through private bank networks. This market is very receptive to Asian issuers, although to date the issuers have been primarily from outside Asia

Offering Features

- Perpetual, NC-5 with no step-up (“true perpetual”)
- Priced on a 30yr benchmark but investor focus on absolute yield
- Reg S only

Retail Targeted Distribution

May 26, 2005

US\$300,000,000

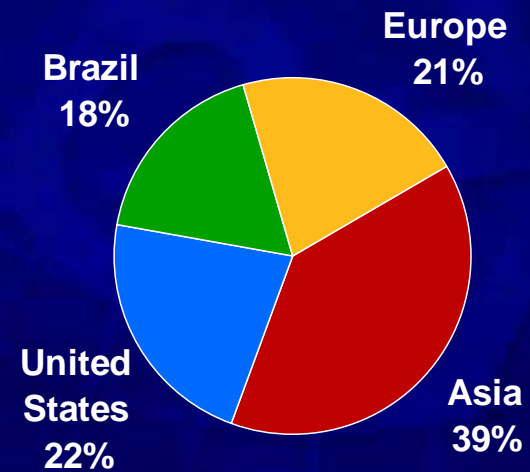
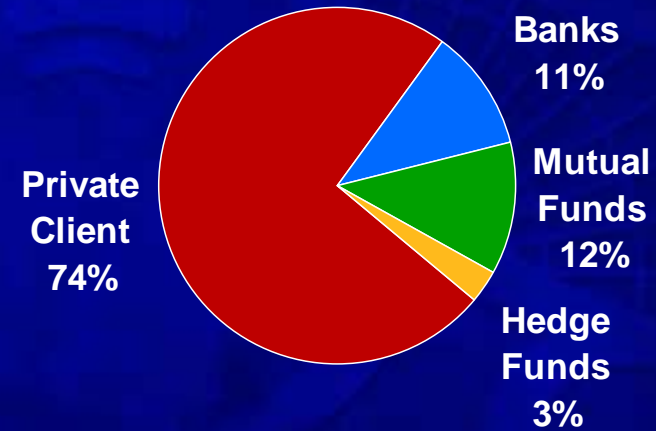


Banco Bradesco S.A.

8.875% Perpetual NC5
with No Step-up

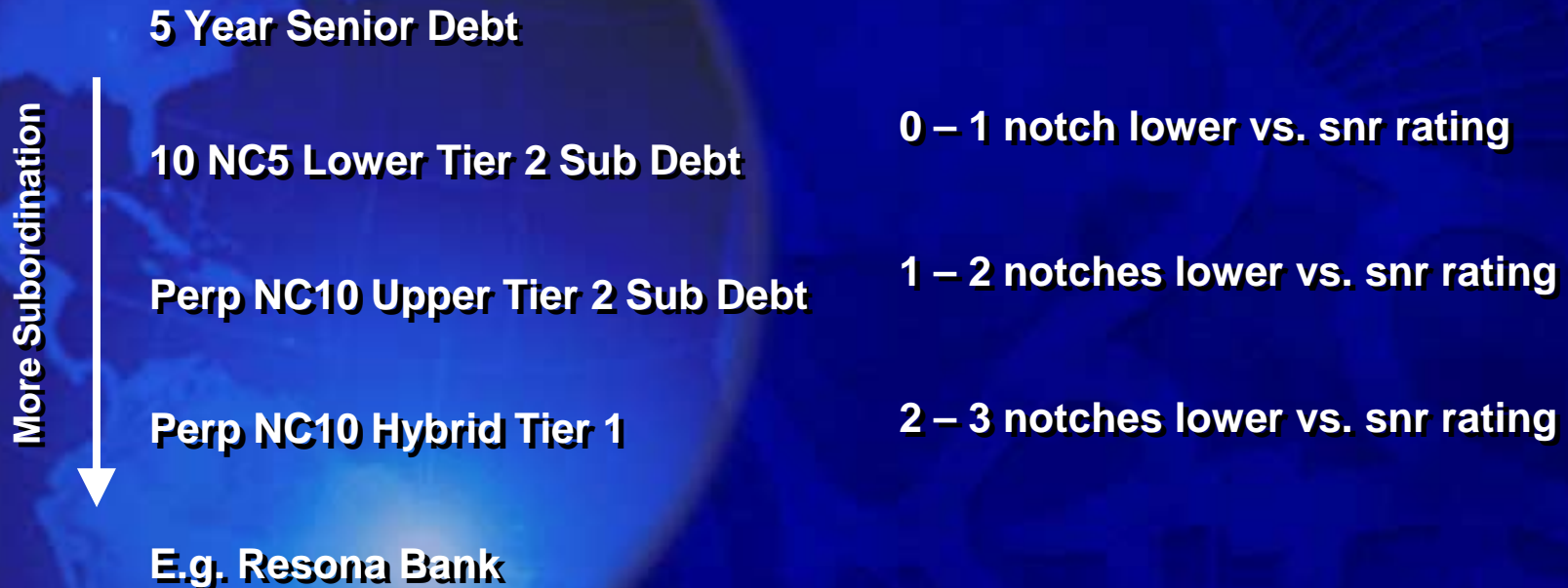
Ba2

Sole Bookrunner



Hypothetical Pricing Methodology

A. Based on the Issuer's Own Credit



B. Based on Secondary Trading Levels of Similarly Rated Hybrid Tier 1 Debt



Capital Raising Considerations

Choosing LT2 / UT2 / HT1 Issuance

Lower Tier 2 (dated subordinated debt)

- Provides the lowest coupon cost of any regulatory capital since it has a fixed maturity and no deferability of coupons
- However, it can only be included in capital up to 50% of Tier 1. Also, since it has a final maturity, the amount included in regulatory capital is amortized down to zero over the last five years before the maturity.

Upper Tier 2 (perpetual / long-dated subordinated debt)

- Provides a greater level of capital treatment compared to Lower Tier 2 since can be included up to 100% of Tier 1
- However, cost is greater than Lower Tier 2 and often not very different from Hybrid Tier 1

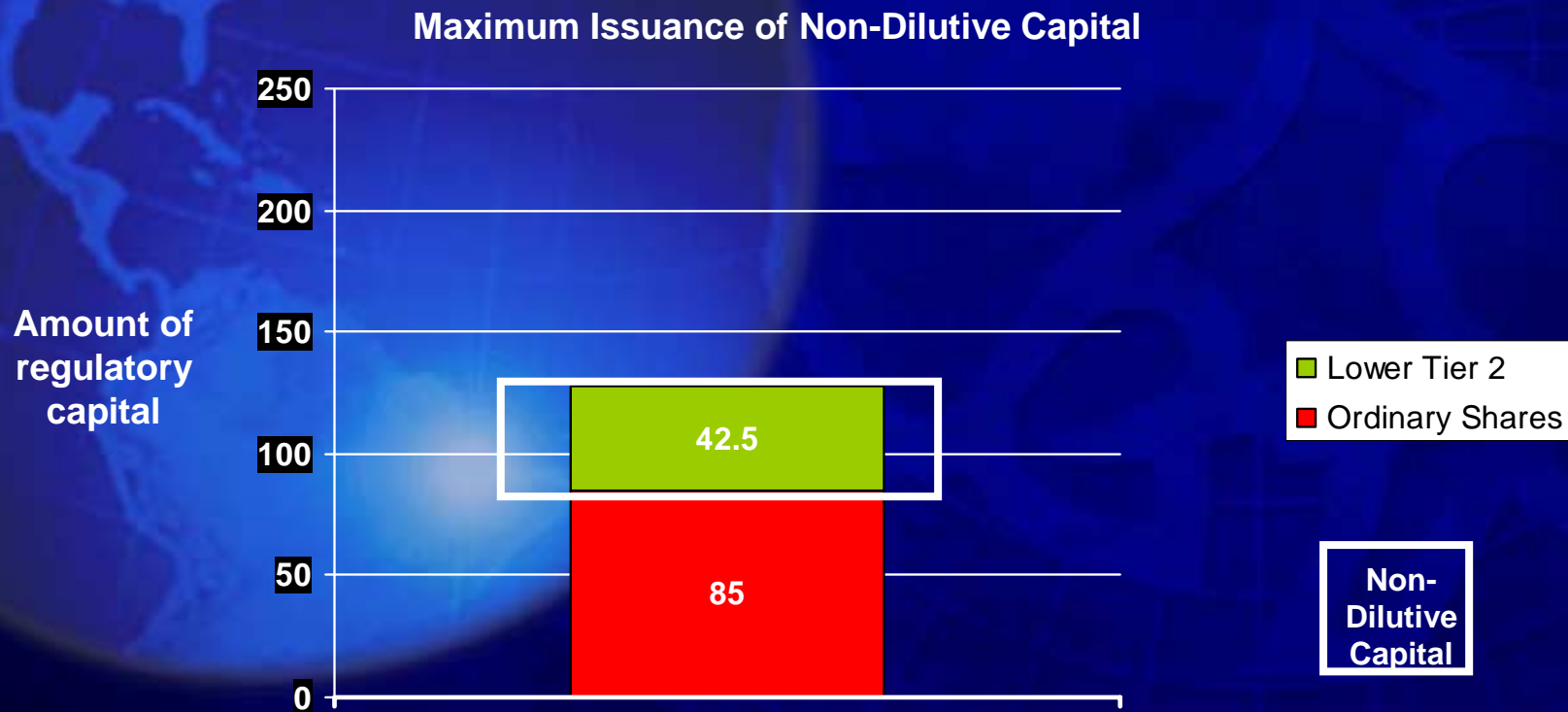
Choosing LT2 / UT2 / HT1 Issuance

Hybrid Tier 1

- Provides the lowest cost of Tier 1 since distributions are tax-deductible. The coupon is usually not much greater than Upper Tier 2 perpetual sub-debt when comparing on similar terms (such as the same step-up date), since both are perpetual and coupons are deferrable.
- However, Tier 1 inclusion is typically limited to 15% of total Tier 1 (although amounts exceeding Tier 1 limits can be used as Upper Tier 2 up to 100% of Tier 1)
- Note: preference shares (non-cumulative and perpetual) in some jurisdictions can potentially maximize regulatory capital treatment since they can often be included above the 15% basket for Hybrid Tier 1 but the dividends paid are not tax deductible so the after-tax cost can be high compared to Hybrid Tier 1

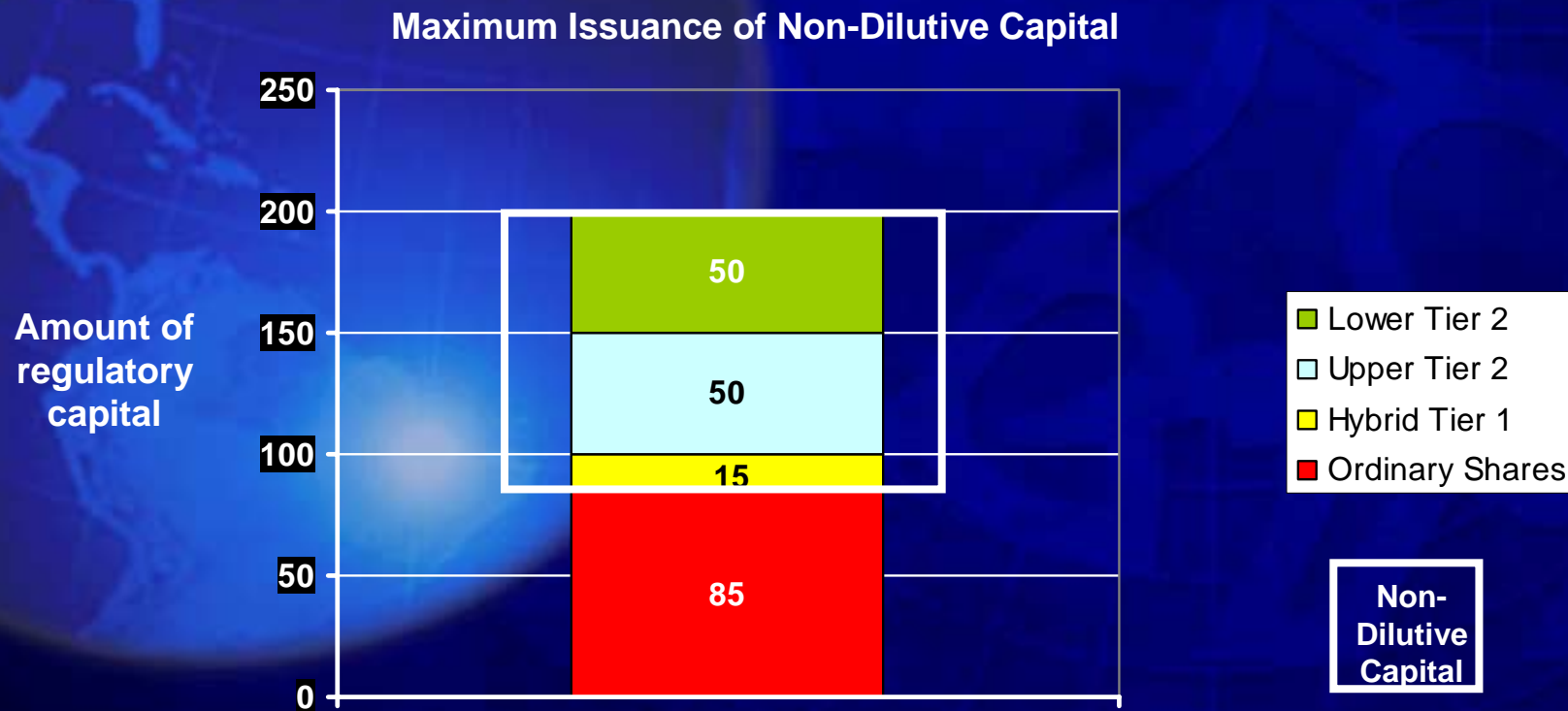
Maximizing Non-Dilutive Capital

- If only Lower Tier 2 capital is available (dated subordinated debt), the potential non-dilutive capital issuance is limited
- For example, a bank with Ordinary Share capital of \$85 million can add \$42.5 million of Lower Tier 2



Maximizing Non-Dilutive Capital

- By layering the capital structure a bank may maximize the amount of the lowest cost form of capital
- For example, a bank with Ordinary Share capital of \$85 million can add \$115 million of capital as shown below



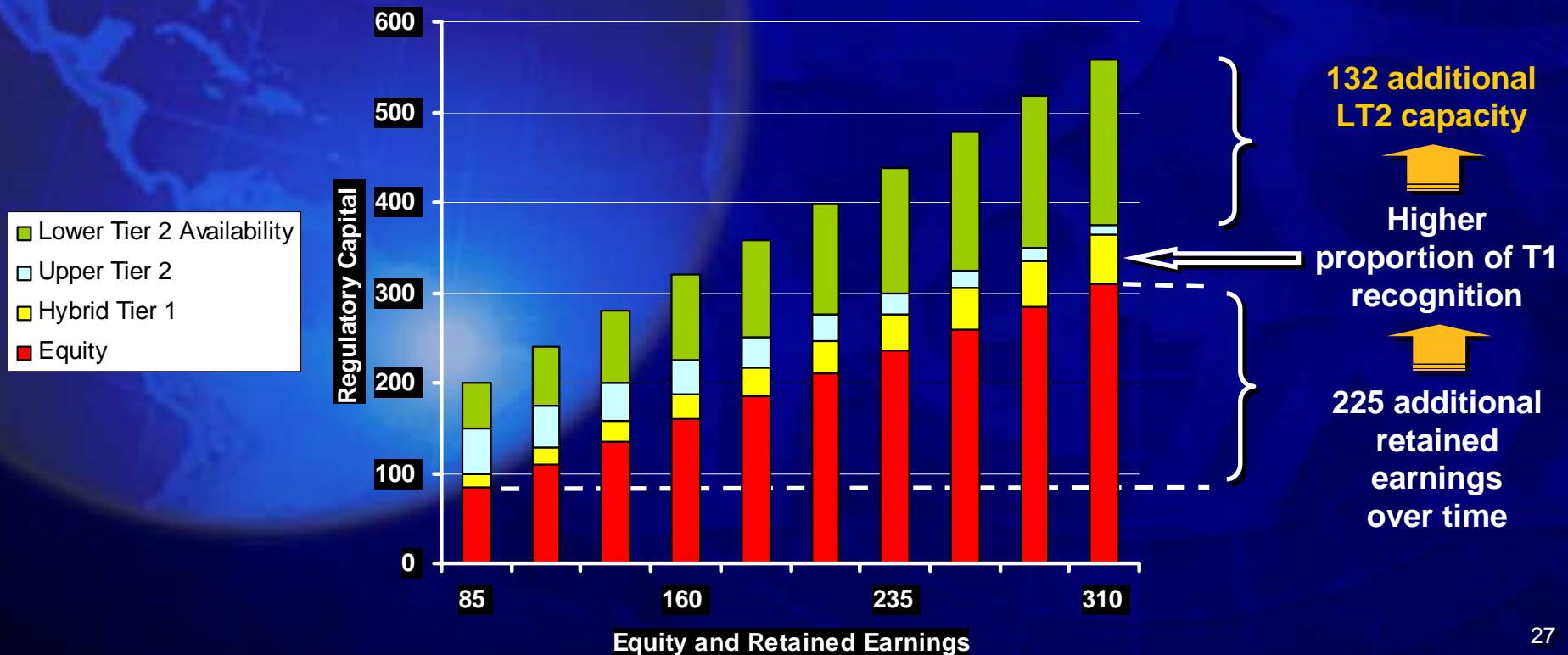
Minimizing Cost of Non-Dilutive Capital

- To minimize cost of capital, Lower Tier 2 issuance is most advantageous but is subject to a tight limitation of 50% of Tier 1 amount
- If Lower Tier 2 capacity is already fully used, **Hybrid Tier 1** can be used to minimize cost of incremental capital by **creating additional LT2 capacity**
 - ▶ For example, incremental capital needs can be met through either
 - Upper Tier 2 issuance, OR
 - Combination of Hybrid Tier 1 and Lower Tier 2 issuance
 - ▶ The combination of HT1/LT2 may be the most cost effective:
 - Assumptions:
 - 300 of UT2 available at **6.0%**
 - 200 of HT1 at **6.25%** and 100 of LT2 at **5.0%**
 - Combination gives **5.83%** average cost

Minimizing Cost of Non-Dilutive Capital

- In can also be advantageous to issue HT1 beyond the 15% maximum
 - ▶ The excess is initially treated as T2 but with additional retained earnings over time, a greater portion may be recognized as Tier 1 (within 15%)
- The HT1 can be leveraged to create additional availability of Lower Tier 2

Effect of Retained Earnings and \$65 million Hybrid Tier 1 Issuance





Conclusions

Conclusions

- After initial Basel Committee approvals in 1998, Hybrid Tier 1 has been widely introduced in Asia
- Global markets have been very receptive to Hybrid Tier 1 issuances and Asian retail markets have recently become available to Asian issuers
 - Indonesian banks are very well positioned to access international markets for regulatory capital
- Use of Hybrid Tier 1 along with Tier 2 subordinated debt allows a bank to
 - maximize non-dilutive capital issuance capacity
 - minimize the cost of capital