CURRENT ASPECTS OF UNSECURED LENDING
THE CHARACTERISATION OF SUBORDINATED DEBT AS CAPITAL

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I will take you down a different path with the problems that the banks experience when they endeavour to go the quasi-capital route or the subordinated debt route. In 1984 my bank was undertaking some pretty heavy expenditure in EDP equipment and they deliberated on an innovative way to raise debt on this particular equipment. After much deliberation it was decided to pursue a convertible unsecured note issue. The terms of that issue was that it was a six year note with conversion rights in 1985, 1987 and 1989, 1991, and 1993 on the basis of 1 share for each note. Now the Reserve Bank had no difficulty with that concept. They were quick to point out that until the notes were converted into shares they would not regard them as part of the bank's capital base for the purpose of measuring a capital adequacy requirement that they were then considering.

The advantages of a convertible note from the bank's point of view was the after-tax costs which I think at that time saw equity funds at 12.5 percent compared with 5.5 percent for the notes. So you can see that it was certainly an advantage from the bank's point of view. The objections that the Reserve Bank had with these notes in treating them as shareholders' funds was the option available to the investor to either convert the notes into shares or to redeem the notes - and obviously the redemption issue was the one that they had the major objection to.

At about the same time banking supervisors around the world were all addressing this capital adequacy issue of banks and with particular emphasis on the subordinated debt issues and also the reserves that were appearing in the banks' balance sheets. Now it was from that research that some of the innovative investment bankers around the place picked up the issue and started calling on the banks and offering to place stock or raising this quasi-equity if you like in the off-shore markets.

The type of concept they were endeavouring to sell was an instrument which gave subordination behind deposit and other liabilities, permanence if in perpetual form, and absence of fixed servicing costs if interest obligations were waived and where the dividends were not paid on ordinary stock. The regulatory authorities in a number of the overseas countries

allow a content of quasi-equity in the capital base for gearing purposes and of course these proposals were being put to the Australian banks on the basis that Mr Johnston at the Reserve Bank and his men would follow suit.

It was being argued by the Australian banks that inclusion of quasi equity in some way as an element of the capital base, would provide those banks whose foreign currency balance sheets were growing rapidly, with the option of holding a portion of their capital resources in foreign currency, in order to limit the effects of exchange rate changes or their capital ratios. In July 1986 the Reserve Bank saw the wisdom of those arguments and saw the scope to widen the definition of capital towards a greater degree of consistency with the banking supervisors in other countries.

If I can just go through the subordinated issues and the terms and conditions upon which they allowed us to proceed into the market.

They accepted the inclusion of subordinated perpetual debt in the capital base on the following conditions.

1. The claims of the lender on the borrowing bank must be fully subordinated to those of depositors and all other creditors, ranking ahead only of shareholders.

2. The documentation relating to the issue must not include any clauses which might trigger repayment of debt.

3. The borrowing bank may not enter into negotiations about repayment of the debt without the prior approval of the Reserve Bank.

4. The documentation should provide an option for interest payments on the debt to be reduced or waived if the bank has not paid or declared a dividend payment in a preceding period. Any interest not paid as a result of the exercise of this option shall not accrue.

5. The documentation must provide:

   (a) for automatic conversion of the debt, and unpaid interest (other than that under condition 4) into share capital should reserves become negative. The bank will be required to maintain a sufficient margin of authorised but unissued share capital in order to allow a conversion of the debt into equity to be made at any time; or

   (b) for the principal and interest on the debt to absorb losses, where the bank would not otherwise be solvent, and for the noteholders to be treated as if they were holders of a specified class of share capital in any liquidation of the bank. The documentation would also

provide for the debt to be treated as if it had been converted into share capital either on the day immediately preceding the presentation of a petition for the commencement of a winding-up of the bank or on the date of the creditors' or shareholders' meeting at which the relevant resolution for a winding-up was passed. An explicit warning to noteholders that the debt can be treated in this way must be included in the documentation.

6. Where it is proposed to make an issue of subordinated perpetual debt which is designed to be included in a bank's capital base, the Reserve Bank should be given prior notice of the issue and sufficient opportunity to consider and agree to the loan documentation in advance.

Now having dealt with the bank side of subordinated debt, how do we treat commercial consideration?

Obviously the guidelines for subordinated debt are not as clear cut in an industry now beginning to be dominated by creative financing.

It used to be easy to be decisive on the treatment of subordinated debt, the typical providers of such debt being, major shareholders or a parent company. Outside parties providing funds through a subordinated loan would want compensation for the loans status and depending on the terms and conditions of the subordination, as lender we would make our judgment as to eligibility of the loan as capital.

Subordinated debt and hidden reserves have always complicated the measurement of capital, and with the advent of leverage buyouts in the United States, the senior ranking and junior ranking subordinated debt concept covered by other speakers, and the decline in capital ratios generally, the role of the banker in defining debt and capital is becoming more difficult.

The question of whether subordinated debt is capital in my view is one of solvency. Do we assess our risk on the basis of an ongoing concern or do we assess our risk on the basis of liquidation?

If we are to assess the risk of an entity as a going concern, and this is the only way I believe a banker can enter a deal, then subordinated debt cannot be considered as capital because such debt can be used to absorb unsecured creditors in the event of liquidation.

In addition it may not be permanently available and could be subject to interest and redemption payments.

Obviously the way around this issue is with suitable documentation but subordinated debt in my view is a "hybrid" and warrants thorough investigation in our critical ratio analysis as to terms and conditions before we accept the concept as capital.