Hybrid Capital Instruments and Small Institution Access to Capital

What GAO Found

Tier 1 hybrid capital instruments, particularly trust preferred securities, have been heavily used by bank holding companies because of their financial advantages, but they are not as effective in absorbing losses as traditional forms of Tier 1 capital, such as common equity. As of December 31, 2010, almost two-thirds of all top-level bank holding companies that were subject to capital requirements included hybrid instruments in their Tier 1 capital, for a total value of $157 billion. Hybrid instruments such as trust preferred securities have offered institutions the benefit of lower-cost capital, largely because of their debt-related features—including tax-deductible dividends. These instruments also are accessible to a broader range of potential investors. However, trust preferred securities do not absorb losses like other Tier 1 instruments because of their obligation to repay principal and dividends. Trust preferred securities may provide limited financial flexibility in times of stress, but they also may hinder efforts to recapitalize troubled banking institutions.

Eliminating Tier 1 hybrid capital likely will have modest negative effects on the existing capital measures of individual banking institutions and lending and could improve institutions’ financial stability. Few institutions will fall below minimum regulatory capital levels without Tier 1 hybrid instruments, and banking institutions’ overall safety and soundness should improve with higher reliance on common equity. GAO’s analysis of the relationship between bank regulatory capital and lending activity suggests that any negative effects on the cost and availability of credit should be small, but the exact impact is unknown. Market participants said that losing access to tax-advantaged Tier 1 instruments could place U.S. institutions at a competitive disadvantage, as some foreign banks may still have access to such instruments. The international competitive effects are unclear, however, given the scope of ongoing worldwide regulatory reforms.

Smaller banking institutions, which often had larger proportions of hybrid instruments as Tier 1 capital, have limited options for raising regulatory capital but indicated little unmet need for it. These smaller institutions now have access primarily to common equity raised from private sources. GAO’s survey results showed that smaller institutions consider their financial condition and performance as the most important factor affecting their ability to raise capital. Market participants identified challenges that could impact smaller institutions’ ability to raise capital, including limitations related to the size of capital raised, liquidity, and return potential for investors. However, GAO estimated that most smaller institutions (65 percent) had not raised regulatory capital since January 1, 2008, and of these, a large majority (88 percent) indicated that they had no need or interest in raising more. Further, most smaller institutions that had raised capital since 2008 were satisfied with the amount and terms involved. Only a small percentage of institutions (3 percent) that had attempted to raise capital since January 1, 2008, were unable to do so. Institutions with a stronger financial condition generally had a more favorable view of the capital raising environment.