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Simplified redemption of participation capital

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Participation capital and legislative amendments

In the wake of financial market turmoil, Austrian banks have rediscovered the appeal of participation capital - an Austrian law, specific instrument for increasing Core Tier I ratio and enhancing risk-bearing capacity. Almost all major Austrian credit institutions (except Unicredit) have issued participation capital over the last year, thereby drawing on the state's assistance under the Austrian financial market stability scheme (because participation capital so issued was either in whole or in significant part subscribed by the state as investor). Originally implemented in the Austrian legal system in 1986 to help savings banks and mutual insurance undertakings to raise funds on the capital markets, participation capital takes an intermediate position between equity and debt. Its distinct regulatory features that allow for unlimited Core Tier I capital recognition are perpetuality and loss absorbency alongside share capital (on a going concern), while dividends must be profit-related and non-cumulative. Since participants do not have voting rights, this instrument has proved increasingly popular over the last couple of months when relying on government support for increasing a bank's Tier I ratio, while at the same time keeping state influence to a minimum.

Initially, participation capital could be reduced or disposed of only by analogous application of the rules governing the reduction of share capital. This proved difficult in practice. Therefore, provisions allowing for redemption of participation capital on the issuer's call were introduced into the Banking Act. Ever since, as an alternative, credit institutions could unilaterally redeem all their issued participation capital by offering participants cash compensation in lieu of their participation notes.

Effective from January 1 2010, the statutory rules on redemption of participation capital have been further revised to reflect changed circumstances in the banking sector - in particular, to ease redemption of participation capital issued under the Austrian financial market stability scheme.

Main modification

The main modification now allows for partial redemption of participation capital (in tranches) only. This is a novelty since previously, based on equal treatment considerations, banks were obliged to redeem any and all of their issued participation capital instruments. The possibility to redeem participation capital partially applies only with respect to individual issues or tranches. Equal treatment of affected participation capital holders must be guaranteed when redeeming individual issues or tranches. Apart from this key innovation, some further modifications to the redemption procedure were also implemented.

Details of redemption procedure

A resolution to redeem participation capital must be taken by the bodies responsible for the issue of participation capital with the required majority votes. A newly added provision in the Banking Act now allows for authorization to the board of directors to redeem participation capital within a five-year period with no requirement for further corporate resolutions. Such authorization must be laid down in the articles of association.

Redemption of individual participation capital tranches subscribed by the state under the Austrian financial market stability scheme requires the prior consent of the federal minister of finance and the federal chancellor.

In case the credit institution is a stock corporation with exchange-listed shares and participation certificates, the proposed redemption of participation capital must be preceded by a conversion offer for shares in the six months before the announcement of the proposed redemption. The announcement of the conversion offer must include a reference to the proposed redemption. Should such conversion offer not be accepted, participation certificate holders are exclusively entitled to adequate cash compensation. Participation certificate holders are entitled to apply for judicial review of the adequacy of the cash compensation offered.

Pursuant to Paragraph 7 of the revised Section 102a of the Banking Act, participation capital may now be redeemed not only against net profits resulting from the annual balance sheet or against free reserves, but also against substitution of capital of the same or better quality. This allows for additional flexibility and hence redemption may also be achieved without reducing an institution's own funds basis.

Expected benefits

Allowing credit institutions to redeem participation capital partially should result in greater flexibility for the institutions concerned. In particular, the revised framework aims to facilitate the disposal of participation capital recently issued under the Austrian financial market stability scheme and is thus expected to increase the chances of a rapid recovery of capital invested by the state. Without these amendments, credit institutions would be obliged to redeem all their issued participation capital (and not only the state's), which could pose a significant financial burden. Furthermore, credit institutions that draw on the state's assistance when issuing participation capital face various constraints that affect their operations under subscription agreements with the state. Therefore, changes to the existing regime are intended to accommodate the credit institutions' interests, as well as those of the state.

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