

1 October 2010

Mr Noel Reynolds
Mr William Coen
Basel Committee on Banking Supervision
Bank of International Settlements
Basel, Switzerland

Re: BCBS Consultative Document / Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of non-Viability ("BCBS 174")

Dear Messrs Reynolds and Coen,

1. We thank the Basel Committee for their efforts to outline a proposal for entry criterion of regulatory capital to ensure that all regulatory capital instruments issued by banks are capable of absorbing losses in the event that a bank is unable to support itself in the private market.
2. It is clear that the world is changing and that governments are now determined to avoid offering state support to failing banks. The financial markets will need to adjust to the removal of the implicit State guarantee which comes with a new framework designed to allow banks to fail without causing systemic collapse. Insofar as the market must adjust to the increase in pricing of bank capital, the Committee is well advised to listen to investors' concerns (many of them being the world's largest pension and insurance funds), because they will have a direct impact on the viability of the proposal.
3. BCBS 174 is based on the proposition that providers of capital should bear losses instead of the State,. We agree unequivocally with this premise, which also provides the basis for our paper, *The Systemic Safety Net: Pulling failing firms back from the edge* (August 2010),¹ which discussed how mechanisms could be designed to allow banks to fail with a much lower risk to the financial system and a lower cost to society.
4. Given the overarching priority of avoiding taxpayer-funded bail-outs, whilst, at the same time, establishing arrangements that enable a failing bank to continue as a going concern to preserve financial stability, we would suggest the Committee take a broader approach. Beyond specifying the criteria of regulatory capital, the Committee should place the

¹ <http://www.afme.eu/document.aspx?id=4276>. Other bodies that have addressed bail-in have expressed similar views to AFME. See, eg, British Bankers Association, *Resolution and Unsecured Creditors* (August 2010); International Institute of Finance, *Preserving value in failing firms* (September 2010), European Commission, Directorate General Internal Market and Services, Roundtable Paper, *Debt Write Down as a Resolution Tool* (10 September 2010).

mechanism by which investors are made to bear losses within the armoury of resolution tools that governments are now developing to avoid bail-outs.²

5. We discuss in Part A below the Committee's proposal in the context of the contractual and statutory approaches to loss absorbency, focusing on the various aspects of conversion that will need to be considered. In Part B we address issues affecting buyers of bank funding instruments such as fund mandates, ratings and pricing.
6. The proposal focuses only on non-common Tier 1 and Tier 2 capital. We will be interested in reviewing the Committee's forthcoming proposals on contingent capital.³ In the meantime, we look forward to a continuing dialogue on exploring whether non-regulatory capital instruments with BCBS 174 conversion features qualify for the proposed capital buffers (should they be adopted).
7. We also note the intersection of BCBS 174 with the bail-in proposals being studied by the industry, together with parallel work being taken forward by the FSB and the European Commission. There are some obvious similarities between conversion and bail-in, and some important differences as well. We would encourage that conversion be developed with a view to co-existing alongside the power to bail-in for those national authorities that do wish to take conversion a step further.
8. For the sake of linguistic clarity, we recommend that the Committee develop terms to better distinguish between 'going concern' and 'gone concern' contingent capital. This will facilitate the market's pricing, on the one hand, of contingent capital that is issued voluntarily (with objective, nondiscretionary triggers), and, on the other hand, of regulatory capital instruments with mandatory conversion features.
9. One approach might be to identify the different trigger points which might be appropriate to different capital instruments. A "going concern trigger" could describe the objective, non-discretionary triggers that a bank might look to insert into instruments in order to boost Tier 1 or core

² These tools include the State's powers of sale, bridge, temporary public ownership and liquidation as seen under the UK Banking Act, the Dodd Frank Act, and the draft German Act for the Restructuring and Orderly Liquidation of Credit Institutions.

³ The Committee's 26 July Press Release confirmed that an issues paper on the use of contingent capital for meeting a portion of the capital buffer had been reviewed: "The Committee will review a fleshed out proposal for the treatment of "going concern" contingent capital at its December 2010 meeting with a progress report in September 2010." Subsequently the 12 September Press Release noted the publication of BCBS 174 and referred to the work with the FSB on developing "a well integrated approach which could include combinations of capital surcharges, contingent capital or bail-in debt."

Tier 1 capital in advance of the critical stage of a crisis. A “non-viability trigger” might refer to the mandatory trigger contemplated by BCBS 174. If these are both contractual triggers, the “non-viability trigger” could effectively become redundant, although the documentation of a going concern contingent instrument would need to contain both.

A. Contractual v Statutory Approach

10. We support the inclusion in regulatory capital instruments of contractual provisions for the purposes of informing the holder that the instrument may potentially be subject to conversion. These provisions will also be helpful in ensuring mutual recognition of the host country’s authority.
11. However, we would assert that private contract law, in isolation, is unsuited to serve as the foundation of the sea change that the end of the State guarantee, whether implicit or explicit, of systemically important financial institutions represents. That transformation should rest firmly with the national regulators’ resolution powers -- which will need to confer the necessary authority -- and should be properly and fully dealt with in that realm. The Committee should encourage countries lacking existing resolution regimes or plans for these regimes to adopt them.
12. Even with conversion clauses in regulatory capital instruments, it is inevitable that there will need to be legal and regulatory changes to vest the national authorities with the power to establish rules governing conversion. In particular, the following areas will need to be addressed: triggers; discretionary powers to convert in part and not whole; dilution; the termination of derivatives and other financial contracts; the treatment of groups; safeguards; and implementation periods, among other things. We deal with these issues in turn.

Trigger

13. We suggest that the trigger for conversion be defined in accordance with those that already exist under local law for the State’s exercise of resolution powers, be it the power of sale, bridge, liquidation, temporary public ownership or, for those states wishing to go further, the State’s power to implement a recapitalisation or bail-in.⁴
14. The determination of imminent failure, by its very nature, involves a high degree of discretion on the part of the authorities, which again underlines the need for legal or regulatory changes to support this determination. To

⁴ For example, under the new UK Banking Act, the trigger for State intervention is the bank’s failure or imminent failure to meet the threshold condition test, which in turn rests on standards of capital and liquidity adequacy set forth by the FSA. It should be noted that in Britain the Bank of England acts as the resolution authority with the FSA making the initial determination that the threshold condition is no longer met.

minimise this uncertainty, we believe it is best to base the trigger on existing criteria for seizure conditions (and other resolution powers) under local law. This is already a responsibility of authorities and is a relatively well-defined event, making it likely to be the best foundation for a transparent and fair procedure.

15. Harmonisation of triggers with resolution powers under local law will lend greater predictability to investors. Employing the same test for invoking the authorities' power to deploy a resolution power(s) will minimise the pricing distortion that could arise from the existence of potentially conflicting or overlapping resolution triggers and powers.
16. We note that the proposal employs very specific language and refers to 'the decision to make a public sector injection of capital, or equivalent support'. To the extent that the Committee continues to use language along these lines, it is important to clarify what is meant by equivalent support.
17. However, the generality of a threshold condition trigger will inevitably generate market uncertainty that may lead to pricing distortions and potentially limit the pool of investors who could hold these instruments. Accordingly, the Committee should seek to explore whether it is possible to devise a formula which articulates unambiguously the scale of the decline in capital that would lead the authorities to conclude that the threshold test for conversion had been met. (There may be other financial resources measures of non-viability which could be assessed in this way.) It should be noted that once these conditions are met, the authorities are not necessarily required to exercise their conversion powers; conversion is simply one of several resolution tools that authorities can exercise as appropriate.

Partial conversion; debt write off

18. BCBS 174 does not deal explicitly with whether the proposal would also include partial conversions. Following our discussions with you, however, we understand that the intention is to allow them, which we welcome. Flexibility to absorb the losses presented at the time of conversion is an essential element of increasing the chances of a firm's survival as a going concern and, hence, avoiding a bail-out. The question is: who should dictate the amount of conversion - the firm or the authorities? While we recommend that firms address loss scenarios in their living wills, the authorities should be the final arbiters of the amount of capital that needs to be converted to effectively avert a crisis.
19. It makes sense to have debt write-off as an option, particularly for institutions that do not issue common equity (mutuals). The difficulty with write-off is not only its failure to penalise shareholders but also its positive impact on the value of their shares; on the other hand, as the proposal notes, the shareholders are penalised ex ante by the increase in

pricing (rather than ex post). If write-off is permitted, write-up should also be allowed, so long as the write-up constraints are strictly defined. There would not appear to be a regulatory interest in prohibiting a write-up once the State has been repaid its funds and the firm has been restored to solvency. Features such as these could offer more alternatives to investors and help broaden the market.

Dilution

20. For shareholders dilution is the principal impact of conversion. In some instances, where an injection of capital is made, a firm's pre-existing shareholders could recover some of the value of their investment.
21. Equity dilution, as opposed to a complete equity cancellation, conflicts with traditional principles of company law and insolvency law whereby shareholders are required to bear losses *before* creditors in insolvency. These laws of priority are based on the public policy that shareholders, in exchange for the privilege of limited corporate liability and the unlimited upside risk profile of the equity instrument, should bear first loss.
22. This is an area where bail-in differs in principle from conversion and goes further by giving the State the ability to cancel shares (and impose losses in order of statutory priority). Whether to have in the armoury of resolution powers both dilution and cancellation, or whether resolution powers should seek to express a consistent policy on the allocation of losses, is an issue to be resolved.

Termination of derivatives and other financial contracts

23. We would agree that firms should be prohibited from including cross-default clauses relating to derivatives, swaps and other financial contracts that are triggered upon conversion and we would propose to work with the International Swaps and Derivatives Association (ISDA) to refine the conventions around this. We note that the regulatory capital instrument itself is insufficient to bind the firm insofar as a breach by the firm would be only a matter of contract breach between the firm and the instrument holder. It would not invalidate the cross-default clause in the ISDA Master Agreement (for example).

Treatment of groups

24. The treatment of groups is complex and needs to consider issues such as the role of the consolidated supervisor and/or colleges, the treatment of minority interests, and the implications for third party investors. (An assumption seems to be that capital can move freely and some members have raised the question of the possible impact of exchange controls in some jurisdictions in this context).

25. We intend to follow-up separately with the Committee on the treatment of groups, but note that our members have highlighted that there may be problems with the second option being considered by the Committee (i.e. where the conversion is to shares in the parent).

Safeguards

26. Any law implementing conversion powers, particularly where the authorities are given the power to determine the amount of conversion, will require consideration of appropriate safeguards for the interference in property rights. We would recommend that, like triggers, these safeguards be the same as those existing for other resolution powers; for example, by having a requirement that no creditor be made worse off than it would be under liquidation (which exists under the UK Banking Act). In addition, we believe that clear rules about the treatment of various classes, including respect for creditor priority and equal treatment in each class, should be published. Clear rules in this regard would improve transparency and fairness for market participants, and improve the quality of market signals available to the authorities. For countries without resolution powers, or indeed pre-existing but inadequate safeguards, these would need to be developed.

Implementation periods

27. If BCBS 174 is implemented, we would recommend that it be phased in according to the same time frame as is outlined in the Committee's press release of 12 September 2010. We also suggest that instruments issued prior to this time should be grandfathered to their first call date (or maturity where there is no call date). We believe it appropriate that the 10 % amortisation of non-conforming instruments outlined in the press release supersedes any existing de-recognition requirements legislated by any regulatory authorities.⁵ Perpetual instruments will need separate consideration for an appropriately compatible period of implementation.

Other issues

28. We note that rules relating to change of control and close links would need to be temporarily 'switched off' upon conversion as it would be impracticable to comply with them in a crisis environment over, say, a weekend.
29. We urge the Committee to consider the potentially substantial tax implications of the trigger mechanism on the issuers of, and investors in, such instruments. In particular, these instruments could be viewed as equity instruments which would result in any interest payments be

⁵ For example lower tier two instruments in their final five years to maturity as outlined in Article 64 of the Capital Requirements Directive (2006/48/EC)

considered as dividends and thus becoming non-tax deductible for issuers. Changes to the terms of existing subordinated debt could trigger a taxable event to the investor in certain jurisdictions.

B. Investor issues

30. We are aware that a number of investors have raised concerns about this proposal. The most prominent of these include the argument that their mandates limit their investment to fixed income instruments, which prohibits equity investments; that rating agencies will not be willing to rate convertible securities because their 'equity-like' features make them unratable as debt; and that the resulting lack of liquidity will severely affect the pricing of these instruments. (Separately whilst the proposal does not directly propose applying conversion to the senior unsecured debt market - and our members have not achieved consensus on this matter - we are aware that a number of national regulators do see this as a distinct option: given the concerns that have been raised above, if further work on it is to be taken forward we would urge the Committee to conduct a specific consultation on this aspect to ensure that unintended consequences are avoided.)
31. Putting conversion on a par with other resolution powers could reduce these concerns insofar as these instruments are convertible in no other sense except upon non-viability. We expect that as the market begins to price for these new resolution powers, mandates will adjust to permit exceptions for equity instruments acquired by virtue of action taken by the authorities and to provide for a transition period for their disposition (this exception could be similar to what currently exists for equity instruments acquired through corporate bankruptcy reorganisations). We note the Committee's proposal for a trust structure but at this stage we are not convinced of its necessity.
32. While a matter for rating agencies to comment on, we would expect them to continue to rate these instruments as debt instruments that are convertible only upon non-viability (whereupon they cease to be rated).
33. We have no doubt that conversion will increase pricing, just as the prospect of liquidation or other enhanced resolution powers is likely to.



We would be pleased, of course, to discuss the issues covered in this submission with you or to provide further information about any of the matters which our members have raised if that would be helpful.

Yours sincerely,

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