Basel Committee proposal to ensure the loss absorbency of regulatory capital at the point of non-viability

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1. Executive Summary

The Australian Bankers' Association (ABA) understands the objective of the proposal to ensure that all regulatory capital instruments issued by banks be capable of absorbing losses in the event that a bank is unable to support itself in the private market. In achieving this objective it is fundamental that the subordination hierarchy for bank-issued instruments is respected.

The Basel Committee appears to implicitly endorse the principle of respecting the subordination hierarchy by the inclusion of certain statements in the consultative documents, but the full write--off mechanism proposed is counter to this view.

The proposed write-off of non-common Tier 1 and Tier 2 instruments at a point where common equity is expected to remain outstanding will result in the non-common Tier 1 and Tier 2 components of the capital structure effectively incurring a greater loss than would have been incurred in a liquidation where the loss would be apportioned to each class of capital sequentially in accordance with their level of subordination.

Rather than the complete write-off of all non-common equity instruments, the ABA proposes that such instruments be written down in sequential order to a value that provides a sufficient surplus to minimum Tier 1 capital requirements, with Tier 2 instruments written down after all Tier 1 instruments have been written down.

The ABA believes that the issuance of ordinary shares as compensation is preferred to the alternative of a write-off or write-down with no shares issued as compensation. However there are implementation matters associated with conversion (eg, disclosure obligations under securities law and stock exchange authorisations) that need to be considered.

The ABA is concerned that the existence of a non-viability trigger may lead to speculation in the market about when the trigger may be exercised by a regulator, especially in the absence of any guidance from regulators. The ABA believes that the Committee needs to consider closely the potential market reactions to the existence of a non-viability trigger when framing the guidelines for regulators.

The ABA is also concerned that the proposals could actually serve to:

- Make it significantly more difficult for financial institutions to raise new equity from the market in times of stress, as investors speculate on the potential exercise of the trigger by a regulator;
- Discourage the types of flows and investments that should be encouraged, that is subordinated long-term instruments with better risk-sharing characteristics; and
- Threaten the ability of banks to replenish the Tier 1 and Tier 2 necessary for a going concern.

The ABA believes that efforts to orchestrate pre-emptive changes to the capital structure cannot take into account the key issues for all banks in all circumstances. It may operate to reduce the flexibility that a regulator may have, and increase volatility within the banking system and so may have material unforseen negative consequences.

The ABA also believes that it will be important to ensure that there is a globally consistent transition developed given the global investor base for Tier 1 and Tier 2 instruments. The ABA recommends that a further consultation process be conducted to evaluate alternatives which could be developed to address the objective that all regulatory capital instruments are loss absorbing whilst respecting the subordination hierarchy. One alternative method suggested by some members is explored.

2. Subordination Hierarchy

2.1 Role of Tier 1 and Tier 2 Capital Instruments

In responding to the actual and perceived failures of regulatory capital to absorb losses in the GFC, it is important to first define exactly what kinds of losses and under what circumstances these different classes of capital are intended to absorb loss. The primary source of loss absorption is common equity. Primary in this context means both the relative proportion of loss absorption capacity and that it takes the first loss and has the most junior place in the subordination hierarchy.

Non-common Tier 1 equity instruments (referred to herein as "Tier 1 instruments") and Tier 2 capital instruments, in turn, are intended to absorb low probability, relatively high impact losses such as those that would cause the bank to breech a Tier 1 minimum requirement or become insolvent. Such capital instruments are by design intended to absorb less loss than ordinary equity and are not intended to be substitutes for holding adequate levels of ordinary equity. The primary function of Tier 1 instruments is to offer a cost effective means of providing an added margin of safety or confidence against the capacity of the banks to survive low probability, high impact losses as a going concern. The role of Tier 2 is to provide additional support on a "gone concern" basis.

Tier 1 instruments fulfil this support function firstly by seeing their distributions suspended when the bank makes an outright loss (already enforced in Australia through pillar 2 supervision) and ultimately by suffering loss of principal should the bank fail. Tier 1 investors are willing to accept a lower return and less control than common equity to the extent they hold a preferred place in the loss-absorption hierarchy. The lower cost of these instruments does not reflect inferior loss absorption but rather that they occupy a more senior place in the loss absorption hierarchy.

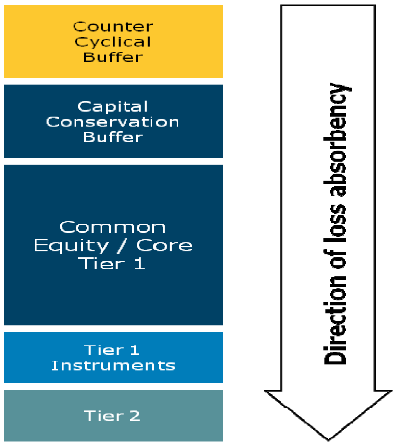
Similarly, Tier 2 capital also fulfils this support function by suffering loss of principal should the bank fail. Tier 2 investors require a lower return than more subordinated capital to the extent they hold a preferred place in the loss absorption hierarchy which sees the risk of part of their capital being lost restricted to scenarios in which ordinary shareholders and Tier 1 holders have absorbed the first loss.

Respecting this hierarchy would require the allocation of losses such that:

1) Common equity absorbs losses first, as capital levels move through the countercyclical buffer (if any), through the capital conservation buffer, and then through the minimum core Tier 1 requirements:

2) Holders of Tier 1 instruments absorb losses next, then

3) To the extent that losses remain, Tier 2 holders absorb losses last.



2.2 Preservation of Hierarchy required

Non-viability has traditionally been interpreted as insolvency, however in the context of the proposal we expect that regulators might take the approach that a solvent bank might be considered to be non-viable once it had used up its capital conservation buffer and breached its Tier 1 minimum requirement. As such we expect that, under the proposal, the non-viability trigger may be reached at a point where common equity capital remains outstanding. Allocating losses to Tier 1 and Tier 2 instruments at the point where ordinary shares capital remains outstanding would not preserve the subordination hierarchy.

The Basel Committee implicitly endorses the principle of respecting the subordination hierarchy when it states that "… a public sector injection of capital … should not protect investors in regulatory capital instruments from ***absorbing the loss they would have incurred had the public sector not chosen to rescue the bank***" (emphasis added). However, the Basel Committee has further proposed that losses be imposed on regulatory capital by these instruments being written-off (with the possibility of common equity issued as compensation) and emphasised that it is the write-off that "… increases the common equity of the bank ***and removes the possibility of the capital instrument holders remaining senior to any common equity injected by the public sector***". (emphasis added).

The proposed write-off of Tier 1 and Tier 2 instruments at a point where common equity remains outstanding will result in the non-common equity components of the capital structure effectively incurring a greater loss than would have been incurred in a liquidation where the loss is apportioned to each class of capital sequentially in accordance with their level of subordination.

Rather than the complete write-off of all non-common equity instruments, the ABA proposes that such instruments be written down to the value of the claim they would have been entitled to in liquidation and that their residual principal retains the seniority held prior to the write-down. In relation to calculation of the size of the claim in liquidation, it is recognised that in a time-critical situation this value may be difficult to ascertain with precision and that some level of conservatism may need to be assumed. The extent of any residual principal will of course depend upon the size of the write-down required to restore an appropriate surplus to Tier 1 minimum capital requirements and more junior classes of capital

may still be written-off. The size of the write-down incurred by each investor will be determined by the place in the subordination hierarchy that those investors have contracted to accept rather than by arbitrary extinguishment of those contractual rights.

3. Non-viability trigger and associated risks

The proposal describes the trigger event as the earlier of a decision to make a public-sector injection of capital or "a decision that a write-off, without which the firm would become non viable, is necessary, as determined by the relevant authority".

The inference is that exercise of the trigger event is intended to be a direct alternative to bank failure and that the trigger should be highly unlikely and regulatory intervention should be a last resort. However, as noted previously, in the context of the proposal we expect that the practical approach of a regulator would be that a solvent bank could be considered to be non-viable no later than when it had used up its capital conservation buffer and breached its Tier 1 minimum requirement.

The increase in the Tier 1 minimum from 4% to 6% therefore also raises the threshold at which the market will start to actively speculate on a bank's continued viability. There is also concern that a regulator may 'pull the trigger' early. In the absence of guidance on how a regulator views the non-viability trigger, the market will likely assume the worst case scenario of early exercise of the trigger.

The greater the potential for exercise of the trigger the more difficult it will be to find investors and, ultimately, the greater the cost to the industry. The ABA believes that the Committee needs to consider closely the potential market reactions in response to the existence of a non-viability trigger event when framing the guidelines for regulators. We see several risks relating to the existence of the trigger event, which are set out below.

3.1 Potentially increases the need for public sector rescues

The potential for all of a bank's Tier 1 and Tier 2 instruments to be converting at the same time means there is the threat of massive dilution of ordinary holders, regardless of whether there is a maximum number of shares applied on conversion. Share prices would become more volatile in times of stress as investors speculate on the application by a regulator of the trigger. The volatility is likely to arise due to fundamental concerns regarding the impacts of dilution; hedging behaviour from Tier 1 and Tier 2 holders looking to protect their potential equity position; and speculative and arbitrage trading likely to be associated with the price disruption.

Consequently, it may be difficult for banks to complete a large private issuance of common equity (a rights issue or placement) as new potential investors would be concerned about the prospects of Tier 1 and Tier 2 being converted, diluting their new stake. At the very least, the risk of additional dilution will raise underwriting costs and increase the discount needed to complete an ordinary equity raising transaction. Failure to complete private sector ordinary share raisings may contribute to the loss in confidence in a bank, exacerbating the situation.

Rather than making the private sector the first source of new common equity to revive a bank and "reduce the number of circumstances in which public sector rescues are deemed to be necessary", the ABA believes that these factors will combine to make the task of raising additional capital prior to the point of non-viability significantly more difficult. This means that the provisions risk creating the very real prospect of increasing the likelihood of requiring such rescues.

3.2 Discourages flows that should be encouraged

Regulators should be encouraging additional capital into the banking system, including subordinated long term instruments with better risk-sharing characteristics. Faced with a potential loss of their contractual preferred position in a capital structure, the risk averse behaviours of investors is more likely to see them seek less risky positions, such as collateralised forms of funding (e.g., high quality RMBS and covered bonds). The traditional providers of supplementary capital will be much less likely to provide that risk capital.

Efforts to orchestrate pre-emptive changes to the capital structure may therefore significantly reduce, if not shut down completely, a valuable source of cost effective risk capital. The shortfall could in theory be made up by issuing more common equity but we believe that forcing banks to completely fund minimum capital requirements with common equity imposes needless costs on the banking system at a time when that limited supply of common equity would be better used to fund the multiple capital buffers already mandated under Basel III.

3.3 Threatens ability to replenish Tier 1 and Tier 2

It is important to recognise that a going concern entity will continue to need Tier 2 capital and possibly Tier 1 instruments. The conversion of existing gone concern capital into equity may 'solve' one problem at the expense of severely hindering rapid investor take-up of the new issues of Tier 1 and Tier 2 securities required to replenish Tier 1 and total capital. This is not to argue that these classes of capital should be sheltered from the losses they are contractually bound to accept but to point out that the complete solution to the problem needs to ensure that the full range of going and gone concern capital is replaced in the supervisor initiated restructure of capital. A write-down rather than a write-off of Tier 1 and Tier 2 instruments, which would result in some principal retained in its original structure, would be one way to help achieve this outcome.

4. Conversion

For any write-off or write-down, the ABA believes that the issuance of shares as compensation (referred to as "conversion" in the consultative paper) is preferred to the alternative of a write-off or write-down with no shares issued as compensation.

Although the issuance of ordinary shares still raises a number of issues, it will at least ensure that holders of Tier 1 and Tier 2 instruments are ultimately placed on at least equal footing with ordinary shareholders. If holders of Tier 1 and Tier 2 instruments are forced to absorb losses at the trigger point, we believe that they should rank no worse than ordinary shareholders and be able to participate in future upside (and downside) of the bank.

A simple write-off with no ordinary shares issued would result in Tier 1 and Tier 2 holders no longer having an interest in the bank. By contrast, existing ordinary shareholders (initially more subordinated) could benefit from future upside in the bank and benefit from the write-off of the more senior non-common equity investors. This is essentially a transfer of value from more senior holders to common equity.

An additional issue is that the proposal does not impose a single method of calculating the number of shares to be issued on the trigger event. Leaving each jurisdiction free to impose the method, or establish caps or minima on the number of shares to be issued means there is potential for significant differences in the economic outcomes of Tier 1 and Tier 2 instruments across jurisdictions.

Specifically, a local regulators interpretation of a maximum conversion number may have a material impact on the cost and availability of Tier 1 and Tier 2 instruments for banks in a jurisdiction. This may lead to different costs of capital and the added complexity reduces transparency in the comparability of bank capital structures. It is noted that the Australian regulator APRA currently has a limit or cap on the number of ordinary shares into which existing Tier 1 instruments may convert (where conversion into a variable number of shares is allowed). A globally consistent approach to the number of ordinary shares to be issued upon "conversion" is recommended to avoid creating an unlevel playing field.

5. Implementation

The Basel Committee has also flagged that they are keen to understand whether there are any operational and legal obstacles to implementation of the proposal. A number of matters in an Australian context are highlighted, and indicate a need for a lengthy implementation schedule.

5.1 Ability to issue Tier 1 and Tier 2 capital securities

We have outlined in section 2 the reasons why it is important to respect the subordination hierarchy in the allocation of losses to investors. The typical investors in Tier 1 and Tier 2 capital securities are currently fixed income investors, both institutional and retail investors. These investors accept a lower return than common equity investors, on the basis that they will rank more senior than common equity.

One of the ABA's most material concerns is that the proposals significantly affect the relative seniority of Tier 1 and Tier 2 capital securities relative to common equity and each other and that it will take time for investors to assess the new risks associated with the securities. It will take time for institutional investors to change their mandates, if at all, to ones which allow for securities which may be converted into ordinary shares.

Some investors will be able to assess the new risks and/or change their mandates more quickly than others. In a situation where the entire banking industry will be seeking to issue such securities within the same timeframe there is a risk that there will be insufficient investor demand. The result may be that only the largest, strongest banks will have access to Tier 1 and 2 capital and the cost efficiency it provides.

5.2 Prior authorisation to issue ordinary shares

The proposals state that the issuing bank must maintain at all times a prior authorisation to immediately issue the relevant number of ordinary shares specified in the instruments' terms and conditions.

Under Australian stock exchange requirements, listed banks are limited to issuing, or agreeing to issue, up to 15% of ordinary shares in any 12 month period unless they obtain the approval of shareholders. A mechanism to facilitate the prior approval of shareholders will need to be developed and implemented.

5.3 Disclosure obligations under securities law

Under Australian Corporations law requirements, securities which convert to ordinary shares have different disclosure obligations to that required in connection with an issue of vanilla subordinated notes. Specifically, the issuance of securities convertible to ordinary shares is likely to require the preparation of a prospectus or equivalent document. This is likely to have at least two detrimental effects:

(1) Prospectuses are more time-consuming and costlier to prepare. This would lead to a reduction in flexibility and cost effectiveness in relation to issuing Tier 1 and Tier 2 capital securities; and

(2) It will no longer be possible to include Tier 2 capital issuance capacity in Australian, European and US debt programs (as is the case presently for the major Australian banks) because the program documents do not qualify as prospectuses. The inability to issue Tier 2 capital securities under a program style document will lead to a reduction in flexibility and efficiency.

5.4 Tax considerations

The ABA believes that the changes proposed by the Basel Committee are not intended to change the fundamental debt-like nature of Tier 2 instruments, which is also recognised by the Basel Committee (page 11). However the proposal results in a number of issues arising under Australian tax law in relation to the deductibility of interest payments for Tier 2 instruments. Australian tax law may need to be amended to ensure that deductibility of interest payments on Tier 2 capital securities is retained as a write-down, write-off or conversion will affect the ability of the securities to satisfy the debt test under existing Australian tax law.

6. Further Consultation and Alternatives

For the reasons set out in this paper, the collapse of a capital structure without regard to the subordination hierarchy poses significant risk and limits to the practicality of implementation. Accordingly, ABA recommends that a further consultation process be conducted to evaluate alternatives which could be developed to address the objective that all regulatory capital instruments are capable of absorbing losses whilst respecting the subordination hierarchy. One outcome of the process should be to ensure that there is a globally consistent transition to any new rules developed given the global investor base for Tier 1 and Tier 2 instruments.

Some members have suggested one option as an alternative approach for consideration, in the event of a public-sector capital injection, which is to provide for the issue of a more senior class of regulatory capital. This would rank above Tier 1 and Tier 2 instruments and "lock up" the cash returns of Tier 1 and Tier 2 holders, such that no coupons or principal could be paid out while the more senior ranking equity is on issue. The cash lock up has the effect of preventing any outflows on the Tier 1 and Tier 2 capital instruments from leaving the bank. This would require the terms of Tier 2 capital to be changed to include:

- a right to defer coupons (on a cumulative basis) and delay redemption if a regulator determines the trigger point has been reached; and
- for jurisdictions (unlike Australia) where a balance sheet test forms part of national insolvency law, the inclusion of loss absorbency features used in their existing Tier 1 securities to ensure the capital is available on a going concern basis.

The key benefits of this strategy are that it allows:

- a regulator the ability to determine on a case by case basis, which instruments would be subject to the lock up and the level of risk that the public sector would carry;
- The existing subordination hierarchy to be respected, with existing Tier 1 and Tier 2 holders able to retain value should the assets of the bank be more than sufficient to provide the return required by the new providers of capital; and
- The investor market for fixed income securities to continue, with improved loss absorbency features required by the Basel Committee, but with the subordination hierarchy for bank issued instruments respected.

The issuing of such an instrument gives time to achieve a more orderly reconstruction of the bank. It also maintains an incentive on the part of the existing providers of capital to achieve a speedy reconstruction or risk continued lock up and further dilution of earnings and their capital value.