Secretariat of the Basel Committee on Banking Supervision ("**BCBS**")
Bank for International Settlements
CH-4002
Basel
Switzerland

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BCBS CP 174 "Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability"

Dear Sirs,

Barclays Bank PLC ("**Barclays**") welcomes the opportunity to respond to BCBS consultation paper 174 "*Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability*" ("**CP 174**"). We have also contributed to the BBA and IIF trade association responses and broadly endorse the comments raised therein.

We support the BCBS objective to raise the quality of regulatory capital and we understand the importance of ensuring that subordinated debt holders share in the burden of rescuing a failing financial institution. However, the regulatory debate seems to have moved ahead of CP 174 to encompass broader concepts of going concern loss absorbency and senior debt bail-in. Incorporating additional principal loss absorption features in subordinated debt instruments seems broadly intuitive and we believe that a market based solution could be developed following a period of investor education on the product. However, introducing going or gone concern conversion features into other classes of debt instrument (e.g. senior unsecured debt) may be more challenging. Our comments on CP 174 should be considered in the context of this wider debate. In particular we note the following:

- there needs to be full engagement with the investor community to ensure that there will be a deep and liquid market for any new instruments (e.g. fixed income investor concerns over proposed conversion/permanent write-down features should be addressed before guidelines are finalised);
- there is uncertainty around national implementation of the BCBS proposals and an unlevel playing field has already begun to develop e.g. though CRD II in Europe and Dodd-Frank in the US; and
- the 12th September 2010 press release (the "September Press Release") introduced significant uncertainty into bank capital markets - the position on grand-fathering of non-qualifying securities is unclear and there is no

guidance on what instruments should be issued to replace maturing or amortising capital stock over the next few years; issuing debt capital whilst this uncertainty persists will be challenging and re-financing cliffs are likely to emerge as a backlog of supply builds in the system.

We believe that each of these concerns could be addressed through closer engagement between politicians, regulators, issuers and investors. Taking each of the above points in turn:

- a working group comprised of home and host regulators, issuers and investors could be convened to work through the outstanding issues;
- we suggest that the BCBS, through its Standards Implementation Group and/or with the FSB, work with politicians and national authorities to minimise distortions to the new regime; and
- a clear statement on grand-fathering from the BCBS would enable banks to re-finance maturing capital stock with "old style" instruments until new rules are developed for qualifying regulatory capital.

Further details on the technical elements of our response can be found in the Appendix to this letter. We would be happy to discuss the CP 174 proposals, or any other aspects of the current regulatory debate, at your convenience.

Yours sincerely,

Jon Stone,
Group Treasurer

APPENDIX

1. High Level Observations

We agree in principle that subordinated debt capital instruments with additional principal loss absorption features could be developed as a market based solution to increase the quality of regulatory capital. We also believe that such instruments would be a useful tool in the continuum of bank recovery and resolution planning. However the proposals in CP 174 must be considered against the backdrop of the wider regulatory debate on bail-in solutions. There is significant market uncertainty over the shape and scope of proposed bail in solutions (e.g. limited to subordinated debt or to include senior debt; imposed by statute or developed through contractual negotiations?). It is difficult to see how a deep and liquid market for CP 174 compliant instruments can develop whilst such uncertainty persists.

We also note that the proposals set out in the Consultative Document of 17 December 2009 "*Strengthening the resilience of the banking sector*" " and subsequent updates (the "**December CP)** require a substantial increase in the quantum and quality of regulatory capital, thereby reducing the likelihood of firms reaching a point of non-viability. It is important that the impact of the December CP and CP 174 are considered in aggregate (together with any subsequent consultations on this issue).

Fixed income investors have a number of concerns in respect of CP 174 capital instruments due to: (i) the regulatory discretion embedded within the proposed trigger; (ii) concerns over subordination following a trigger event (especially in relation to the permanent write-down feature) and (iii) inability for most fixed income funds to hold equity (either as a result of mandate or UCITS constraints). Unless CP 174 proposals permit a structure that fits within a traditional fixed income framework, we believe there will be a material impact on access to, and cost of, regulatory capital.

2. Analysis of Timing and Implementation Issues

The timing and overlap between CP 174 and the September Press Release has created uncertainty among market participants and national regulators.

It is not clear whether the comments in the September Press Release regarding phase-out of non-qualifying instruments seeks to prospectively apply CP 174. The transitional arrangements outlined in the September Press Release (which apply to instruments outstanding as at 12 September 2010) also imply that instruments which currently qualify as

regulatory capital (without the various December CP and CP 174 features currently under consultation) will not be eligible for inclusion as capital from 1 January 2013 onwards. We believe that this has prevented some banks from raising capital which we assume is an unintended consequence. The market would benefit from immediate additional clarity on the application of the September Press Release.

We also recommend that final policy should only be applied after a transitional period during which market participants can develop new compliant instruments without preventing issuance of "old style" capital. This would result in a slower transition to a capital structure that was fully loss-absorbent at the point of non-viability, but will allow banks to continue to access capital and manage re-financings to avoid any cliff effects of moving to the new regime. The higher capital requirements introduced by the December CP should mitigate the risk of reaching the point of non-viability in the interim.

3. Methods of Principal Loss Absorption

(i) Permanent write down

A permanent write-down feature creates Core Tier 1 capital on a trigger event, from both an accounting and a regulatory perspective. Under IFRS the liability will be permanently extinguished to the extent of the write-down and a corresponding gain can be recognised in the bank's income statement. However, from a tax perspective, instruments with a permanent write down feature (i) may not be tax deductible in many jurisdictions (including the UK); and (ii) is likely to give rise to a taxable gain at the very point the bank is seeking to conserve income to maintain capital strength.

A permanent write-down also effectively subordinates debt investors to ordinary shareholders. On the occurrence of a trigger event the claims of subordinated debt holders would be made *pari passu* with ordinary equity but, unlike ordinary shareholders, the subordinated debt holder has no opportunity to participate in the upside if the bank returns to health. In a liquidation scenario, claims of the subordinated debt holders would be permanently written down to zero, whilst ordinary shareholders are entitled to a proportionate share of the liquidated assets of the bank. This seems illogical and will doubtless reduce the available market for, and increase the cost of, regulatory capital (outlined further in "Investor Perspectives" below).

For this reason, we believe it makes sense to consider a partial permanent write down within the proposals. A partial write-down imposes losses on the capital instrument holder, but also respects the liquidation preference of regulatory capital vis-à-vis ordinary shares. A partial write-down could be constructed to replicate the losses typically absorbed by regulatory

capital in an insolvency. It could also be set at a different level depending on the relative subordination of the instrument.

(ii) Conversion to ordinary shares

A conversion to ordinary shares will create Core Tier 1 capital on a trigger event, from both an accounting and a regulatory perspective. Under IFRS the liability will be de-recognised and Core Tier 1 will be created (depending on the value of the shares issued) through the issue of new ordinary shares and, potentially, through the recognition (in retained earnings) of any gains or losses on conversion.

The corporate law authorisations required to issue instruments which convert into ordinary shares will present challenges to issuing banks. In particular, any issuance between Annual General Meetings may require Extraordinary General Meetings to approve the terms of the security, Directors authority to allot underlying shares and disapplication of pre-emption rights

Conversion to ordinary shares creates challenges for fixed income investors and is not compatible with many investor mandates. In addition, many European insurance and pension funds cannot hold ordinary shares as a result of the UCITS directive. Outstanding contingent capital instruments with conversion features have not seen widespread investor support for this reason (outlined further in "Investor Perspectives" below).

(iii)Temporary write down

We understand the BCBS concern that a permanent write-down is the only way to avoid any residual claims ranking senior to new common equity. However, permanent write-down features are unpalatable to the fixed income investor base and we believe that a write-up can be constructed so that any payments made (and the method of the write-up) are *pari passu* with common equity.

As an example, the following temporary write-down feature would appear to us to adequately absorb losses: (i) upon non-viability, the instrument is written down to zero such that there is no claim in liquidation (e.g. immediately after any public sector injection); (ii) any write-up would only occur once the bank has returned to health and in a manner that is *pari passu* with ordinary shares - this could be achieved by the write-up being permitted only from distributable profits allocated *pro-rata* across the equity base and the written-down debt investors (i.e. written-down debt investors receive a share of future distributable profits as if they had been converted into common equity); and (iii) the amount of written-up capital could be held in escrow during write-up and used to off-set any subsequent losses (*pari-passu* with ordinary shares).

To summarise, we believe a temporary write-down mechanism is preferable as it (a) respects the ranking of subordinated debt capital and common equity; (b) will attract a deeper and more liquid investor base; and (c) is a sufficiently flexible concept to achieve the required level of loss absorption.

A temporary write-down structure may not create Core Tier 1 from an IFRS perspective, as the liability cannot be de-recognised to the extent of the write-down. However as the recovery process puts an instrument *pari passu* with common equity, we believe that the instrument demonstrates the required principal loss absorption characteristics from a regulatory perspective (there are precedents for a temporary write-down structure in some jurisdictions e.g. the French TSS and German silent participation) and that a filter to the statutory accounts could properly be applied in these circumstances.

4. Issuer Perspectives

We welcome BCBS' flexible approach to national implementation, which will allow for principal loss absorbency mechanisms to be designed in the context of national legal, tax and accounting frameworks. However, we make the following observations which may be useful in ensuring that the final guidelines contain sufficient flexibility to develop a viable instrument from an issuer's perspective.

The proposals in section three of CP 174 are phrased requiring permanent write-down first, with compensation being subsequently provided in the form of ordinary shares. This suggested sequencing may purely be a drafting issue, but may create challenges. For example, in the UK, this sequence may make it difficult to ensure tax deductibility of coupon payments. Greater flexibility in the wording of the guidelines such that the requirement is for either a write down <u>or</u> a conversion into ordinary shares (and not a permanent write down followed by ordinary shares issued in compensation) would be helpful.

We understand and agree with the analysis that the quantum of shares to be provided (e.g. zero to a fully variable number issued at par) represents a trade-off for shareholders between dilution of their shareholdings and cost of coupons. This trade-off will need to be evaluated and debated between debt investors and shareholders and, consequently, we support maximum flexibility in establishing the appropriate conversion ratio. The choice between a fixed and a variable number of shares will affect the corporate approvals sought by an issuer prior to issuance. For example, if the conversion price is not fixed (i.e. a fully variable amount of shares could be issued), the shareholders would need to grant authority to allot, and dis-apply pre-emption rights in respect of, the maximum number of

shares which could be issued on conversion (namely principal amount of the relevant instruments multiplied by the par value of the ordinary shares). This should be contrasted with a fixed conversion price (subject to customary adjustments) where shareholder approval will be based on the conversion price (which would be in excess of par).

We are concerned that the existence of widespread equity conversion features in a substantial volume of debt capital instruments may result in significant hedging activity (e.g. share shorting) during a stress situation. This will have the impact of materially depressing the share price, undermining confidence in the bank and increasing the likelihood of non-viability.

5. Investor Perspectives

We believe that developing a product suitable for fixed income investors is crucial if there is to be a future for non-Core Tier 1 regulatory capital. Developing acceptable methods of principal loss absorption will require some flexibility to (i) accommodate fixed income investors and (ii) allow for different legal, tax and accounting frameworks.

We are concerned that some investors in fixed income instruments will be reluctant to accept an instrument that converts to ordinary shares in sufficient volume for a viable market. This has been the experience of recent issuance in the contingent capital market. The main group of institutional fixed income investors that have been involved in such products are hedge funds, which are not large enough alone to provide a future viable market and do not necessarily have the stable buying patterns necessary to achieve BCBS corporate governance aims.

We also expect fixed income investors to be concerned that a permanent write-down effectively subordinates them to shareholders. This is because in they have no claim to the written-down amount (in the event of insolvency) and no ability to benefit from any recovery post-write down.

Consequently, we suggest a viable future market with maximum investor participation requires an instrument that can be written-down and subsequently written back up on a return to health. We believe this can be achieved whilst maintaining the required regulatory loss absorbency (see "Methods of Principal Loss Absorption - Temporary write down" above).

A deep and liquid market for fixed income regulatory capital ideally requires bond market index eligibility (used to benchmark investors' performance). Index providers generally lag product development and are unlikely to confirm whether CP 174 features meet index-eligibility until after issue and following consultation with investors. However we note that bond index eligibility is more challenging for instruments with equity

conversion features, and in particular recent contingent capital instruments converting to equity are currently not eligible for inclusion. We note this as an additional factor supporting (i) a phased implementation of CP 174 proposals and (ii) consideration of temporary write-down (there is precedent for capital instruments with temporary write-down features being index eligible).

Fixed income investors also require instruments that can be rated by all three major rating agencies. We note that one major rating agency (Moody's) has indicated concern over the ability to rate instruments proposed by the BCBS due to the difficulty in determining the probability of the trigger being exercised and extent of any loss imposed. Both concerns would argue for maximum flexibility in instrument design and further consultation directly between BCBS and the rating agencies.

If conversion to ordinary shares is the preferred method of principal loss absorption, there should be flexibility for the instrument to convert into a variable number of shares. As noted above, the dilution / coupon and market-access cost trade-off can then be considered by shareholders with full flexibility.

BCBS comments with respect to solutions for investors who are not able to take delivery of ordinary shares are useful, as this problem is widespread. The preferred solution is to avoid issuing shares as we expect some investment and pension advisers will view equity holdings via a vehicle as mandate arbitrage and so will remain only a partial solution. We also believe that this solution could be implemented in a private context (e.g. via existing custodian and special purpose vehicle mechanisms) without a government-backed solution being required.

6. Trigger Points

To ensure a continuing viable market it is critical that the trigger for non-viability is as transparent as possible and truly reflects a situation of non-viability. There is a concern amongst investors that excessive regulatory discretion contained within such a trigger may become highly politicised and materially changes the risk profile of regulatory capital. We propose that the trigger for non-viability is connected to an observable metric (e.g. a bank's threshold conditions for authorisation).

We do not believe that the first proposed trigger of a public sector injection is necessary and that the second trigger should provide sufficient flexibility to cover non-viability scenarios. We believe it is important that there is protection against situations such as those that occurred in the US where there were widespread public injections of capital across major banks, not all of whom were at the point of non-viability.

We appreciate it is difficult to design a completely objective test for non-viability and an element of regulatory discretion is necessary. However, we also note that regulators may find it difficult to exercise discretionary powers provided in the terms of the trigger without some statutory protections or safeguards.

We believe the proposals relating to multiple regulatory triggers (where a capital instrument is eligible capital in more than one jurisdiction) will add incremental cost as investors will seek to price for the additional inherent regulatory discretion. There is a fear that multiple triggers could lead to confusion and a race to the bottom between regulators in the activation of a trigger. The above will deter issuance by and increase costs for multinational banks.

We propose that the aims of this proposal could be more effectively achieved with the "home state" supervisor taking responsibility for the trigger with appropriate co-ordination and communication between relevant "host" regulators.

As an overarching point on triggers, we note that there are currently a wide range of proposals in discussion that may require a trigger to be determined (e.g. going-concern contingent capital, principal loss absorption features in hybrid Tier 1, as well as loss absorbency at the point of non-viability). We believe it would be beneficial for the BCBS to map out how these triggers will interact with each other and with the proposed capital conservation and counter cyclical buffers. We believe that the triggers need to be determined to provide transparent distinction allowing the market to efficiently price instruments with different trigger points.