The voice of banking & financial services

1st October 2010

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland
baselcommittee@bis.org

Dear Sirs,

The Basel Committee's *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability* (CD 174)

The British Bankers' Association (BBA) is the leading association for the UK banking and financial services sector, speaking for over 230 banking members from 60 countries on the full range of the UK and international banking issues. All the major banking players headquartered in the UK are members of the association as are the large international European Union (EU) banks with operations in the UK, the US banks operating in the UK and many other financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit-taking and other retail/commercial banking activities.

Key messages

The BBA welcomes the opportunity to comment on the Committee's proposals. We consider them to be an important initial step in generating debate before the concept is finalised. The concept is one we see fitting very much into the continuum of the overall regulatory process surrounding recovery and resolution. The ideas within the consultation should therefore be considered in tandem with the concepts of bail-ins, and recovery and resolution plans, which the BBA has worked closely with the authorities on. In addition, there is a need for a broader review of the respective roles of the various types of capital instrument as a bank begins to get into distress.

We fully appreciate and support the intention that capital should be able to absorb losses so that depositors (on a secured creditor basis) and taxpayers are not called upon to save a bank. There is a need to reduce the moral hazard. No firm should be considered too big to fail. We therefore understand the area the proposal is seeking to solve but believe there is more work required to ensure the technicalities of developing such instruments are fully considered and taken account of.

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The appetite of the capital markets for these instruments is crucial. Substantial dialogue is required with the investor community to understand their concerns and issues, and the Committee should not rely solely on the responses received to this consultation as they may not be representative of all major investors. There are significant regulatory, legal, and accounting aspects to be worked through for the investor community to be clear about their ability to invest in such instruments, and for them to be priced appropriately. It is particularly important in this regard that there is clarity as to where any particular investment sits in the capital structure on failure. These issues are laid out further in the attached Annex.

In addition it is important to recognise that regulatory capital instruments that are loss absorbing at the point of failure are not the only answer. They are one of a range of mechanisms, and perhaps not the principle one, that can be deployed to mitigate the impact on society of the failure of a bank. These mechanisms should seek to reduce the risk of a bank's failure (for instance more and higher quality regulatory capital and higher liquidity standards) and the impact of its failure should it nonetheless fail. Gone concern capital has a role to play in reducing the public impact of a bank's failure, but a far more important tool will be the development of an effective resolution regime that properly addresses the failure of all banks, including those operating internationally. These initiatives should equally be pursued by the Committee to ensure uniform application.

We therefore think it critical that more joint industry work be undertaken to develop a more comprehensive framework for resolving banks that includes recovery and resolution planning, more effective supervision, cross-border cooperation through the crisis management groups and appropriate powers for the resolution authorities. This work should involve a cross section of investors, banks and regulators to develop the framework. The BBA and its members remain keen to play a role in taking such work forward.

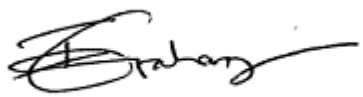
Conclusion

This principles-based approach as outlined is merely a starting point for further dialogue. There are many issues that need to be resolved in greater detail, as outlined in the attached Annex. The BBA looks forward to engaging with the Committee as this and related proposals are developed.

The Annex to our letter contains further specific observations and questions arising from the Consultation.

We hope that you will find our comments useful. Please do not hesitate to get in touch either by e-mail (irene.graham@bba.org.uk) or telephone on 020 7216 8874.

Yours faithfully,



Irene Graham
Director
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Annex

Scope

The proposals appear to target trans-national and multi-purpose banks. However, many banks with a domestic or limited focus failed in the crisis. Therefore, all banks should be brought into scope. We do not support the view that it is possible to define systemically important financial institutions (SIFIs). Institutions are dynamic and there are risks in trying to place institutions into buckets which will change over time.

In addition, there appears to be no distinction between debt capital securities. An indication of what the different types are for would be useful. For example, Annex 1 of the September 12 2010 press release includes reference to the counter-cyclical buffer as consisting of "common equity or other fully loss absorbing capital" (while it has been made clear that the capital conservation buffer consists only of common equity). It should be confirmed that instruments meeting the requirements of this proposal would count for this purpose.

It would be helpful if the Committee could clarify its view on the requirements for "host instruments" generally. As the trigger foreseen by BCBS 174 is clearly designed to deliver Core Tier 1 to a bank in advance of its bankruptcy or liquidation, it can be argued that the nature of the host instrument (in which the trigger is embedded) is of little consequence. It could be said that any instrument with such a trigger should be eligible for use in buffers.

Resolution

This proposal suggests three options:

- regulatory capital instruments capable of bearing losses,
- the exclusion of Tier 2 instruments from regulatory capital for systemically important banks, and
- the inclusion of provisions in the terms and conditions of regulatory capital issuances that ensure that these securities take a loss at the point of non-viability.

A global resolution regime in our opinion is the only way of tackling failing firms, preventing moral hazard issue and recourse to the taxpayer. This should respect the integrity of the capital structure, and in particular the waterfall of subordination on failure, and operate in a way which is predictable so as to enable investors to price risk. Alignment will be a challenge, but it should be tackled now. Some of the issues that complicate harmonisation are detailed below.

Much work has been undertaken in the past year by policymakers and the banking industry, including the BBA, to develop appropriate resolution regimes, including the development of recovery

and resolution plans (also known as living wills), bail-ins and new types of regulatory capital securities. All these form part of the overall framework. Policymakers should adopt a holistic approach. The Committee should encourage countries lacking existing resolution regimes/ tools or plans for these regimes to adopt them.

Ranking/ Shareholder dilution

Ranking on insolvency/failure will become more important as the range of regulatory capital instruments is widened, especially for investors. Seniority is based on contract and commercial law. Clarity of the position of any particular instrument in the capital structure – both in an insolvency and in a resolution (together "failure") – is absolutely critical to investors. Any measures which leave uncertainty as to the ranking of a particular instrument on failure will be likely to result in increased cost of capital for banks in relation to the relevant instrument, impairing the efficiency of capital raising for banks. Any changes to the existing framework should therefore respect the integrity of the capital structure.

In addition laws governing shareholder rights will need to be considered as this proposition evolves to ensure accommodation and adherence to existing company law and therefore ongoing permissibility of any conversion of such instruments to equity.

Trigger

As a matter of general principle, those powers which have the potential to affect third parties (outside the regulated institution itself and its management) clearly need to be objective, and used as a matter of last resort. This points towards the same trigger being used for loss absorbent capital as for other resolution tools.

Determining the correct trigger point is particularly important to investors. Industry participants are therefore keen that the trigger be as objective as possible, to enable stakeholders to manage the risks associated with the bank being subject to the write down, albeit there is a balance to be made between this and the flexibility needed by authorities over the trigger, to prevent stakeholders from precipitating a bank failure.

We therefore recommend the regulatory trigger for the loss absorbent instruments to be based upon those aligned to an institution having failed or being likely to fail its threshold conditions for authorisation under the relevant Regulatory code e.g. in the UK the Financial Services and Markets Act 2000, where the two principal requirements are focussed upon the institution being fit and proper and that it having adequate financial resources. The importance of maintaining market confidence points to the need for an element of supervisory discretion and confidential triggers.

Demand for convertible securities

Our discussions with institutional investors suggest that they doubt whether they would be able or willing to invest in convertible instruments, suggesting that the returns on such instruments would have to be higher than for equity given the potential downside and no upside after the trigger event. In any case, their investment mandates and limits will have to be reviewed. Further, questions of whether conversion rights are contractual or arise as a matter of applicable law may influence whether institutional investors which are subject to restrictions on their investment powers (such as mutual funds and insurance companies) may continue to invest in Tier 2 instruments. Questions of whether institutional investors may invest in convertible instruments will need to be considered as part of considering viability and economic impact of any more detailed proposals.

Investors in regulatory capital instruments accept that in the event of the insolvency and liquidation of a failed bank they will absorb losses, in the correct sequence – that is Core Tier 1 investors will do

so first, progressing down the waterfall through non-Core Tier 1 going concern instruments and finally Tier 2 gone concern regulatory capital instruments. The Committee's proposals should not disturb this accepted and proper sequence of loss absorbency. In particular gone concern regulatory capital instruments should not be written off or converted until existing Tier 1 shareholders and investors have first either decided to invest more money or have taken all relevant losses.

In addition, due consideration to the approach Rating Agencies will take to these instruments needs to be taken into account and worked through.

Future funding requirements

Gone concern contingent capital instruments cannot alone make up for the expected shortfall in funding and, while there remains uncertainty about the eventual regime for capital instruments and grandfathering, this gap is unlikely to be filled. The Committee could help in enabling the market to create the appropriate capital instruments by establishing a clear timeline for further deliberations on going concern capital, and for local and regional jurisdictions to establish relevant jurisdictionally based approaches to implementing the principles proposed in this consultation paper. Grandfathering of existing instruments will be necessary.

Internationally active banks

Conflicts of interest may arise between the home and host supervisors of cross-border banking groups. For example, there may be political sensitivities if the affected creditor or shareholder is affiliated to a foreign power. Similarly, there may be political considerations for national authorities if the affected debt holders are domestic retail investors, or pension and insurance funds, or, conversely if the debt holders are foreign. It will be essential to harmonise standards in this area and for there to be clear guidelines as to roles and protocols surrounding consolidated supervisor lead co-ordination with host supervisor and relevant participants of colleges/ crisis management colleges.

Operational challenges

Grading will have to be aligned across jurisdictions. There should be a timetable set to achieve harmonisation.

The accounting of the conversion/write down process in accordance with IAS 32 and US GAAP should be examined. Therefore, the Committee should engage the IASB and FASB, issuers and investors. Please note that the eligibility of an instrument for regulatory capital purposes should not be determined by its accounting and/or tax treatment.

Pre-emption rights differ around the world. Some countries require authorisation for the issue of new shares, which may hinder conversion. The impact of the proposals on the cost and management of capital, including the ability to meet regulatory requirements and tap capital markets when conditions are favourable, should be considered.