ASSOCIATION DES BANQUIERS CANADIENS
CANADIAN BANKERS ASSOCIATION

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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Sirs/Madams:

Re: CBA Comments on the Basel Committee's *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability* consultative document

The Canadian Bankers Association[1] appreciates the opportunity to comment on the Basel Committee's consultative document entitled *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability.* While we are supportive of the principle that capital needs to be loss absorbing in times of stress, more debate and discussion of the contingent capital concept is needed before it becomes an integral feature of regulatory capital. We have several concerns with the Basel Committee's proposal, which we outline below.

1. Market Capacity

We are fundamentally concerned that the market capacity for capital instruments that are written off on the occurrence of a trigger event and converted into common stock (i.e., contingent capital) is untested and may be inadequate for the following reasons:

Investor Demand

Contingent capital instruments are new complex instruments that do not fit well with the existing investment mandates of most investor classes. For subordinated debt (subdebt) in particular, the conversion feature conflicts with the investment mandates of most fixed income investors who are prohibited from holding equity securities. This is especially significant from a market capacity perspective since access to the fixed income investor base is essential to achieve large transaction sizes.

The marketability of contingent capital will also be highly dependent upon receiving an investment grade credit rating. Rating agencies have indicated that they may not rate these securities in the absence of a transparent trigger. This is a significant issue since the instrument will need to be

[1] The Canadian Bankers Association works on behalf of 51 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 263,400 employees to advocate for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions.

rated to be cost-effective and to achieve a wide enough investor base to make issuances successful. We also note that if the ratings of the new embedded contingent capital instruments are a few notches below current ratings, this may pose difficulties for investors that have minimum rating thresholds. Inclusion in bond indices (for subdebt) will also be critical since it will help marketability and acceptance of contingent capital among fixed income investors.

We are generally concerned that the subjective trigger decision (at the regulator's discretion) will materially impair the marketability of contingent capital instruments. This view has been expressed to us by numerous market participants, including many from the Canadian investor community.

In addition, there may be liquidity concerns with the proposed new instruments, given these instruments are new, complex and would have a more limited buyer base.

We would also note that investors may prefer shorter maturities, fearing conversion, which would constrain a bank's ability to raise longer term subdebt, therefore concentrating maturities in the short end of the curve.

Impractical to Fully Recapitalize with Embedded Contingent Capital

It is risky to rely solely on contingent capital to fill all non-common capital needs. We note that Canadian banks alone have approximately $75 billion of non-common capital instruments outstanding. This volume of capital, combined with the non-common capital outstanding from other jurisdictions around the world, leads to considerable risk that there would not be enough world-wide capacity to meet the banks' need for contingent capital.

Negative Impacts on Depth of Market

It is critical to the sound health of a bank to maintain access to a diversified and deep investor base to support capital issuances. We believe that the investor base for contingent capital would be significantly smaller and less diverse than that for traditional bank non-common instruments. It would be essential that contingent capital support a broad investor base, and that fixed income investors in particular support the instruments, in order for banks to issue benchmark sized transactions.

2. Cost of Capital

Cost of capital would rise significantly if existing non-common instruments were to be replaced with gone-concern contingent capital. This would put further pressure on the ability of the banking community to provide cost effective lending products to consumers and businesses.

Tax deductibility of interest expense may not be achievable in many jurisdictions. Without deductibility, the cost of these instruments may approach that of common equity, which would put further pressure on cost of capital. Beyond cost of capital to the issuers, the fixed income nature of the instruments is important for marketability to the tax exempt investor base that underpins the Canadian fixed income market. Accordingly, we recommend that the tax-deductibility of interest expense associated with certain non-common Tier 1 and Tier 2 debt instruments be assured.

Furthermore, pricing needs to be competitive relative to common equity, and designing a trigger that investors feel is sufficiently remote will be critical to achieving broad marketability and a competitive cost.

3. Risk of Market Manipulation and Other Unintended Consequences

We note that certain market participants may have an incentive to short the common stock during times of stress, due to the nature of the proposed trigger. This could destabilize the financial condition of the bank during a stress event and make it more difficult for a bank to recapitalize ahead of the trigger event. Even in a stable environment, the cost of raising equity capital would likely increase due to dilution concerns of the trigger events. The pre-existing potential dilution created by the contingent capital will make it very difficult for a bank, which is experiencing a moderate problem, to re-capitalize itself prior to the conversion event.

Also, contingent capital conversion would not be a catalyst for attracting new private capital. It is questionable whether a bank could attract new private capital immediately after a trigger event from either the equity market or contingent capital market, thereby necessitating government support.

We note that it is critical that the conversion of non-common instruments to common shares be non-dilutive to EPS until an actual conversion occurs. We recommend that regulators work with accounting bodies to ensure that this is the case.

Further, there may be numerous corporate law considerations in different jurisdictions. For example, the quantum of convertible capital required by this proposal may conflict with anti-dilution laws, which limit potential dilution in the absence of existing shareholder approval.

4. Conclusion

Due to the considerable hurdles and uncertainty around the market feasibility of the proposal, the market capacity issues, increased costs and unintended consequences related to the current proposal, we recommend that the Basel Committee investigate introducing contingent capital into the capital structure as another form of capital, to exist alongside existing structures and to count towards buffer requirements, rather than making all non-common instruments contingent. If the proposal in the Basel consultative document is implemented, a long and clear transition period will be appropriate for the same reasons.

Preserving existing non-convertible capital instruments (including non-convertible preferred shares) in the capital structure will assist in maintaining a well diversified investor base for capital-raising activities.

We note that there is talk of going concern capital as well. As we move forward, we recommend that a holistic approach be adopted and clarity established between the two.

Finally, we recommend that an internationally consistent approach be adopted for implementation. In essence, our concerns over the implementation of contingent capital would be exacerbated if the proposal was implemented asymmetrically in different jurisdictions. Moreover, an asymmetric implementation of contingent capital (i) may create competitive advantages between banking institutions in different jurisdictions depending on the timeline and scope of implementation, and (ii)

may create obstacles to the issuance of regulatory capital across borders as a result of structural inconsistencies in the various instruments.

We would like to thank you for considering our comments and would be pleased to supply additional information at your request.

Yours truly,

cc: Mark White, Assistant Superintendent, Regulation Sector, OSFI
Gilbert Ménard, Senior Director, Capital, OSFI
Richard Gresser, Managing Director, Bank Capital, OSFI