CreditSights NEW YORK LONDON NEW DELHI SAN FRANCISCO DUBAI BOSTON
5th Floor, 35 New Bridge Street London, EC4V 6BJ Tel +44 (0)20 7429 2080 www.CreditSights.com

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

24th September 2010

Dear Sirs,

**Comment on Loss Absorbency Proposal**

Please find attached a summary of points raised during a recent round table discussion held at the London office of CreditSights, in response to the Consultative Document released on 19 August 2010, **Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability**.

As a leading independent credit research provider, CreditSights periodically organises "round table" events to allow market participants from different constituencies to share views on topical issues. On this occasion we invited representatives from the fields of asset management, sell side research, financial institution debt origination, bank strategy and planning, and from regulatory bodies.

The attached report is our summary of the concerns, questions and suggestions that arose from the discussion held on 16 September 2010.

Yours faithfully,

Simon Adamson and John Raymond
Senior Analysts, European Financials
CreditSights, London

Credit Sights

## Euro Banks Round Table: Basel Bail-ins & Bail-outs

Sector Analysis: 22 Sep 2010, 11:41 PM ET

- We held a round table discussion at our London office with a small group of market participants to discuss the Basel Committee's latest proposals on loss absorbency for regulatory capital instruments.
- While there was general support for the Committee's aims to strengthen the quality and quantity of bank capital, the overwhelming impression was of confusion and uncertainty regarding the implications for investors.
- In particular, there was unease over the shift in the balance of risk between bondholders and shareholders, and scepticism over whether there will even be an investor base for the new loss-absorbing instruments.

On 16 September 2010, we held a round table discussion at our London office with a small group of market participants from different constituencies, including asset management, sell side research, FIG origination, bank strategy and planning, and regulatory bodies. The topic of the discussion was the **Consultative Document** issued by the Basel Committee on Banking Supervision on 19 August 2010, "Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability". After we sent invitations to the round table discussion, the Basel Committee published a **press release** to announce higher global minimum capital standards, which included decisions on the grandfathering and phasing-out of existing capital instruments. We also included parts of this document in our discussion. We have previously published our own analysis of the two documents (see **Bank Subordinated Debt: Basel's Loss Leader** and **Euro Bank Capital Model 2Q10: Basel 3 is Here**).

**Basel 3: Minimum Capital Requirements**

| | Common Equity (after deductions) | Tier 1 Capital | Total Capital |
|---|---|---|---|
| Minimum | 4.5% | 6.0% | 8.0% |
| Conservation buffer | 2.5% | | |
| Minimum plus buffer | 7.0% | 8.5% | 10.5% |
| Countercyclical buffer range | 0% - 2.5% | | |

Source: Basel Committee on Banking Supervision

**Basel 3 Phase-in Arrangements**

| 1 January | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|
| Minimum Common Equity Ratio | 3.5% | 4.0% | 4.5% | 4.5% | 4.5% | 4.5% | 4.5% |
| Capital Conservation Buffer | | | | 0.625% | 1.25% | 1.875% | 2.5% |
| Minimum plus buffer | 3.5% | 4.0% | 4.5% | 5.125% | 5.75% | 6.375% | 7.0% |
| Regulatory deductions | | 20% | 40% | 60% | 80% | 100% | 100% |
| Minimum Tier 1 Ratio | 4.5% | 5.5% | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% |
| Minimum Total Ratio | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| Minimum Total plus buffer | 8.0% | 8.0% | 8.0% | 8.625% | 9.25% | 9.875% | 10.5% |
| Non-qualifying instruments | 90% | 80% | 70% | 60% | 50% | 40% | 30% |

Source: Basel Committee on Banking Supervision

**The main conclusions from the discussion were as follows:**

- There was general support for the aim that banks should be better capitalised, and the principle that banks should be regarded as 'gone-concerns' in situations in which the public sector provides support to distressed banks that would otherwise have failed.
- However, the proposed loss absorbency feature of new capital instruments – a write-off clause with or without conversion into equity – was regarded as deeply unattractive, and the consensus was that it would be very difficult to find an investor base deep enough to purchase the required issuance.
- The proposed 'trigger events' were seen as problematic, in particular the possibility that non-viability, which would cause a write-off, could be determined by the regulator, even before a public injection of capital might be necessary. This could lead to bondholders taking losses ahead of, and even instead of, shareholders.
- On this basis, bondholders are exposed to the downside of bank failure but not the upside available to shareholders, unless the conversion feature is attractive, although many fixed income investors would be unable to hold equities. The question asked by several participants was "why would an investor buy such an instrument in preference to equities?".
- The proposals need urgent clarification in several areas that affect outstanding Tier 1 and Tier 2 securities, including the grandfathering and phasing-out of instruments that will no longer qualify as capital. It remains unclear whether banks can enforce regulatory calls in 2013, how certain they are to redeem bonds on their first call date, and whether the hybrid and subordinated debt market will be dormant until questions over grandfathering are clarified.
- However, an even bigger concern to the fixed income market is the "parallel efforts to ensure that all banks that fail are capable of being effectively resolved and losses allocated to both senior and subordinated instruments", with fears expressed over the implications for the senior debt market of possible 'bail-in' proposals.
- The general view was that the original aims of the Basel Committee and the G20 – more standardized, less complex capital instruments in a globally co-ordinated framework – have been abandoned.

**Who will buy the new instruments?**

There was no real dissension around the table to the rationale for the Basel Committee's aim to improve both the quality and quantity of banks' capital, nor to the principle explained in the Consultative Document that "we define gone-concern also to include situations in which the public sector provides support to distressed banks that would otherwise have failed". Nor was there any argument with the view that most existing regulatory capital instruments did not really absorb losses during the banking crisis (or did so to a very limited extent, mostly via coupon deferral). The issuance of hybrid securities was in effect a conjouring trick in which they were regarded as bonds by investors and equity by regulators. **However, the view that investors have had a free ride on the back of government bail-outs – the moral hazard argument – was challenged.** The Basel Committee appears to see loss absorbency differently for bond and equity investors by focusing solely on the accounting treatment of the capital instruments. **In fact, many holders of hybrid and subordinated debt have suffered losses in the same way as shareholders, by marking-to-market bonds as prices fall, by being forced sellers of bonds at distressed levels as ratings are downgraded, or by taking part in distressed exchanges and buybacks.** This element of burden sharing appears to have been unrecognized by the Basel Committee.

**It was clear from our discussion that regulators are focusing mainly on the quality of eligible capital instruments, not on the nature of the investor base or on types of potential buyers.** The danger is that the Basel Committee is prescribing instruments that no-one wants to buy. The majority view at the round table was that the proposed loss absorbency features will make the instruments extremely unattractive to traditional fixed income buyers. In effect, these

proposals might end up being "a messy way to accelerate disintermediation", as investors avoid subordinated bank paper in favour of industrial issuers' bonds. For large and well-rated industrial companies with direct access to the debt capital markets, that may not be a problem, but it could prolong the funding difficulties of small/medium-sized corporations that still rely on banks as financing intermediaries.

| Summary of Changes | | PAST | | FINAL RULES - 1 JAN 2019 | |
|---|---|---|---|---|---|
| | | Typical Features | Requirement | Typical Features | Requirement |
| Tier 1 | Core or Common Equity Tier 1 | Common equity and reserves | Not formally stipulated | Common equity and reserves | 4.5% + 2.5% conservation buffer = 7% |
| | Hybrid Tier 1 | Perpetual, Non-cumulative deferral option, Step or non-step<br><br>Limited/temporary or no loss absorption on principal | Up to 50% of overall Tier 1, with 15% sub-limit for step-up or innovative issues | Perpetual, Non-cumulative deferral option, No step-ups<br><br>Write-off/equity conversion if bank is supported as a "gone concern" | Difference between Common Equity Tier 1 and overall Tier 1 |
| Overall Tier 1 | | | Min 4% RWA | | 6% + 2.5% = 8.5% |
| Tier 2 | Upper Tier 2 | Perpetual, Cumulative deferral option, Step or non-step | No sub-limit within Tier 2 | No distinction between Upper and Lower Tier 2 debt. Likely to be dated and must be non-step. No coupon deferral requirement. Must contain full write-off/equity conversion | Difference between actual Tier 1 and required total capital. No change in 8% total capital requirement before conservation buffer |
| | Lower Tier 2 | Dated, No coupon deferral, Step or non-step No loss absorption except through liquidation of the bank | Max 50% of Tier 1 | | |
| Total capital | | | Min 8% RWA | | 8% + 2.5% = 10.5% |

Source: CreditSights

Problems include the punitive write-off feature, the lack of clarity over conversion and the wide discretion allowed to regulators to declare non-viability. Presumably, therefore, non-viability could reflect problems related to liquidity and funding as well as to solvency. One participant expressed the opinion, widely accepted, that some regulators may be unhappy at the prospect of being in a position to decide on non-viability. **There was genuine concern that the proposals are too complex to be workable.** A minority thought that, over time, and with a generous enough coupon, buyers could be found. Important factors will be the willingness of rating agencies to assign ratings (they avoided rating Rabobank's SCNs) and the willingness of bond indices to accommodate them. And it was accepted that regulators might like the idea of more activist bondholders, such as hedge funds**. However, there was deep scepticism whether bondholders of any persuasion could exert a serious influence over management.** For hedge funds, one way to concentrate the minds of issuers is to short bank capital instruments by buying subordinated credit default swap protection, but the lack of uniformity in these new instruments might not allow the subordinated CDS market to continue functioning, as we noted in our initial reaction to the proposals. Also, a significant proportion of the new-style subordinated debt might eventually be held by private clients, who would not be able to fulfill an activist role either.

There was no agreement on what sort of coupon these new instruments would have to offer, partly because the market will need to see how they are structured first. However, it was accepted that the cost to the issuing bank might be higher than that of issuing equity. Together with the perceived unattractiveness to investors, the question was asked **"why does the Basel Committee not simply insist that banks meet regulatory capital requirements with common equity?"**.

One participant expressed the view that the instruments might be more attractive if the conversion at point of non-viability were contingent on shareholders explicitly refusing to participate in a deeply discounted rights issue. The rationale is that, if the regulator stepped in early enough, the chance of write-off and conversion would be reduced because shareholders might be positive about the bank's ability to recover. This idea was received positively, although the caveat is that conversion would happen only when shareholders were too bearish to consider a rights issue, i.e. when the prospects of recovery were at their most negative. It was agreed that regulators would need to have an agreed code of conduct on when to declare non-viability, to ensure consistent treatment across the sector, across borders and among different classes of stakeholder.

**Confusion over outstanding instruments**

Spreads on many hybrid and subordinated securities have tightened significantly since the Basel Committee's 12 September press release, on assumptions that many bonds will be called early. However, the round table discussion revealed considerable uncertainty around these issues. The key phrase is "instruments with an incentive to be redeemed will be phased out at their effective maturity date". **It is not entirely clear from the text whether this means that Tier 1 and Tier 2 bonds will fall out of the capital structure immediately and entirely as their step-up dates are passed, or whether they will start going through a regulatory amortisation process, but the consensus of opinion favoured the first interpretation.** That will give a very large incentive to issuers to call. However, there was uncertainty over whether this means banks will automatically exercise calls. Several participants pointed out that calls might not be allowed by regulators (especially if the instruments cannot be replaced by new ones). Some issuers have lower-coupon Tier 2 bonds that might still be cheaper after they have stepped up than senior funding at today's levels.

**In addition, many Tier 1 bonds give the issuer the option to call at par if the instrument no longer qualifies as Tier 1 (the 'regulatory call').** Phasing-out of non-loss absorbing subordinated debt begins in 2013, with an incremental 10% per year regulatory amortisation. Again, it was not clear around the table whether this sort of gradual amortisation will be deemed to have triggered the right to call, and this may be something that lawyers have to fight out. But the market is assuming that it will, and is bidding up lower-coupon Tier 1 bonds that have been trading at par or a discount. Higher-coupon Tier 1 bonds, trading above par, have performed less well or in the extreme cases even suffered, because they might be pulled back down to par by 2013. Another unresolved question is how the phasing out might interfere with the current amortization of Lower Tier 2 bonds – 20% per year in most countries over the last 5 years to maturity. **Overall, the view was that the regulations are becoming too complex, and the sequencing of events and triggers too complicated.**

**Implications for European banks**
There was some confusion over which banks the new capital requirements will affect. The Basel agreements apply to "internationally active" banks, but the key document for EU banks will be CRD IV (the third set of amendments to the Capital Requirements Directive in two years). It is unclear if this will apply to all banks. **If it does not, then there is a prospect that smaller banks could continue to issue old-style instruments and would not be constrained by the new requirements on loss absorbency.** There was also some frustration over the failure so far to identify systemically important financial institutions (SIFIs). It was widely agreed that small banks that are part of large groupings, such as savings and co-operative banks (probably the majority of small banks in Europe) should be seen as SIFIs, and that markets remain sensitive to the failure of even small banks.

**One specific source of concern was how the final CRD IV amendments will reconcile the grandfathering arrangements in CRD II with the Basel Committee's recommendations.** CRD II was adopted by EU member states in September 2009 and will enter into force on 31 December 2010. Existing capital instruments will be grandfathered for 30 years – in full for the first 10 years and capped at 20% of Tier 1 capital in the following 10 years and 10% in the final 10 years.

One phrase in the Basel Committee's 12 September press release was highlighted by participants as an example of the need for further clarification and of the example of differing interpretation: "**only those instruments issued before the date of this press release should qualify for the above transition arrangements**". The use of "should" is interesting, while it was pointed out that the Basel press release has no legal force. Two examples from the week of the round table were discussed: Macquarie Bank's decision to go ahead with a Lower Tier 2 issue, and Investec Bank's decision to terminate an exchange of debt instruments into new Lower Tier 2 notes, citing uncertainty in the wake of the Basel Committee's statement. **It was felt that new issuance will be light in coming months given the uncertainty, but that much will depend on the attitude of local regulators, and perhaps on when particular issues were approved.**

**Bail-in concerns**
Our sense is that fixed income investors are more concerned about proposals for resolution and recovery plans that could involve mandatory partial conversion into equity for senior unsecured bondholders, based on the final two sentences of the Consultative Document: "parallel efforts are ongoing to ensure that all banks that fail are capable of being effectively resolved and losses allocated to both senior and subordinated instruments. The proposal in this document should not be viewed as an alternative to effective resolution schemes, but rather a complement". **While this was seen by participants as a longer term threat – the discussion seems more advanced in the US – it would have significant implications for the availability and pricing of senior unsecured debt.** Some participants also expressed concerns about the growth of secured debt, such as covered bonds, and the consequent reduction of assets available to cover unsecured creditors. The possibility was even raised that senior unsecured bank debt might need to contain covenants in future, to protect investors against the risk of increasing structural subordination.

**Simon Adamson**
sadamson@creditsights.com

**John Raymond**
jraymond@creditsights.com

**Puja Poojara**
ppoojara@creditsights.com

**Published in:**
European Morning Comment [September 23]