European Association of Public Banks

– European Association of Public Banks and Funding Agencies AISBL –

Basel Committee on Banking Supervision
Bank for International Settlements
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EAPB comments on the Basel Committee's consultation on "Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability"

The Basel Committee rightly criticises the fact that, during the financial crisis, losses were not absorbed by all capital instruments (notably Tier 2 instruments) held by banks. Therefore public "bail-out" was necessary via injections of capital. The proposed rules of the Basel Committee of Banking Supervision aim at a equal accountability for losses by both, Tier 1 and Tier 2 capital.

Among the three options outlined in the consultative document, **Option 1** appears to be the most suitable compared to the other two alternatives. Here, the Basel Committee proposes a national and international bank resolution framework that enable losses to be allocated to all capital instruments negotiated by internationally active banks that have reached a point of non-viability. Another alternative put forward would be to prohibit all systemically important banks from including Tier 2 instruments in their regulatory capital (Option 2). A third and last possibility (Option 3) set out by the Committee envisages a mechanism to be included in the contractual terms of all instruments whereby, when a bank faces non-viability, these will be permanently written off or converted to common shares.

The EAPB supports **Option 1** because it offers the best prospects to increase loss absorbance of capital instruments. Eventual difficulties arising from implementation schedule should not give a reason to prefer Option 3, where a quicker implementation is assumed but does not yield the same merits.

There are several reasons why the EAPB is less enthusiastic about **Option 3.** First of all, the expected advantage of a shorter implementation period will not hold true because already issued capital instruments cannot be amended unilaterally due to existing contractual obligations that must be respected. This will lead to a lengthy transition period of at least 10 years before new instruments can be issued on the basis of the required terms, after expiry of existing instruments. Needless to say, new requirements will not apply to capital

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instruments that have already been issued and the introduction of a new requirements will only affect new issues after a respective grandfathering period.
Germany and Denmark have already initiated legislative procedures on bank restructuring and resolution which essentially reflect Option 1. In Germany, the Act on bank resolution will enter into force on 31 December 2010. Moreover, in early 2011 the European Commission is expected to present proposals for legislation with a clear outline for convergence of bank resolution schemes, that are ought to be similar to Option 1. The EAPB therefore considers it more useful to follow an option that is already under way, such as the envisaged EU bank resolution framework. We would therefore emphatically support the Basel Committee in pushing for rapid implementation of Option 1 rather than pursuing Option 3.

If Option 1 – or any other scenario – is applied, it must be ensured that the proper order of loss absorption is kept by the various components of regulatory capital. Losses must first be allocated to core Tier 1 investors, then to other providers of Tier 1 capital, followed by owners of contingent capital where appropriate. If a bank faces failure, investors of Tier 2 capital should be also addressed. In the case of restructuring, Tier 1 investors may decide voluntarily to waive debt. Any other procedure, however, would encroach inadmissibly on investors' property rights and irreparably damage the investor base for bank securities.

<u>Option 3 mechanism critique</u>

The EAPB fears that tougher loss absorbency requirements for Tier 2 capital would be imposed, if the envisaged provisions are incorporated into contractual terms as outlined. Tier 2 instruments would in practice dwindle in significance and, in the medium to long term, banks would no longer make use of them. Given the lack of participatory rights, investors are hardly likely to accept the same treatment as shareholders or other lenders of common equity core capital in the event of an impending solvency crisis, unless this less favourable position is compensated by banks through higher returns. Banks would consequently have to expect a marked increase in the cost of Tier 2 or hybrid capital and may even be confronted by a steep shortage of such capital in the market due to a lack of investor appetite. Presumably, investors would expect a bigger risk premium than for share capital if the mandatory permanent write-off of the instrument is not offset by a compensation mechanism offering some benefit if the bank actually recovers (conversion to company stock allowed by the Committee or the prospect of subsequently reallocating value to the asset). As a result, issuers would also have little to gain commercially from negotiating non-common Tier 1 or Tier 2 capital instruments.

Apart from the above mentioned concerns, Option 3 would at first and foremost undermine the distinction between going-concern and gone-concern capital that was drawn in the Basel

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Committee's consultative document "Strengthening the resilience of the banking sector" in December 2009.

The Option 3 mechanism requires that Tier 2 and hybrid Tier 1instruments must be permanently written off – possibly in conjunction with a mechanism for converting the value of the former Tier 2 capital that has been written off into common shares or an equivalent (and hence into common equity core capital). This reduces the bank's balance-sheet debt and, by the same token, boosts the bank's common equity Tier 1 capital. We fail to understand the need for a permanent write-off. If the bank recovers its economic health and pays back the public support it has received, it must be possible for that value to be reallocated as well. If that is not the case, it is essential that the conversion mechanism described by the Basel Committee as merely optional is always agreed, otherwise investors who put up hybrid or Tier 2 capital would be at a disadvantage compared with shareholders who, if the economic situation improves, are able to benefit from the company's success through rising share prices and the payment of dividends. Such provision would however discriminate against banks which are not set up as joint stock companies – e.g. those in public or cooperative ownership – as they have no convertible equity. By contrast, an investor in a bank operating as a joint-stock company would under these circumstances obtain shares from conversion, and if the bank recovered they would increase their value. In this respect, the proposed mechanism would create distortions to competition, and therefore should be rejected.

Moreover, legal problems might arise with the limits in corporate law regarding authorized and unissued stocks. Even a joint-stock company is not always able to hold the required amount of authorised equity to draw upon in the event of conversion. For example, a bank with a core Tier 1 ratio of 5% plus non-core Tier 1 and Tier 2 capital worth 7% RWA will probably have to hold authorised stock worth more than 100% of its stock issue in order to be able to compensate non-core Tier 1 and Tier 2 investors adequately if the need arises. In terms of company law, this volume of provision is questionable, and even if it was legally admissible it would be bound to encounter major shareholder resistance under normal circumstances. However, the situation would even be problematic if the maximum requirement of authorised capital was available (e.g. in Germany, stock companies are restricted to 50 % of authorised stock). If these authorisations are used up in full to cover Tier 1 or 2 notes, there would be no residual leeway to authorise a conventional capital increase. That is not an acceptable constraint. Furthermore, some debt investors might not be allowed to hold shares in their books because of their company statutes or ownership structure, so consequently these features could change or reduce the investor base for Tier 2 instruments.

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Should have any questions, please do not hesitate to contact us.

Kind regards,

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The European Association of Public Banks (EAPB) represents the interests of 35 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.

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