

Mr Stefan WALTER  
Secretary General  
Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel  
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[baselcommittee@bis.org](mailto:baselcommittee@bis.org)

Brussels, 1 October 2010

Dear Mr Walter,

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

The EBF welcomes the proposal made in the Consultative Document to ensure that non-common Tier 1 and Tier 2 instruments issued by banks absorb losses to avoid taxpayer's money being injected into ailing systemically important banks in the future. The proposed embedded automatic re-capitalisation mechanism may contribute to avoiding a possible failure or, at the very least, to reducing the cost of a bail-out. We therefore support the thrust of the proposals and agree that there would be a merit in exploring ways to develop conversion of debt into equity or a debt write down as a tool to restore the capital position of systemically important banks that have reached the point of non-viability.

Nevertheless, the EBF strongly believes that it would be far more preferable developing the proposed measure within the framework of an international insolvency/resolution scheme for systemically important banks as such an approach would be more likely to achieve convergence across countries and, therefore, to reduce level playing field concerns. This is where most regulatory attention should be focussed; gone concern contingent can be a helpful tool, but it is an ancillary one rather than a key solution.

Yours sincerely,



Guido RAVOET

a.i.s.b.l. **Enclosure:** 1 – D1545H-2010

**EBF COMMENTS ON THE CONSULTATIVE DOCUMENT**  
***“PROPOSAL TO ENSURE THE LOSS ABSORBENCY OF REGULATORY CAPITAL***  
***AT THE POINT OF NON-VIABILITY”***

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**OVERALL ASSESSMENT OF THE PROPOSAL**

1. The main concern which the Consultative Document wishes to address is to ensure that non-common Tier 1 and Tier 2 instruments issued by banks absorb losses to avoid taxpayer's money being injected into ailing systemically important banks in the future. The EBF fully agrees that initiatives need to be taken to limit public intervention in the financial sector as much as possible and minimise the fiscal burden of rescue operations undertaken by governments. In the future no bank should be regarded as too-big-to-fail; regulatory initiatives should focus on reducing the probability of failure and, in event of a failure (including the requirement to inject public funds) to also reduce its impact.

The proposed measure will contribute to achieving this objective as the triggering of the conversion/write down is likely to contribute to the recovery of the bank at a moment in time when its financial situation has deteriorated and it otherwise may not be able to raise capital in the equity markets. Therefore, the proposed embedded automatic re-capitalisation mechanism may contribute to avoiding a possible failure or, at the very least, to reducing the cost of a bail-out. We therefore support the thrust of the proposals and agree that there would be a merit in exploring ways to develop conversion of debt into equity or a debt write down as a tool to restore the capital position of systemically important banks that have reached the point of non-viability. Nevertheless, the EBF strongly believes that it would be far more preferable developing the proposed measure within the framework of an international insolvency/resolution scheme for systemically important banks as such an approach would be more likely to achieve convergence across countries and, therefore, to reduce level playing field concerns. This is where most regulatory attention should be focussed; gone concern contingent can be a helpful tool, but it is an ancillary one rather than a key solution.

2. The EBF also agrees that the proposed measure has merits.
  - As debt is less expensive than equity, the capital instrument is likely to remain a cost-effective instrument for banks to finance themselves in good times.

- It may, moreover, result in organising a more equitable type of burden sharing amongst the stakeholders involved by explicitly exposing holders of such regulatory capital securities to risk of loss.
- As the stressed situation of the bank will usually be visible earlier to the market, the conversion is not likely to disrupt the market but, on the contrary, be evaluated positively as a countermeasure to overcome the stress scenario.

Clearly, however the crucial question that needs to be answered first and foremost is how the markets will react to the proposed measure.

- Will they indeed be prepared to accept the proposed embedded automatic re-capitalisation mechanism at the point of failure, including the proposed non-market driven trigger event?
- If they do, will there be a sufficient market appetite meeting the demand?
- What will be the return on investment that investors expect (bearing in mind that they will recognise that they will be forced into a conversion that would transform their debt holdings into diluted equity at the point of failure )?
- A likely consequence of the proposal would be banks will experience more difficulties to find investors for Tier 1 hybrid capital and Tier 2 capital. This seems particularly problematic now that the Basel III package requires banks to hold more capital. This requires closer scrutiny.

Moreover, it should be examined together with the proposed measure if, instead of transforming all non-common regulatory capital instruments into contingent capital, it would not be more appropriate to introduce contingent capital into the capital structure as another form of capital to exist alongside existing structures. One obvious advantage of such an alternative solution is that it would enable the maintenance of a well diversified investor base to capital-raising activities. Whilst we await with interest the forthcoming proposals which the Committee is preparing in the area of going concern contingent capital, we believe that presenting both proposals together would have been far more appropriate as this would have allowed adopting a more encompassing perspective and would, moreover, have contributed to avoiding blurring the distinction between “gone concern” and “going concern” capital to which the Consultative Paper has contributed, including their conceptual foundations.

Finally, to the extent that the proposed measure is meant to restore the level playing field between small banks and systemically important banks, we note that additional measures are currently being discussed to address the situation of systemically important banks (capital surcharges, etc.). Clearly, it is important to adopt a holistic view on the vast range of regulatory initiatives which are being developed in respect of systemically important banks: each of those measures may be reasonable as such whilst their impact might be unreasonable if they are applied on a cumulative basis.

3. Anyway, the fragmented approach adopted by the Consultative Paper is a major cause of concern: it is merely prepared to consider imposing a conversion/write down mechanism as part of the regulatory capital requirements framework and refuses from the outset to examine the pros and cons of a statutory solution that would be achieved within the framework of an international banking resolution scheme.

The Consultative Document explicitly recognises that the most appropriate way forward would be indeed to develop an international resolution framework for financial firms and does not fail to highlight, “*effective bank resolution schemes can achieve more than the allocation of losses to regulatory capital*” (page 2). The Consultative Document adds, however, that this path does not need to be examined because there is only a limited prospect for developing an international insolvency framework for financial firms in the near future.

- This ignores that a fully fledged international insolvency framework may not be necessary to make the proposed measure acceptable to investors and/or avoid creating competitive distortions. The experience which the European Union has gained within the framework of establishing a Single Market shows in any event that adopting a staged approach is an option that may need to be considered. It may, more particularly, be sufficient to start identifying those issues that really matter from a competitive point of view and/or to make the proposed measure more workable and address those as a matter of priority. We believe that observing the ranking of the debt holders and the transparency of the trigger to be the main issues that will need to be addressed in particular (see below).
- Furthermore, it should be borne in mind as well that the measure which the Basel Committee proposes will need time to become fully effective and operational as the old instruments will need to be replaced by new instruments (incorporating the requirement) over time once they will have been matured – which may take even a longer time as most of those instruments have maturities of five to ten years.

Our conclusion is that developing an international resolution framework would be more appropriate and that the proposed measure should, more particularly, be elaborated in parallel. This means that the focus should be on examining how a future international solvency framework should evolve to facilitate the objective that the proposal aims to achieve. Within the framework of such a more encompassing framework, it may be considered advancing contractual approaches such as those described in the Basel Committee’s Consultative Document.

Furthermore, the more comprehensive approach that we advocate would make it possible to provide more focus as to what the proposed measure should ultimately seek to achieve: the objective should be to maintain the institution as a going concern to allow the competent authority to make use of the powers which an international resolution framework would confer to it - replace management, redefine strategy, find private purchaser, sell assets that are not systemic, reduce the balance sheet, close activities, etc. – including, possibly, an orderly liquidation if that is what is decided to be the most appropriate solution.

4. The impact which the proposed measure would have on non-joint stock companies is unclear.

The 2009 Consultative Document entitled "Strengthening the resilience of the banking sector" emphasised that the new capital regime should accommodate the specific needs of non-joint stock companies, such as mutuals and cooperatives, which are unable to issue common stock (paragraph 68). We are not convinced, however, that the current proposal would support a level playing field between non-joint stock companies and other ownership structures. The reason is the proposal's requirement for a permanent principal write-down or conversion into shares at the point of non-viability.

A permanent principal write-down without any possibility of a temporary write-off feature under which the capital instrument can be written up again when the bank has recovered seems to disadvantage investors in capital instruments subject to principal write-down compared with investors in capital instruments that are convertible into shares. As a result, issuing capital instruments which are subject to a permanent principal write-down is likely to become significantly more expensive. If so, non-joint stock companies would be put at a competitive disadvantage compared to joint stock companies.

It is therefore essential to the future level playing field between non-joint stock companies and joint stock companies that non-joint stock companies be authorised to issue Tier 1 and Tier 2 instruments on equivalent terms of competition (instruments with a revaluation option) so that they are not penalised.

## **THE CRUCIAL IMPORTANCE OF THE RANKING ISSUE**

5. We welcome that the application of the proposed measure is meant to be restricted to all debt qualifying as regulatory capital – meaning that its scope will extend to all subordinated debt and exclude any type of funding that is not regulatory capital. Therefore, the proposed measure is not intended to touch upon the ranking of senior creditors – which we welcome.

We note that the ranking issue is likely to become even more important as a further category of regulatory instruments is most likely to be introduced, i.e. (going concern) contingent capital.

6. Within the category of regulatory capital instruments, the ranking of the various classes of capital providers plays a key role: if a bank becomes insolvent, common shareholders will absorb losses first; holders of non-common Tier I instruments will bear the second tranche of losses, whilst Tier II instruments are the last to bear the cost of the closure.

Commitment to observing the ranking of those various types of instruments is critical to maintain a sound investor market.

The Consultative Document, however, does not address this issue. It goes to some effort to explain the need to avoid capital instrument holders remaining senior to any common equity that the public sector may need to inject after the conversion/write off clause has been triggered.

However, it does not confirm that any conversion or write down which would be triggered would indeed need to be consistent with the seniority of Tier I and Tier II instruments. This can probably be explained by the fact that harmonised legislation would be needed to achieve this. Our impression is that it should be feasible to agree on a global basis within a limited timeframe that every legal system should recognise the ranking referred to above. It should in particular ensure that:

- shareholders are first very severely diluted by Tier-1 instruments being converted into ordinary shares;
- shareholders would again be strongly diluted by the subsequent or simultaneous conversion of Tier-2 instruments into ordinary shares.

This would have two important consequences for any additional recapitalisation that could be needed, be it from private or public funds. The first one is that existing shareholders (including historical shareholders, as well as previous holders of Tier-1 and Tier-2 instruments) will further bear the cost of the failure by being even more diluted. The second consequence is that it would ensure that any capital injection would not be subsequently diluted as all regulatory capital / subordinated debts would first have been converted into ordinary shares. We support these two objectives.

7. Furthermore, it is absolutely essential for the design of the measure to ensure that the hierarchy between subordinated debt and equity is not destroyed. This is particularly important in those instances where shareholders may not be affected, in particular when no public capital injection is undertaken. Under such a scenario, non-common Tier 1 and Tier 2 investors would become junior to ordinary shareholders in the event of a pure write-down (i.e. without conversion into common shares). As a result the traditional risk profile – under which non-common Tier 1 and Tier 2 holders suffer permanent losses only once shareholders have lost everything – would be reversed.

Moreover, an unconditional write-down without proper compensation paid to the instrument holder may result in an unequal treatment of classes of investors. Allowing

a write-up mechanism with restatement of the notional would probably be the only way to preserve the burden sharing hierarchy. We accept that such a write-up may need to be subject to certain conditions such as strong solvency situation and/or complete reimbursement of public funds used.

If the bank doesn't recover and enters in a wind-up situation, the restatement of the nominal value of these instruments should be allowed in order to preserve their seniority in relation to common shares.

## **THE TRIGGER EVENT NEEDS TO BE MORE TRANSPARENT**

8. There seems to be a common understanding that the trigger event for the conversion/write off is one of the key issues in the debate. What will trigger the conversion/write-off? When precisely will the conversion/write-off be triggered?
  - The first criterion proposed in the Consultative Document is acceptable: the trigger will be activated when the relevant authority agrees that public money may need to be used to keep the bank in a going concern. Such a criterion is objective as a conversion of regulatory capital followed by a public injection provides evidence that of the view of the relevant authorities that the institution can remain a going concern, which would contribute to restoring market confidence.
  - The second criterion, in contrast, – i.e. a decision by the relevant authority that the bank is no longer viable – appears to be challengeable as it is totally discretionary and not easily verifiable.. Such a trigger would introduce much uncertainty amongst investors who may be expected to invest in the proposed capital instruments only if the trigger event is predictable and observable. If it would appear that this second criterion would reduce the investor base to a significant extent, so it would be inappropriate to include it.
9. If the second criterion is nevertheless maintained, the Committee should introduce some additional safeguards which would make sure that the conversion/write down would be triggered as a last recourse action only.

Furthermore, the Committee should clarify (e.g. by means of recommendations) the specific circumstances in which authorities are expected to put it to use. Such scenarios should be sufficiently realistic to include possible negative knock-on effects on other market participants which may, for instance, refuse to provide liquidity to the ailing bank.



## OTHER DIFFICULTIES

10. The Resilience Paper which the Basel Committee published in December 2009 innovated by introducing a clear cut distinction between “capital which absorbs losses on a going concern basis” (i.e. Tier 1 capital) and “capital which absorbs losses on a gone concern basis” (i.e. Tier 2 capital). The common understanding was that “going concern capital” must help a bank to remain a going concern whereas gone concern capital is capital that is available after a bank has been declared insolvent and which will be distributed amongst the bank’s depositors and senior creditors first.

The proposed measure, however, does not seem to fit into this picture: the instrument is presented in the Consultative Paper as “gone concern capital”, although the objective of the measure is not to widen the depositor base or to support senior liabilities but rather to be used as a stage in the bank’s recovery process and, therefore, to help the bank to remain a going concern

This comment is not merely of an academic nature. The distinction between Tier 1 and Tier 2 capital – and, therefore, the risk to investors - was so far well understood in the market. The proposed measure, however, is blurring the divide between the two classes and may, as a consequence, narrow down the current price differentiation between both categories – meaning that, in reality, the Tier II category may evaporate if the proposed measure is not understood by the market as a last resort mechanism.

11. We welcome the proposal made in the Consultative Document that any compensation paid to the instrument holders as a result of the write-off must be paid immediately in the form of common stock (or its equivalent in the case of non-joint stock companies) (page 5, under 2). Indeed, the debt write down inevitably needs to be combined with compensation by means of common stock as investors in reality are not likely to accept a permanent write-down. Moreover, a conversion into new shares is necessary to maintain the ranking in burden sharing among different classes of investors: through the dilution of their shares, common shareholders will bear a larger portion of the cost of the recovery; in a second step investors can participate in the benefit of the recovery together with the shareholders.

The Consultative Document concludes from the compensation requirement that the issuing bank must maintain at all times all prior authorisation necessary to immediately issue the relevant number of shares specified in the instrument’s terms and conditions should the trigger event occur (page 5, under 3). This may, however, result in authorisations for a multiple of the existing number of shares of the bank whilst the company laws of many countries and/or many banks bylaws impose limitations on the number of authorised but unissued shares that a bank may have. Moreover, such limitations will in turn limit the size of Tier 1 and Tier 2 instruments that can be issued. Finally, any issue of Tier 1 and Tier 2 instruments may also restrict banks’ possibilities



to issue common shares if the limit on new shares already has become fully or partly utilised by the rights related to Tier 1 and Tier 2 instruments.

Another difficulty for which a solution will need to be found is that some investors (such as pension funds, insurance companies) are not authorised to invest in such instruments on the ground that their bylaws prohibit them investing in equity components.

## UNCERTAINTIES

12. It would need to be closely examined if the way in which the embedded conversion/write down mechanism needs to be accounted for in accordance with IAS 32 does not hamper the objective which the Consultative Document aims to achieve.

The stated objective of IAS 32 is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and liabilities. It may require splitting up compound financial instruments into an equity and liability component which then need to be accounted for and presented separately. This implies that optionalities which may be embedded in Tier I or Tier II instruments (e.g. a regulatory call) may have to be presented and measured separately either in equity or as a liability. As a result, the amount of equity that needs to be recognised under IAS 32 may not correspond to the nominal value of the non-common Tier I and Tier II instruments adding, unhelpfully, greater complexity.

13. The Consultative Document proposes that the measure would apply to “all regulatory capital instruments” (page 1).

However, the Resilience Paper that the Committee published in December 2009 already included a proposal according to which, to be recognised for inclusion in Tier 1 Additional Going Concern Capital Instruments classified as liabilities must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point (page 20, under # 11).

The Consultative Document does not explain how its proposal ties in with the proposal made in December 2009.

Our understanding is that the Tier 1 Additional Going Concern Capital Instruments referred to in the Resilience Paper will most likely already have been written down before the conversion/write down referred to in the latest Consultative Document will be triggered.

**14. The proposed measure contains some market-driven features.**

- (i) The Consultative Document argues that it is likely to restore the level playing field between small banks and systemically important banks as, today, systemically important banks are able to fund themselves more cheaply because of the perception that they are too big to fail. This is because the proposed measure will result in investors seeking for a higher return for regulatory capital instruments issued by systemically important banks whilst at the same time taking into account that the likelihood of the clause being triggered in respect of small banks is non-existent. Market discipline will thus be exercised.
- (ii) Furthermore, the proposed measure adopts a market-driven approach to determine which banks are systemically important as it will be the investor community – and, therefore, not the regulators – who will decide on this. Moreover, a market-driven approach allows addressing the issue in a more nuanced manner as it will allow the markets, through the pricing of the embedded mechanism, to express their view on the extent to which a banks needs to be considered systemically important.

However, there may be a need to examine if the view which the Consultative Document adopts in this respect would not be too theoretical taking into account the following:

- The perception of what is a “systemically important bank’ is dynamic and may vary over time, according to where one stands in the economic cycle: in good times, markets are likely to be more flexible in this regard than in situations of stress.
- Moreover, banks which are not deemed to be systemically relevant may become so over time (e.g. because of a merger or an acquisition or by organic growth).
- Such uncertainties may provide an incentive to investors to prefer shorter maturities. The possible implications of such a trend should be examined closely. Clearly, compressing the maturity structure of the investment class, would make it necessary for banks to access the market on a regular basis to replenish shares, which is less cost-effective than accessing the market less frequently with larger offerings. We expect, however, the macro-economic and financial stability implications to be even more significant and worrying.

**15. The Consultative Document tunes down possible conflicts of law and practices which may exist between the legal systems of the home and host countries in which a cross-border bank is active. It does so by construing the proposal as a measure which merely pertains to capital requirements and suggesting that it would be sufficient within this framework to accept that the relevant jurisdiction in determining the trigger event is the jurisdiction in which the capital is being given recognition for regulatory purposes.**

However, the definition of capital in any jurisdiction is closely linked to company law requirements whilst the ranking between the various categories of debt holders is determined in each jurisdiction by insolvency legislation. The Consultative Document does not examine possible knock-on effects that company laws and insolvency laws may have on the home/host relationship.

The Consultative Document does neither consider possible conflicts of interest which may exist between home and host supervisors

- 16.** Our understanding is that the proposed measure will not have a retroactive impact and, therefore, only apply to future issuances of non-common Tier I and Tier II instruments.

## **Conclusion**

Whilst we support the objective of the proposed measure, there still remain a number of issues that need to be addressed in finer detail. The EBF looks forward to engaging in this refinement process with the Basel Committee.

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