FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

NB NORGES BANK

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

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BCBS CONSULTATIVE DOCUMENT: PROPOSAL TO ENSURE LOSS ABSORBENCY OF REGULATORY CAPITAL AT THE POINT OF NON-VIABILITY

JOINT COMMENTS FROM NORGES BANK AND FINANSTILSYNET

We welcome the opportunity to comment on the proposal of 19 August 2010 to ensure the loss absorbency of regulatory capital at the point of non-viability.

Norges Bank and Finanstilsynet are generally supportive of the proposal to ensure loss absorbency of all regulatory capital in the event that a bank is unable to support itself in the private market. To reduce moral hazard, strengthen market monitoring and lessen the need for public sector bailouts, it is important that also Tier 2 instruments share losses when a bank becomes non-viable.

During the recent financial crisis a number of distressed banks were rescued by the public sector, while private capital - both Tier 2 and in some cases non-common Tier 1 - did not absorb losses. We had the same experience in the banking crisis in Norway in the late 1980s and early 1990s, when a number of banks were rescued, but subordinated debt did not absorb losses. This led to amendments in our Deposit Guarantee Act, which subsequently stated that such capital in Norwegian banks could be written down even in situations where the bank is not liquidated.

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The consultation document notes that the development of better bank resolution frameworks should be a high priority. Only when national authorities have systems in place for quick resolution can losses be credibly assigned to owners and unsecured creditors, enhancing the disciplining effects of debt financing on banks. Since it will take time to develop international agreement on a new banking resolution framework, we agree with the Committee's parallel tracks approach to improve the loss absorbency features of regulatory capital while working for improved national and international bank resolution frameworks. We would also point to the need for convergence on early intervention and resolution triggers across nations, in order to improve crisis resolution in cross-border banks.

More specifically on the proposal:

Trigger event

The Committee proposes that the trigger event for both non-common Tier 1 instruments and Tier 2 instruments should be the earlier of: "*(1) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority; and (2) a decision that a write-off without which the firm would become non-viable, is necessary, as determined by the relevant authority.*" Norges Bank and Finanstilsynet assume that interpretations of the term "non-viable" may differ between jurisdictions. Also, there may be a danger that the supervisory authorities will wait too long to activate a common trigger, at the point of non-viability, for both non-common Tier 1 capital and Tier 2 capital with the consequences this may have for financial stability. The write-off of losses at an early stage may facilitate a sale of a distressed bank, a merger with another bank or a recapitalisation in the private market, possibly combined with a change of the management and replacement of the Board of Directors. If the write-down or conversion of all regulatory capital other than common equity is only triggered when asset values have been severely reduced and little own funds are left in the bank, a public sector injection of capital may be the sole remaining alternative to liquidation.

Norges Bank and Finanstilsynet consider it important that all Tier 1 capital instruments absorb losses at an early stage to reduce the likelihood of failure of the issuing bank. Hence, in order to ensure that non-common Tier 1 instruments cover losses on a going concern basis we would stress the need for a further requirement enabling the loss absorption mechanism for non-common Tier 1 instruments to be activated after losses cause a significant deterioration in the solvency level of the bank and certainly when a breach of the minimum capital requirements is about to happen, as set out in the CEBS' guidelines on hybrid capital of 10 December 2009. Moreover the mechanism to be used, including the trigger point, should be clearly defined in the contracts and disclosed and made transparent to the market in an appropriate way.

Mechanism

The proposal states that a permanent write-off or conversion to common equity is necessary to prevent the original instrument holders from having a residual claim that is senior to the common equity injected. Norges Bank and Finanstilsynet agree that any residual claim of the instrument holders should not be senior to any public sector common equity injected, and supports the proposal that temporary write-downs should not be accepted. We also agree that any issuances of new shares must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

Group treatment

With regard to the inclusion of non-common Tier 1 instruments and Tier 2 instruments issued

by subsidiaries abroad, it is proposed that the capital issued to third parties may only be included on a consolidated basis provided the conversion/write-down can be triggered by the consolidated supervisor. In addition to the proposed requirement, we believe that only the third party's share of the capital supporting the risks of the subsidiary should be recognised in the calculation on a consolidated basis. The third party's capital in the subsidiary cannot be used to cover losses of the parent company or other group companies and the third party's share of the excess capital above the minimum of the subsidiary should therefore be deducted on a consolidated basis.

Scope
It is difficult to estimate in advance which institutions will be needed to be rescued, as this will be influenced by the severity of the financial crisis, likely market reactions and the effects on the real economy. Norges Bank and Finanstilsynet therefore believe that the required write-down and conversion features should apply to the non-common Tier 1 and Tier 2 instruments of all banks, not only to the instruments issued by internationally active banks. Considering also the importance of a level playing field, the requirement should apply to all banks.

Yours sincerely,

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Copy: The Norwegian Ministry of Finance