Investment Management Association response to the Basel Committee's Consultative Document: "Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability"

The Investment Management Association (IMA) represents the UK based investment industry. Our members include independent fund managers, the investment arms of retail and investment banks and life insurers and the managers of occupational pension schemes. They are responsible for the management of about £3,400 billion of assets (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds such as pensions and life funds and a wide range of pooled investment vehicles.

IMA members manage around £1,000 billion in fixed income securities, mainly insurance assets and pension scheme mandates but also retail bond funds. They are therefore major investors in the £ quoted corporate bond market (about £430 billion).

The IMA's response to this proposal is split into four sections:

1. Key Points.
2. Comments on the actual proposal.
3. Response to the proposal's view of its potential impact.
4. Answers to the common questions that were detailed in the Annex of the proposal document.

1. Key Points

The IMA would like to make the following key points regarding this proposal:

a. Transparency is required as to the conditions that would cause a trigger event

There needs to be absolute clarity over when a trigger event would occur, not just to regulators or the banks but also to the whole market. Regulators' are conflicted, in that it could be in a regulator's interest to declare a bank non-viable at the earliest sign of non-viability, and this may disadvantage bondholders unfairly. IMA members therefore seek independent processes to establish a trigger event. Specifically, we propose that regulators should be required to obtain a Court Order or equivalent before a trigger event can occur. This is in line with other provisions in respect of insolvent companies.

Transparency and disclosure requirements applying to listed companies should be maintained throughout: this did not always appear to be the case during the credit crisis. It illustrates another conflict faced by regulators, many of whom both supervise the banks and preside over listing arrangements.

b. The objective of any regulation introduced must be clear as to whether the intention is to support a bank that is failing but still prospectively a going concern, or whether it addresses only the transition to a gone concern

Arguably it is unrealistic to believe that the announcement of a trigger event will not create a "run" on the bank and a cessation of trading – which would indicate

that the proposals are directed at banks as gone concerns. If that is the case, we believe safeguards should be introduced for bondholders such as the establishment of "no creditor worse off" provisions, and these must be fully respected (for example, the process of determining "no creditor worse off" compensation must be transparent, independent and above all, not involve lengthy delays, as have been experienced by bondholders awaiting the outcome of Independent Valuer reviews in the UK.)

c. Any regulation introduced should not be retrospective: existing bonds should be unaffected

Applying a bail in scenario to existing bonds would be unfair. Bondholders did not purchase bonds in the knowledge of a likely change to their status in the event of going concern problems. There is no credible reason to disadvantage existing subordinated bondholders and it would cause disruption in the smooth running of the bank debt market. It may, for example, require a re-valuation of debt held, with a destabilising impact both to market operations and to holders of bond funds, pension schemes and insurance funds. For example, the UK's decision to pass emergency legislation to change the terms of the Bradford and Bingley LT2 instruments retrospectively caused significant market disruption. The attached link provides further reportage:
http://www.euromoney.com/Article/2119664/Hybrid-capital-UK-knocks-lower-tier-2-with-B-B-threat.html

d. The current capital structure must be maintained, so that bonds maintain their priority ranking over equity

The established priority in a wind down scenario of a company provides a clear ranking of capital with equity suffering a complete write off prior to debt holders being disadvantaged. It is essential to maintain this structure even in a non-viable but potentially going concern situation. The role of any government agency providing emergency funding, and any deposit protection scheme providing guarantees to depositors, must also be clear from the outset, and throughout the restructuring process, so that all parties know where their liabilities rank in the capital structure. It is also imperative that the legal and structural hierarchy of different legal entities within the group is respected.

e. Furthermore the IMA's response assumes that senior debt is not included in these proposals

The paper addresses conversion/write off in respect of Tier 1 and Tier 2 instruments but does not indicate explicitly that senior bonds are included in the proposals. Our response is therefore written from the perspective that senior bonds are **not** included. However, clarity on this issue is very important. Senior bond holders should not be singled out for conversion/write off ahead of other senior creditors such as wholesale depositors, bank counterparties and trade and pension creditors.

f. The IMA response assumes that the proposals and any subsequent rule making will apply only in respect of banks

There are several references in the text to "financial institutions" rather than merely to banks. Because on the face of it the discussion paper appears to apply only in respect of banks, the IMA has responded to the proposal as if it only is

relevant to banks. If it is the intention to extend the scope in some way, then this should be consulted upon separately.

2. IMA Comments on the Proposal

The complete proposal is set out in the following box. The IMA's comments on these proposals are set out in detail in the section following the box.

Proposed minimum requirement

Scope and post trigger instrument

1. All non-common Tier 1 instruments and Tier 2 instruments at internationally active banks must have a clause in their terms and conditions that requires them to be written-off on the occurrence of the trigger event

2. 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).

3. 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.

Trigger event

4. The trigger event is 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.

5. The issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

Group treatment

6. The relevant jurisdiction in determining the trigger event is the jurisdiction in which the capital is being given recognition for regulatory purposes. Therefore, where an issuing bank is part of a wider banking group and if the issuing bank wishes the instrument to be included in the consolidated group's capital in addition to its solo capital, the terms and conditions must specify an additional trigger event. This trigger event is the earlier of: (1) the decision to make a public sector injection of capital, or equivalent support, in the jurisdiction of the consolidated supervisor, without which the firm receiving the support would have become non-viable, as determined by the relevant authority in that jurisdiction; and (2) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority in the home jurisdiction.

7. Any common stock paid as compensation to the holders of the instrument can either be common stock of the issuing bank or the parent company of the consolidated group.

IMA Comments on each element of the proposal:

1. All non-common Tier 1 instruments and Tier 2 instruments at internationally active banks must have a clause in their terms and conditions that requires them to be written-off on the occurrence of the trigger event.

This element of the proposal has been put in place to ensure that if the public sector subsequently needs to inject money into the group, by issuing common equity, there is no contingent claim that is senior to the public sector from the original non-common Tier 1 and Tier 2 instruments. Whilst the reason for this element of the proposal is clear the unintended consequence would be to treat all non-common Tier 1 and Tier 2 instruments as the first line of defence in the case of non-viability, perhaps even before common equity. There must therefore be a mechanism for fully writing off equity ahead of subordinated debt.

2. 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).

The IMA would like it to be made clear that any issuance of common stock at the trigger point of non-viability should not affect the relative standings of equity to debt i.e. no equity holder would escape unscathed when a bond holder may have taken a considerable write down.

3. 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.

This is a sensible precaution. The authorities will also need to consider the practical process of such an equity conversion – the process of identifying, notifying and exchanging instruments in recent cases (e.g. the Citigroup exchange) has caused considerable administrative problems and taken several months to achieve. The IMA see this process as a natural outcome of the initiatives requiring banks to have recovery and resolution plans ("living wills").

4. The trigger event is 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.

Again, the IMA would welcome clarity as to whether these proposals are intended to operate in both a going concern and gone-concern scenario. The definition of non-viable will be critical.

5. The issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

The IMA can agree with this element of the proposal as long as there is clarity on the subsequent ranking of the "old" equity, "ex-debt" equity, "new" or "public sector" equity, senior unsecured bonds, covered bonds, depositors both corporate and individuals. Any public sector injection of capital should not include terms that are variable at a later date (as has happened with some recent government capital

injections, adding to uncertainty about the rights of existing bondholders), so that the full capital ranking post trigger event is clear and fixed.

6. The relevant jurisdiction in determining the trigger event is the jurisdiction in which the capital is being given recognition for regulatory purposes. Therefore, where an issuing bank is part of a wider banking group and the issuing bank wishes the instrument to be included in the consolidated group's capital in addition to its solo capital, the terms and conditions must specify an additional trigger event. This trigger event is the earlier of: (1) the decision to make a public sector injection of capital, or equivalent support, in the jurisdiction of the consolidated supervisor, without which the firm receiving the support would have become non-viable, as determined by the relevant authority in that jurisdiction; and (2) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority in the home jurisdiction.

The IMA agrees that conversion needs to be capable of being triggered by the jurisdiction in which the debt is given recognition as regulatory capital. It is not acceptable for the institution (or the regulators) to have the choice as to how to operate the conversion mechanism at the trigger point. Bond investors need to know the risks they are exposed to in lending to a specific legal entity, and must be able to analyse these risks. Any ability to trigger conversion into shares of another legal entity in a different jurisdiction may give rise to arbitrage opportunities for banks and regulators.

7. Any common stock paid as compensation to the holders of the instrument can either be common stock of the issuing bank or the parent company of the consolidated group.

We are not sure why this flexibility is introduced. There is likely to be a material difference in the value of a listed equity in the parent company, and an unlisted minority interest in a subsidiary company. The equity to be received needs to be clearly specified in advance and we believe this is only feasible at a legal entity level, since bondholders are creditors of a specific legal entity and the structural subordination/ranking needs to be respected throughout.

3. <u>IMA's response to the proposal's view of its potential impact</u>

Common stockholders

The proposal states *"In the absence of a presumption of public sector intervention, subordinated forms of funding should impose significant incremental costs on shareholders of firms which pursue increased rewards by assuming additional risk."* Some additional risk will lead to some increase in the cost of subordinated fund raising. However if the majority of the risk is moved to subordinated bonds from equity this will require such a significant increase in the cost of subordinated bonds that they will cease to be an acceptable method of capital raising.

Even if the possibility of a write-off is not considered, and the only option is a conversion that fully compensates the bondholder, it would still not be a viable option if the original equity holders only suffer a dilution of their holdings (ie rather than a write-off of their equity holding). In this scenario all bonds would effectively be convertibles and would attract only shorter term and specialised investors.

The paper states *"So in both cases above, the shareholders of banks will suffer the cost of increased risk taking: In the case of the write-off mechanism this happens through shareholders having to pay high coupons on the bank's non-common capital instruments".* We would say in this case the shareholders would have to fund all capital raising themselves. "*and in the case when a high number of shares are issued, this occurs through dilution of ownership at the trigger event. In practice if a bank issues an instrument with a fixed or capped number of shares to be issued on the trigger event, the cost to shareholders will be borne through a mixture of higher coupon rates and dilution.*" The prospect of dilution is still not sufficient pressure on the equity holders to ensure they keep the bank on a sensible path, while the outcome for bondholders remains relatively far more penal than that to which shareholders are exposed..

The IMA agrees that: *"A write-off can be viewed as a transfer of wealth from the instrument holder to the common shareholders, as the common shareholders escape the liability and the net assets to which they have a claim grow."* and finds this conclusion patently undesirable and inequitable.

Capital instrument buyers

The IMA accepts that capital instruments should take a proportion of the loss if a bank becomes non-viable but might still be a going concern. However this has to be structured in a way that promotes efficient and fair capital raising. If the proposal goes ahead, in its current form, it is highly likely that the cost of borrowing in the form of subordinated debt will become much more expensive for banks. The probability of default is much lower than the probability of non-viability, given the current structure of most countries' banking systems. To price the risk of "non-viability" into a bond would increase the required coupon rate on new bonds significantly.

For existing bonds there are two options: either they could continue as they are to maturity and this would be an efficient way to phase-in the new proposals; or there could be a carrot approach where each issuer has to offer an alternative higher coupon for a change in the conditions of the bond – this may be rather expensive and may not succeed.

In support of transparency and fairness, the IMA would like to suggest that if there is a phasing in of this scheme, banks' report and accounts, and the prospectuses under which the bonds are marketed and traded, should clearly differentiate between bonds that have the conversion clause and bonds that do not.

4. The IMA's answers to the common questions in the proposal's annex

Would the development of effective bank resolutions schemes be a better approach to ensuring gone-concern loss absorbency?

Effective bank resolutions schemes should go hand in hand with a clear intention to shift the risk of non-viable banks to the investors in the bank from the public sector. In principal the IMA agrees with the proposal that in the future there should not be an expectation of a bail-out of the banks by the public sector.

The paper discusses only "*imposing losses on subordinated debt holders"* It would be extremely useful to have clarity on the expected status of senior bonds and other creditors.

The IMA agrees that any resolution scheme that imposes losses on non-common capital instruments must be supported by a significant proportion of the global regulator community, to remove any cross border advantage that weaker banks under different regulators could obtain by raising cheaper funding due to an implicit guarantee by their sovereign.

Would it be simpler to de-recognise Tier 2?

The IMA notes the comment in the text *"the presence of subordinated debt funding, which can be expected to take a significant loss at the point of failure of a bank, can provide an important market mechanism that leans against excessive risk taking."* As we stated earlier the "significant loss" of the subordinated debt holder would happen at the much earlier time of the trigger point not at the point that the "bail-out" would have taken place. The valuation of these new style bonds would be complex and may lead to a demise of Tier 2, as there would be strong disincentives for debt holders to own subordinated debt. Investor demand would shift to secured or covered bonds thereby leaving the available unencumbered asset pool of the bank significantly smaller - a further disincentive for investors to buy unsecured and subordinated bonds.

The IMA agrees with the statement: "*De-recognising Tier 2 for systemically-important institutions suffers from the problem that we first need to identify such institutions, which is not an easy task and potentially has associated moral hazard issues."* Specifically stating which banks are systemically-important and which are not may be a rather blunt instrument – some banks will be borderline and move between the two categories and some banks may be relatively small but have a portfolio of deals that would cause systemic risks if they failed abruptly at a specific time. Such banks may not be viewed as a danger to retail depositors but do, nevertheless, form an important liquidity function for the financial system. A public list of systemically important banks would create moral hazard.

Will this not impose unnecessary costs on small banks?

We do not believe so.

Would the proposal change the investor base?

The traditional investor base for subordinated bank bonds was broad and long term - providing a certain amount of liquidity and stability. The longer term differentials in yield between junior subordinated bonds and senior bonds highlight that there was not necessarily a presumption, in the past, that these bonds had an implicit government guarantee. However if new subordinated bonds now become high yielding quasi equity instruments they will appeal to a different investor base which would not be as broad and will have shorter time horizons. It is doubtful whether these investors would fulfil the stated intention of encouraging a risk averse banking sector.

The paper states "*As the proposal retains the essential debt characteristics of the relevant instrument and does not give the holder equity risk outside of a failure situation, it should not be viewed as traditional convertible debt by investors, accountants or tax authorities.*" We disagree with this assumption and doubt whether

sufficient investors would be comfortable with the status of these bonds. It is not that the current investor base needs an implicit public sector guarantee, but it does need in the long term: liquidity; transparent rules; credit ratings and inclusion in market indices.
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What if the holders of the capital instruments are not permitted to own shares in the bank?

This is likely to be a problem for investment managers, although it is not possible to quantify precisely as it depends upon the exact wording of each individual investment mandate, fund prospectus or fund sector definition. It is not unusual for bond funds, for example, to prohibit the holding of equities. Although the IMA fund classification sector scheme permits a small amount of equity in fixed income funds, the European Fund Classification Scheme (EFCS) bans all holdings of equity in fixed income funds. These funds would therefore immediately breach sector requirements. Likewise, investment managers who hold a mandate (for example from a pension scheme) on an asset-specific basis may find themselves in breach of the mandate if their bond holdings are converted to equity. Since many mandates are held for long periods, and there is a substantial number of existing funds (about 2,500 in the UK), it would be an enormously complex and extended operation to change the wordings in the mandates and in the fund prospectuses.

Would it be better to have an automatic trigger for conversion/write-off linked to some market variable or regulatory ratio?

There will need to be some measure of transparency but there is some understanding of the usefulness, from the regulators point of view, that some flexibility should be retained. Some banks may be failing in a way that means there is no chance of a going concern outcome and so using this mechanism would just be delaying the inevitable. Specific share price or credit spread levels are open to market abuse and should be avoided. If regulatory ratios are sufficiently timely they could be used to specify certain triggers for non-viability, but these would need to include all the ratios that regulators consider important rather than a single ratio that was open to manipulation.

How would the approach apply to capital issued out of subsidiaries, could this not lead to the break up of a group?

This issue must be handled carefully. As any rules should be the same across all banks it is difficult to see how specific instances of a subsidiary issuing capital that would change the structure of the whole group. However if there is an element of differential in the conversion of debt issued out of a subsidiary company that may cause market distortions. If the bank's subsidiary is non-viable perhaps a restructuring and then a split of the bank may ultimately be the best result.

Would we not be transferring the problem of a failing institution to the insurance companies and pension fund sectors that hold the bank capital?

This is exactly what is happening and that is the point of long term capital that the risk is spread widely and so occasionally, when there is a loss, it is of a manageable size. If the risk that is being transferred is material then so should be the reward; the potential extra yield should be a benefit to those institutions over the longer term and in a well diversified portfolio the long run returns should be appropriate for the risks taken. The losers would be riskier banks, investors in badly managed investment

funds and higher risk borrowers who prior to 2008 had access to cheap debt from banks. As long as initial and ongoing disclosure is appropriate, and the legal and regulatory framework for investment clear, we see no particular issues with this. How to ensure small or unusual borrowers are not penalised along with high risk companies is another issue – an important one but not for this paper.

How can we be sure that the conversion/write-off is not considered a default?

This is crucial but needs to be resolved in the technical wording of the regulations, which must be clear to investors.

Does conversion/write-off improve loss absorbency even though it does not bring in new money?

It should in theory, but it is difficult to be sure until it actually happens. The regulators may find that they are unable to trigger "non-viability" of several banks at once, for example, for confidence or logistical reasons, and thus the new instruments may prove less loss absorbent than expected.

Could banks be encouraged to issue instruments with a conversion/write-off feature by giving some additional credit, rather than by making this feature a requirement?

If existing issues are grandfathered this would lead to this proposal being phased in at a steady pace and this may ameliorate any harsh effect. As the old vs new debt will be different despite having similar names they should be separated out on banks' published report and accounts. All bonds must be clearly described to avoid any confusion in investors' minds and to ensure rating agencies/index creators understand and label them clearly. However if there is no phasing in - older bonds would then not count towards regulatory capital and banks would either redeem them early or try and alter them to "new" style bonds with the conversion feature.

Could the proposal reinforce moral hazard in relation to senior debt?

As the IMA's response to this proposal presumes that senior bonds would be as unaffected as other senior creditors in a non-viable scenario, the position of senior debt would be unchanged in the longer term. This would lead to it trading at a relatively low yield and so remain as a reasonable priced capital raising instrument that the banks could use. However lack of clarity may lead to investor demand for more secured/covered debt that would clearly be excluded from these proposals, or expensive subordinated debt that would fully compensate the investor for the risk that they would be taking on by having a conversion feature written into the bond. The issuance of more secured debt would then encumber more of the higher quality assets of the bank and reduce the attractiveness of senior debt.

Clarity is the key issue and investors would need to know in advance where the line of inclusion would be drawn. There would need to be a perception that the rules were clear and that bond investors would be treated "fairly" compared to other investors in a non-viable scenario.