October 1, 2010

IIF Views on the Basel Committee Consultative Document *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability*

The IIF's Working Group on Definition of Capital (WGDC) has reviewed the Basel Committee's consultative document, *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability* and the Committee's September 12, 2010 press release stressing the endorsement by the Governors and Heads of Supervision of the aim to strengthen the loss absorbency of non-common Tier 1 and Tier 2 capital instruments. The WGDC on behalf of the Institute is grateful for the opportunity to comment on the proposal.

The IIF has done previous work on the subjects of dealing with failing firms and resolution, which are the overarching themes of the proposal. The Institute commented on the Basel Committee's paper on cross-border resolution last December, and recently delivered further comments on the "bail-in" concept.[1]

The consultative document is an important first step in the development of international thinking on this topic. However, the Institute believes that a good deal more debate, and perhaps some reconceptualization, is needed before making the proposals an integral part of the international regulatory-capital structure.

The IIF and its relevant working groups would be pleased to discuss further these comments or the overall issues of recovery, contingent capital, "bail-in" and resolution. It is understood that the Committee is working on "going-concern contingent capital" ideas as well[2] and the Institute would also be pleased to contribute to that discussion (as some preliminary thinking has already been discussed with certain members of the regulatory community, it could be further developed if useful to that next-stage project).[3]

General comments:

There is merit to the idea that regulatory capital instruments should be made to absorb losses so as to avoid losses to depositors, more senior investors, and the taxpayers, even if the official

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[1] IIF Report on *A Global Approach to Resolving Failing Financial Firms: An Industry Perspective*, May 2010; IIF Working Group on Cross-border Resolution submission to the Financial Stability Board on Preserving value in failing financial firms, September 9, 2010; IIF Response to Basel Committee Consultation on Cross-border Bank Resolution, December 22, 2009.

[2] Page 20, item 11 of 'Criteria for inclusion in Tier 1 Additional Going Concern Capital', Basel Committee on Banking Supervision, *Strengthening the resilience of the banking sector*, consultative document, December 2009; and Section V of the Annex to the Committee's July 26, 2010 press release..

[3] IIF Working Group on Definition of Capital submission to the Financial Stability Board and the Basel Committee on Banking Supervision *IIF Industry Considerations on Contingent Capital*, May 2010.

sector decides to save a financial institution on an open-bank basis, owing to financial stability concerns, by injecting public funds.[4] While many in the industry support the underlying idea of exploring contingent-capital concepts, several issues have to be clarified and fleshed out to understand the present proposal fully and diminish the chances of unintended consequences. These issues are discussed in detail in the *Specific comments* below.

The current design of the proposal suggests that governments remain willing to bail out failing banks. This is a cause for considerable concern as it undermines the overall effort to remove moral hazard from the market, an effort to which the industry attaches the greatest importance. For the reasons discussed in this paper, it should not be necessary to tie conversion triggers to the intervention of the authorities.

In part because of the need to reduce moral hazard, it is important that this proposal not distract from efforts to pursue a broader approach to resolution that does not rely on public funds for support. The Institute has recently published a report, *A Global Approach to Resolving Failing Financial Firms,* designed to contribute to this development. Efforts toward this goal are underway in several jurisdictions. For example, the Dodd-Frank Act of the US prohibits public support of specific institutions (while allowing official sector support of the market as a whole in a crisis), and provides for resolution of non-bank financial institutions as well as banks. It is also understood that the European Commission is preparing, and plans to fast-track, a European "bail-in" plan next year.

As the proposal itself recognizes, there may be trade-offs or accommodations necessary between contingent capital proposals and resolution proposals, especially those having to do with the "bail-in" concept. Therefore, the proposal needs to be understood and evaluated in the rapidly changing overall context and should avoid locking in provisions until that context is clear.

In addition, the proposal seems to look backward to the pre-crisis world, rather than advancing a proposal in the context of all the regulatory, supervisory, and risk-management changes that are taking place in the international financial system and in firms. Again, it needs to be presented in its overall context in order to be well understood and evaluated.

The impact of the proposals (and of related concepts such as going-concern contingent capital and bail-in (if different from the proposal)) is difficult to evaluate exactly given the many open questions; however, analysis by market analysts suggests that the proposed measures may, by increasing the risk that various classes of bank investors must accept, contribute to a structural increase in the cost of funding for the sector.[5] Assuring that such investors, rather than the public, bear losses is of course the point, but the resulting effects on investors' perceptions need to be taken into account in designing requirements for bank instruments such as those in the proposal. In addition, there needs to be greater recognition that funding instruments cannot be

[4] The Institute is committed to the proposition that no firm should be too big to fail and that failing firms should be able to exit the market without state assistance. Please see IIF Report on *A Global Approach to Resolving Failing Financial Firms: An Industry Perspective*, May 2010.
[5] The Institute continues to study the cumulative impact of regulatory proposals on the macro economy and the credit-generating capacity of the industry, and is updating the *Interim Report of the Cumulative Impact on the Global Economy of Proposed Changes in the Banking Regulatory Framework* (June, 2010).

created by fiat but need to be developed by market negotiations with investors, albeit within broad prudential bounds.

Specific comments:

Section 1

Three options to ensure regulatory capital instruments are capable of bearing a loss

It is important to pursue a broader approach to resolution in order to achieve the desired objective of ensuring that a failing bank, whatever its size or the scope of its activity, is able to exit the market in an orderly manner. As mentioned above, there are efforts toward this goal in several jurisdictions. This is a positive development since this is a move toward the "highly desirable" Option 1 of the proposal.

This being the case, the proposal's discussion of the changes of the international resolution regime, while correctly indicating the challenges, is much too pessimistic in assessing the chances of achieving a robust international outcome. While the Committee needs to be realistic, it should also encourage rather than dampen the extensive international efforts through the FSB and elsewhere toward an internationally coherent resolution regime, the achievement of which could modify the eventual role or even reduce the need for gone-concern convertible capital as envisioned in Option 3. Practical solutions are possible, given sufficient political impetus, and could result in tangible progress toward an effective international resolution framework.[6] Achieving a coherent, workable international resolution framework should be a priority for the Committee as well as the FSB.

Closely related to resolution issues is the development of Recovery and Resolution Plans, which are an important supervisory agenda item in many countries, and a part of the international regulatory-reform program. Contingent instruments as envisioned in the proposal would figure importantly in those plans, but clarification is necessary to understand how they would fit in the recovery or resolution phases of that planning.

Certain members believe that contingent capital instruments are intrinsically likely to create instability because they undermine well-established corporate-finance concepts and traditional hierarchies of subordination, and that bail-in solutions would be preferable if they create fewer complexities in capital planning, keep challenges to investors' rights firmly limited to the most extreme situations, and aim explicitly at stability at the point of non-viability. Other members have reservations about the potential scope and reach of bail-in and therefore the implicit implications for corporate finance and investors' rights and potential for unintended consequences. Some are uncertain whether there is any difference between the present proposal and "bail-in" as the Committee uses the term.

These concerns reflect the current lack of clarity on the relationship between the proposal and bail-in ideas, which have not as yet been expressed in an official-sector document. Only once the principles and the interrelationships are clear will a more definitive evaluation be possible. A

[6] IIF Report on *A Global Approach to Resolving Failing Financial Firms: An Industry Perspective*, May 2010.

coherent overall picture, including clarity on the subordination hierarchy, the relationship between the different visions of contingent capital and between them and "bail-in", in the context of an overall view about the supervisory dimensions of recovery and resolution is essential.

As a general matter, strict seniority based on contract and corporate law should be respected, except in extremis. It is especially important not to reverse the traditional hierarchy. Normally, common shareholders should bear losses first, followed by Tier-1 instrument holders, followed by Tier 2 instrument holders, etc.; any variant of the proposal should aim to maintain the fundamentals of corporate finance, as discussed further below with respect to write-off. Respect for the finance hierarchy would of course imply clarity on the degree of protection of (smaller) depositors and deposit-guarantee funds from loss.

Section 2

The definition and use of "gone concern" is on its face confusing, and a better term should be found.

This confusion is not just rhetorical; it is sometimes unclear in the paper whether the idea is to give the firm the chance to recover and continue in business in some form (probably subject to some degree of restructuring as well as recapitalization) or whether it is truly addressing a final resolution scenario. It is important to be clear about the distinction because, given all the work going on with respect to bail-in and resolution, it is easy to confuse the discussion. Clarity of concepts is essential in what will be a major redefinition of finance for financial firms.

Clarification that "gone-concern contingent capital" is not really about "gone concerns" but about something akin to the US concept of *prepackaged recapitalization* of firms that may still be turned around could be a useful way to proceed, recognizing that this concept should be treated only as a heuristic device given that it is not found in other systems. On this basis it would be possible to define clearly what (if anything) differentiates the proposal from the "bail-in" stage, which, if intended to be a different stage in the process of coping with a firm's decline, would presumably occur after conversion of contingent instruments as proposed here.[7]

Section 3

Explanation and elements 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.*

   Differentiation of Tier 1 and Tier 2 instruments. Non-common Tier 1 *debt* instruments would already be required under the December proposals to have write-off/conversion

[7] See the IIF Working Group on Cross-border Resolution submission to the Financial Stability Board on *Preserving value in failing firms*, September 9, 2010, for a discussion of resolution and bail-in issues.

feature[8], which some had presumed would be triggered in a going-concern state. However, the "gone concern" proposal seems to put such instruments on the same plane as Tier 2 for purposes of the write-down or conversion requirement. The relationship between the "going concern" and the "gone concern" triggers needs to be clarified. While it is understood that the Committee is still working on going-concern ideas, there is a need for a fuller understanding of the present proposal to see how the two types of contingent capital features would relate to each other, and how the treatment of Tier 1 Additional Going Concern Capital and Tier 2 instruments would differ.[9]

There may be a case for two-trigger structures that would in effect be triggers of going- and gone-concern capital, or a structure whereby the first trigger would give the firm a grace period to rebuild capital, before the second "non-viable" trigger of "gone-concern"[10] conversion would apply. Such dual trigger concepts have the possibility to add a good deal of flexibility (and perhaps additional market reality) to the general contingent-capital concept, but obviously need to be developed as part of a comprehensive analysis and debate. In any case, there should be latitude for appropriate trigger patterns to be negotiated in relevant instruments as appropriate to the issuing firm's capital structure and investors' requirements.

In short, a joined-up package is needed and these concepts should not be developed in isolation.

Write-off. While strong assertions are made about the need to make any write-off permanent, the reasons given are not compelling at this stage. While most firms organized as joint-stock companies would be less than likely to use a pure write-off approach, it should not be ruled out and firms with other forms of organization may have to make use of write-off without conversion.[11]

There is a strong case for allowing *temporary* instead of permanent write-off or write-down, given that public injections of funds generally must be repaid as soon as possible. Write-up would be subject to appropriate conditions on solvency and complete reimbursement of public funds contributed prior to the subsequent write-up. Such structures are likely to be rare, but it is not evident why negotiation of such a solution in appropriate circumstances should be forbidden.

It would also make sense to allow *partial* write-*downs* as well as complete write-off. One well-known deal in the market is already based on a partial write-down, and, again, it is not

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[8] Page 20, item 11 of 'Criteria for inclusion in Tier 1 Additional Going Concern Capital', Basel Committee on Banking Supervision, *Strengthening the resilience of the banking sector*, consultative document, December 2009.
[9] Note: the proposal applies to all regulatory capital instruments. It should be made clear that a firm would have the right to issue whatever other instruments it wishes for liquidity or general corporate purposes, depending on its own analysis of its needs.
[10] As indicated above, the term "gone concern" is misleading as the firm would not be insolvent and might still be turned around at this phase.
[11] It is understood that write-off structures may be the only channel available for firms organized on a cooperative or other than joint-stock basis. In addition, discussions have made it clear that write-off is a more familiar concept in some markets than in others, and this should be taken into account in further developing the proposal.

evident why this should not be allowed within reasonable bounds if doing so would achieve both the corporate finance and the regulatory goals of the issuance.

Therefore, *partial write-down* and *possible write-up* provisions should not be excluded unless it is strictly necessary to do so. This is discussed further under Section 4, below. Firms should be allowed to negotiate with investors for provisions that make sense for their corporate structures, so long as the goals of protecting the public from any (permanent) injection of funds are achieved.

A write-off without a corresponding reduction of the equity interest in the firm (however characterized legally) would be a "gift" from the debt to the equity. Even if the written-off debt had fully priced in the write-down risk (no doubt a costly proposition for the firm), a full write-off without compensation, generally in the form of conversion, goes against the grain of basic corporate finance concepts. If the instruments are converted for the equivalent of a prepackaged recapitalization (or in case of bail-in), normally the debt should be fully compensated before any residual value accrues to the former equity. If there is a write-down without conversion, and the firm continues in a restructured form, there would be a strong case for write-up for benefit of the debt holders, before value is allowed to the former equity or equivalent, subject to the conditions stated above.

Grandfathering. In the Committee's September 12 press release, it was stated that only instruments issued before September 12 should qualify for the grandfathering arrangements. This appears to mean that national supervisors should insist on more or less the new provisions for new regulatory capital instruments even if the details are not fully worked out and even if there is no specific legal basis for doing so. This policy is understandable and rating agencies and market expectations may have somewhat the same effect; nonetheless, it implies that firms will need to negotiate financing instruments without knowing how the requirements will finally be expressed in Accord terms, or how they will be translated into applicable law. This in turn implies that, where supervisors have the power to enforce such an informal mandate, they should also be urged to accept on a permanent basis instruments that approximate the intent where necessary before final regulations are available, subject to appropriate phasing-in of the proposal.

Phase-in. As the Institute has argued in prior submissions to the Committee, an appropriate phase-in period is necessary for requirements such as those of the proposal, which would fundamentally change the nature of bank finance. This is especially important as the market impact and cost of the new instruments cannot now be assessed, but could be substantial. It would make sense to phase in the requirement incrementally, perhaps in tranches similarly to those announced on September 12 for phasing in deductions from CET1.

Maturity criteria. Neither the present proposal nor the July 26 or September 12 releases give guidance on how the proposal relates to the December criteria for Tier 2 instruments. This will presumably become apparent when fully fleshed-out Accord language incorporating the final form of the proposal is available.

Consideration should be given to adjusting the December criteria for the effects of the present proposal, if finally adopted. Given that the loss-absorption capacity of regulatory capital instruments would be increased through proposed write-off/conversion features, the maturity criteria for inclusion of these instruments in regulatory capital should be relaxed, in particular by eliminating the requirement of the December proposal to amortize Tier 2 capital instruments on a straight line basis in the last five years before maturity.

Relationship to Countercyclical Buffer Proposal. Annex 1 to the September 12 press release includes reference to the countercyclical buffer as consisting of "common equity *or other fully loss absorbing capital*" (while it has been made clear that the capital conservation buffer consists only of common equity). It should be confirmed that instruments meeting the requirements of this proposal would count for this purpose.

Tax Issues. Tax issues will of course depend on the tax law and regulations of various countries. Nonetheless, it will be important for the Committee to take into account the tax provisions of the major jurisdictions and, if necessary, work with the tax authorities to obtain favorable rulings where possible. While the design of regulatory requirements cannot be tax-driven, the deductibility of interest payments on debt is an essential component of corporate finance, one that should be of interest to the Committee, especially during the transition period during which the industry will need earnings power to build capital and attract investors. As a broad generalization, this implies reinforcing the debt-like nature of the instruments. Any technical impediments to favorable tax treatment should be avoided if at all possible.

Accounting Issues. The IASB and FASB are currently in the midst of important discussions on changes in the accounting treatment of convertible debt. The outcome of these discussions will have a significant effect on both issuers and investors. The Institute urges that the Committee's Accounting Task Force look carefully at the proposal in light of likely outcomes of the current accounting discussions to minimize the danger of dysfunctional interactions between the regulatory and accounting frameworks.

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 proposal seems to contemplate that a method of calculating the conversion rate would be imposed by law or regulation in each jurisdiction. However, it should be made clear that, within the requirements of national law, conversion rates should be determined by negotiation of each issuance, since the ability of the firms to negotiate conversion rates with investors will be critical to the firms' ability to retain some control over their capital planning and structures. The ability to negotiate will also be important to investors in deciding whether they are willing to take up such instruments. If need be, negotiated conversion rates could be made subject to prior supervisory approval, which could also make any needed decisions on caps or minima on a facts-and-circumstances basis. It may be necessary in some cases to amend legal provisions to facilitate such negotiations.

As argued above, write-up, as well as compensation in the form of stock or equivalent, should also be allowed under appropriate conditions. Allowing write-up will be essential to making the instruments acceptable where write-off is the sole mechanism. Allowing write-up, subject to appropriate conditions, would also give firms room to negotiate deals with different classes of investors, which will be especially important to firms that face constraints arising from preemptive rights or other corporate-law requirements.

Several jurisdictions have volume restrictions on issuance of new shares excluding subscription rights, as the Committee is aware (see next section). Tying up all or a substantial portion of such issuance capacity to cover required issuances could become a serious constraint on traditional capital raising. While flexibility as to write-down/write off provisions is not a complete solution to this problem it would be helpful to making the transition to the new corporate-finance environment that the proposal will engender.

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.

As the Committee recognizes, in some jurisdictions there are limits on the percentage of shares that may be issued to new shareholders without offering preemptive rights to existing shareholders, or there are limits on the number of shares that can be approved for issue in a year. All these could potentially limit conversion rates.

Given the existence of these limitations in important jurisdictions, the Committee should consider in its analysis of the impact of regulatory change the fact that requiring reservation of shares for possible conversion of substantial amounts of contingent capital may effectively block a bank from taking advantage of market conditions to issue equity directly. This would have implications both for its ability to meet regulatory capital requirement and, perhaps more importantly, for its credit-generating capabilities. In light of the changes in the quality of capital and the calibration of the Accord that have been announced, the effect of such measures on firms' cost of capital and on the flexibility of their capital management needs serious consideration.

3. *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.*

As articulated by the Institute in its May 2010 Report on *A Global Approach to Resolving Failing Financial Firms: An Industry Perspective*, there should be no expectation that losses be borne by taxpayers. The direct reference to the possibility of a public sector injection of capital as one of the proposed triggers, however, gives rise precisely to concern about creating such expectation, a serious form of moral hazard.

Keeping the door open to future public-sector interventions may make sense on one level, but needs to be reconciled with some jurisdictions' efforts to preclude the use of public funds to

save failing financial institutions. As mentioned above, the US Dodd-Frank Act is an example of this.

This raises a significant issue of the extent to which this proposal for basic requirements for future financing of banks should be predicated so directly and narrowly on the experience of the recent crisis. As with the ambiguous and confusing definition of "gone concern", excessive focus on what happened last time seems to be impeding clear definition of how corporate finance of the financial sector is going to work in the future. What is needed is a more straightforward discussion of the subordination hierarchy that is envisioned for regulatory capital in the future, in the context of bail-in and resolution powers, such as the super-priority created by the Dodd-Frank Act (discussed below).

Given all the measures being taken to carry out the G20 program to avoid future instability, it is questionable whether any linkage to state support should be necessary. It might well be counterproductive.

When the Institute considered going-concern contingent capital, there seemed to be a clear consensus among members and investors alike that a trigger depending on regulatory discretion would not be attractive to investors, who naturally wish to have as much certainty as possible about the risks they are undertaking. That position still seems reasonable.

In the "gone-concern" (or "almost gone-concern") context, there is probably a stronger argument for official-sector determination, in part because of the need for very quick action (presumably over a weekend) and because events may be moving so quickly that an objective test might be hard to apply. However, some members feel strongly that, even in the context of the proposal, basing triggers on administrative fiat is inadvisable and likely to be harmful to the market for such instruments.

The Institute does not at this stage have a consensus view for or against supervisory discretion on "gone-concern" triggers; however, there is certainly a case for more research and debate on whether an objective trigger might be more appropriate. Again, the answer may depend on where such instruments fall in the hierarchy of subordination and how they relate to a bail-in mechanism, which would presumably depend on some kind of intervention by the authorities.

If the present concept of supervisory discretion is retained, there is a strong view that clear guidance regarding when injections of public funds should be necessary should be given, both to put some boundaries around that discretion and to provide transparency to the trigger. The criteria that would be used to determine when a financial institution is "non-viable without public support" should be clarified. While such determinations will probably always need to have a dimension of "I know it when I see it", more guidance from the Basel Committee could be helpful to forming expectations of investors, and also helpful to supervisors who have to make the decision to pull the trigger.

Pulling the trigger will not only have drastic effects on the firm and its investors, but may be a significant market and political event, which will most likely require painful decision-

making. Thus, any clear and objective criteria for any triggers mandated by the Basel Committee, including "necessary injections of public funds" and "non-viable without public support" (if those concepts are retained despite the moral-hazard issues they raise) would reduce the uncertainty as to when conversion would be triggered, which should be helpful in pricing (and ultimately in marketing) these instruments, and helpful in giving supervisors sound grounds for action when they determine they do have to act.

In addition it is troubling that the concept seems to be that "it will not be triggered if the authorities deem it not to be necessary"; and at page 11, it is said that "conversion is only triggered for banks which the authorities decide need to be rescued", which allows discarding smaller banks. This is another reflection of the ambiguity of this proposal: is it about discretionary public rescues (in any case prohibited in some jurisdictions)? Or is it about last-chance recapitalizations based on contractually agreed instruments already in the capital structure of the bank? If the latter, then why should the institution and its investors not be given the last chance that conversion would allow? Why force banks to bring to market instruments that would only have the benefit of those features if and only if a regulatory decision is made, one that may be influenced by macroeconomic or political factors extraneous to the ability to recover value from the firm, as opposed to letting it fail?[12]

From a financial-stability perspective, it is important to take into consideration the possibility that the threat of a trigger event could cause holders of regulatory capital to withdraw at early signs of trouble. This could potentially hasten the failure of a financial institution and could possibly lead to wider market instability. This issue is separate from the related issue, discussed under the corresponding question of the Q&A below, of whether a trigger would constitute a default.

Equivalent support. The Committee should clarify what is meant by "*equivalent support*". Does this include other supervisory actions aside from injection of public equity, such as provision of guarantees, discount-window access, liquidity support, etc?

It will be important to clarify that drawing from generally available market emergency liquidity facilities during a crisis situation would not be considered as equivalent support. Note that the Dodd-Frank Act, while forbidding firm-specific bail-outs, does recognize the need for market-wide facilities under certain circumstances. Similarly it is important that the trigger not be considered tripped by traditional "lender of last resort" support for solvent firms with good collateral that may have temporary liquidity problems (as has been recognized at least since Bagehot).

4. *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.*

In addition to prohibiting firm-specific interventions, the Dodd-Frank Act includes, among other things, a super-priority provision (Sect. 210(b)(3)), providing that when a resolution occurs, unsecured claims of the Federal state arising under the receivership process "shall, at

[12] This point seems all the more stark if a bail-in stage is inserted that would be available after the conversion stage, which would permit presumably more drastic intervention actions, and possibly wider conversion of debt.

a minimum, have a higher priority than liabilities of the covered financial company that count as regulatory capital."[13]

Thus, in US case at least, if the concept is that "gone-concern" contingent capital would be part of a resolution, there would not necessarily be a reason why conversion would have to occur before an extension of credit in conjunction with the resolution. It would seem logical and appropriate to consider whether other resolution (or perhaps bail-in) regimes should similarly provide for super-priority for public funds that may be provided in the *resolution* process to avoid the destruction of value that can occur during a precipitous liquidation, as in the Lehman case. Whether such super-priority would be appropriate in *open-bank recovery* programs involving public funds should be explored carefully in each jurisdiction.

Once again, this illustrates the ambiguity of the proposal, and also the need to allow for adaptation to post-crisis changes of law and circumstances.

It also provides another reason why the thrust of the proposal might be reoriented to late-stage but pre-insolvency events, allowing the contingent feature to operate as, in effect, a prepackaged recapitalization while there still is a chance of saving the firm.

5. *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 Committee correctly identifies the proposal's issues in reference to groups. Curiously from the industry perspective, it does not mention the role that the college of supervisors might play in the process, especially in the case that is discussed where capital is given recognition at both the solo and the consolidated level. Consultation through the college might resolve some of the issues that are mentioned where a host regulator might preclude issuance of certain instruments; while that power probably cannot be denied to the host regulator, nonetheless there should be a strong mandate from the Basel Committee to collaborate with the home regulator insofar as possible to help the bank and the group achieve a coherent, sensible capital structure. It would be helpful if the Basel Committee and the FSB would promote appropriate mandates for cooperation through colleges in national legislation as well.

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[13] In addition, the Dodd-Frank Act requires that other forms of public support, such as through market-wide facilities (as opposed to assistance to individual failing institutions, which is prohibited) be fully secured to protect the public fisc from losses. This, of course, has traditionally been the case for lender-of-last-resort facilities of central banks.

Possible conflicts of interest may arise between relevant home and host authorities of cross-border banking groups. For example, there may be political sensitivities if the affected creditor or shareholder is a foreign state or owned and controlled by a foreign government (e.g. a sovereign wealth fund). Similarly, there may be political considerations for national authorities if the affected debt holders are domestic retail investors or pension funds, or, conversely if the debt holders are mostly foreign.

These conflicts offer another argument to put more boundaries and internationally understood standards around the decision to exercise the trigger (if it remains discretionary), both to give some greater clarity about expectations and perhaps to take some of the possible untoward pressure off of the authorities who have to make the decision.

While a system would be conceivable where either authority might have the trigger power, in most cases there would need to be a natural balancing of interests. In addition, it would have to be examined whether there were potential conflicts-of-laws issues to be taken into account. Thus, the Committee should use this as an opportunity to mandate insofar as it can within its limited powers a role for the college and for joint decision making where possible.

These issues are further discussed with respect to point 7 below and the seventh question of the Q&A, below.

6. *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.*

The principle that conversion should be allowable for regulatory capital purposes into the stock or other securities of the ultimate parent (or possibly an intermediary company of the group) is appropriate.

This principle does raise a number of questions, but these questions should not preclude establishment of the principle for purposes of regulatory capital. Many of the problems will be resolvable either through negotiation of specific transactions or over time, and some may have different resolutions in different cases. For example, where the bank is not 100% owned by the holding company, some recognition would need to be given to the effect of the minority interest; where the holding company is the holding company for more than one bank there may be an effect on conversion ratios; where the holding company is a regulated entity (e.g. an insurance company), special authorizations may be required, etc., and crossing jurisdictional lines may add complexity. The point for these purposes is that the door should be left open for solutions that may be found and there is no need to preclude such solutions at the Basel level.

Section 4

Common stockholders

As mentioned in the consultative document, write-off can be viewed as a transfer of wealth from the instrument holder to the common shareholders. While the document correctly points out that the common shareholders do not have an incentive to trigger a write-off (firstly because the trigger is not their option, and secondly because they do not want their bank to be labeled as non-viable), there is still a concern that the absorption of loss by non-equity regulatory capital holders and the resulting transfer of assets to equity holders at the point of non-viability would not be equitable or compatible with general notions of appropriate corporate finance.

This may be solved by conversion to equity, which makes equity holders absorb losses by diluting or eliminating their ownership. However, as discussed above, the limits to the number of shares that can be issued in some jurisdictions could limit conversion rates and, hence, could also limit the extent shareholders absorb losses through dilution of ownership. Where such legal issues would obstruct creation of a coherent structure of regulatory capital, the Basel Committee and the FSB ought to take up the burden of urging countries to adopt appropriate legal frameworks for the new international vision of capital structures.[14]

Capital instrument buyers

The possibility that traditional investors in regulatory capital would find the proposed instruments unattractive is a serious one, and one that merits a great deal more research, analysis, and discussion.

The Institute has conducted some discussions with investors and rating agencies, but the Committee needs to have its own view. Therefore, it should organize a program of roundtables or soundings of the sentiments of investors, analysts, rating agencies, and investment bankers as to the marketability and attractiveness of the new instruments. The Institute would be happy to help either by participating in the process or in helping to organize it.

The Committee clearly recognizes that these measures could change the nature of the investors in bank instruments (see further discussion under the Q&A). This is not just a matter of the price at which such instruments can be issued, as is well recognized. There are also serious legal-investment issues for some traditional institutional and foundation investors (who may be forbidden to take any equity risk). In addition, the regulations to which investors such as money-market funds and insurance companies are subject are also undergoing rapid change, but there is no indication that these changes have been taken into account in this analysis. Investors will be reassessing their risk appetite, and some may simply conclude they are not interested in instruments with conversion or write-off risk (and this is quite apart from the question of the effects of the removal of implicit guarantees from bank paper, a goal that the Institute supports). Rating agencies could also change their views about whether or not the instruments can be rated.

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[14] While any legislative program is of course daunting, international legal reform on the basis of internationally agreed norms has moved forward in such areas as securities regulation and anti-money laundering law.

Many questions need to be examined, but among them is the possibility that a substantial part of the financing of banks, and perhaps more pertinently, the control of banks that undergo conversion could be transferred to the unregulated sector (e.g., hedge funds or private equity funds). This is not a bad thing or a good thing per se, but it would have serious implications for the future of markets for bank paper and for the behavior of investors in banks that enter the resolution stage.

Annex

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

As argued in the beginning of this note, it is important to keep up the pace of international discussion of resolution and bail-in schemes and not to be defeatist about what can be achieved. Ultimately, sound resolution is the best solution. Sound resolution and bail-in schemes may also be important to provide the underpinning of the overall structure, and it could be that conditional capital instruments will be more stable, more attractive, and more viable in the market if there is credible resolution grounding under the industry. A good resolution solution would also assure that ultimate losses are fairly allocated among all claimants.

The argument that the "cost of the proposal will tend to zero" is not compelling. There will certainly always be a cost to the contingencies that are being built in compared to straight debt, even without the implicit state guarantee that is to be removed. That said, resolution must be pursued conjointly with other projects, and not left as some distant or utopian goal.

Would it be simpler to de-recognise Tier 2?

As stated above, the industry sees no case for derecognition of Tier 2. In fact, what is needed is exactly the opposite: a clear reinforcement of the traditional corporate finance categories of subordination, correcting where necessary anomalies that arose in the crisis. Tier 2 capital has an important role to play as a buffer providing depositor protection and there is no reason this should be changed. Required terms should not render Tier 2 so onerous as to create a disincentive to its issuance or to make it unattractive to investors.

The Institute has argued in many different contexts that it is inadvisable to identify systemically important firms.[15]

Will this not impose unnecessary costs on small banks?

See the comment made above on triggers: clear definition of the new instruments in the hierarchy. Small banks have also been bailed out. Solutions should aim for a level playing field.

[15] The IIF Report *Systemic Risk and Systemically Important Firms: An Integrated Approach*, May 24, 2010, summarized the IIF stance as follows: "Approaches to systemic risk based on identifying "categories" of firms should not be adopted. They would not reflect the complexities of systemic risk and would perpetuate the perception that certain classes of firm are too big to fail."

In addition, any attempt to define a size criterion (what would be "small" in this context) would necessarily be arbitrary and could open the door to arbitrage.

Would the proposal change the investor base?

The analysis of potential effects on the investor base is absolutely fundamental to the future health of the industry and its ability to generate credit for society. While soliciting general comment from investors is greatly encouraged, the Institute does not believe that simply seeking written feedback will be enough. As the accounting standard setters have found, it is difficult to get truly representative feedback from the various classes of investors; they are not typically interested in commenting on regulatory proposals; and they need outreach and prompting to solicit valid feedback. In this case, it will be important to talk to different classes of investors, get an understanding of their needs and issues (including their own changing regulatory contexts), and discuss with them what might make ideas more or less attractive.

It is also important, as the Committee recognizes, to get legal and accounting – and also tax -- feedback.

What if the holders of the capital instruments are not permitted to own shares in the bank?

The solution of a public-sector trust to solve the problem of investors that are not permitted to own shares is a creative one, but one that will clearly need detailed discussion with lawyers and accountants from the Basel Committee jurisdictions. Further, it should not be assumed that legal-investment issues would necessarily be solved by such devices. In some cases investors may not be able to assume equity risk however characterized (form over substance), which might prohibit investment in instruments with conversion risk.

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

See the extensive comments on the trigger problem above. In many respects, automatic triggers would be much preferable to discretionary ones; the difficulties of this in the gone-concern context are recognized, but automatic triggers should not be assumed away – as seems to be the first conclusion here – without substantially more research, analysis, and debate. As footnote 9 notes, the pros and cons may be different for going-concern instruments, and the IIF advocates avoidance of supervisory discretion as the sole trigger for such instruments.

We also note the oddity of the comment that "we do not want all banks to be rescued via the conversion/write-off mechanism, as many should be allowed to fail and enter the traditional insolvency/resolution process." This again raises the underlying conceptual unclarity of this proposal: if the "rescue" is via conversion of private capital instruments, why should that be precluded in any case? While the Institute agrees that firms need to be allowed to fail, in the new world suggested by "Basel III" and this proposal, wouldn't failures occur *after* the conversion of the instruments envisioned in the proposal?

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

Group issues are discussed above.

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

The question of transferring problems of a failing institution is a serious one, partly addressed above. The real issue here is the market for bank securities. While it is appropriate to make other functional supervisors aware of regulatory changes, the issue is not there, but whether the ultimate design will be saleable in the real-world market. There is little indication that a real market assessment has taken place.

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

Measures should be explored to diminish the chances that the conversion trigger would be considered a credit event among the counterparties of the concerned financial institution. As noted, this requires close discussion of the ISDA Master Agreement and similar agreements, as well as covenants that are common in major markets. The question makes some very facile assumptions about what constitutes a failure to pay, and a serious consultation with the major financial-market law firms is obviously in order.

However, even if the conversion trigger does not represent a credit event, it may still lead to adverse implications on the institution's reputation, making it difficult for the institution to obtain market funding for a considerable period after such an event. As discussed above, even the threat of a "non-viable" determination may cause creditors to flee from a given bank, perhaps precipitating serious problems in the market as well, regardless of whether formal default issues would be triggered or not.

The effects on ratings should also be considered. While the converted instrument would certainly be considered non-performing, the effects of a conversion on the issuer's other ratings need examination.

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

Write-down or conversion would increase the quality of capital and immediate loss absorbency of the firm's resources. It would not increase the total risk-bearing capacity of the firm, however, so it is necessary to envision what would happen if the recapitalization achieved by conversion or write-off failed. Perhaps, as already suggested, bail-in becomes the next step, before liquidation.

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?

This question and, even more, the answer, again shows the lack of conceptual clarity about what is being proposed. However, it could be clearer if the proposal were reworked as comprehensive progression of measures envisioning a weakening bank's progression from healthy going concern to entry into a recovery stage (perhaps with conversion of going-concern instruments) to decline to a near-non-viability or intervention stage (where "gone-concern contingent capital" such as contemplated by the proposal would be converted) to a bail-in stage (if in fact bail-in is seen as something separate from the proposal) as a last resort to save value, to resolution and liquidation. In such a clearly phased structure, with clarity about the goals of each stage and about how the proposal would fit in the overall structure, a solution reliant on incentives might be possible.

The second paragraph is confusing in its suggestion that banks would issue instruments but somehow the supervisors would make clear they would not use the power to convert them. Perhaps this is intended to address the Dodd-Frank Act's prohibition on specific-firm bail outs; however, if it were made clear that the proposal includes in effect a prepackaged *private-sector* recapitalization by conversion of all non-equity regulatory capital instruments as here proposed, this concern would disappear. If the recapitalization failed, then, as suggested above, the next step would be bail-in, or perhaps direct resolution and liquidation (at which point the converted security holders would presumably suffer a further substantial loss).

Once again the comment seems to confuse the old world of bail-out with the new world where conversion will occur before bail-in and last-resort official intervention.

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

The Institute agrees that the proposal should be viewed as a complement to effective resolution regimes.

As argued above, there is serious concern that embedding public-sector intervention in the basic trigger concepts of the proposal would have the effect of ratifying and even institutionalizing moral hazard.

Conclusion.

The proposal makes a substantial intellectual contribution to the development of thinking on contingent capital, but needs to be revised and enhanced before it can be implemented as part of a coherent and internationally consistent regulatory system. This further development should be in the context of active advancement of internationally coordinated resolution measures; resolution should not be put off to another day. The moral hazard implicit in tethering the proposal to public intervention should be minimized.

The proposal needs to be clarified and reconfigured for the new, post-crisis environment, taking into effect its interaction with other aspects of regulatory reform, such as Recovery and

Resolution Plans, bail-in, and resolution. It needs to be defined clearly in relation to the overall scheme of going-concern regulatory capital requirements and of the progressively increasing measures to be taken as a weakening bank approaches the point of non-viability. The proposal should be clarified to make clear what is now at times implied, that the instruments envisioned could form part of a pre-packaged private-sector recovery plan that would not be tied to public intervention. It should be designed to respect the customary hierarchies of corporate finance.

Finalization of the proposal should take place through consultation with the industry, but also in a context of active outreach to the various classes of actual and potential bank investors, and representative lawyers, accountants, and tax specialists in the major jurisdictions.