ABI comments on the Basel Committee consultation document "Proposal to ensure the loss absorbency of regulatory capital at the point of non viability"

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POSITION PAPER

Introduction

The Italian Banking Association (ABI) welcomes the opportunity to contribute to the Basel Committee consultation on Banking Supervision (BCBS) on the document entitled *Proposal to ensure the loss absorbency of regulatory capital at the point of non viability*.

ABI shares the objective of the BCBS proposal: to ensure that also non-core Tier 1 and Tier 2 financial instruments should absorb losses in the case of bank crisis. This objective should be pursued in specific, well-defined situations, and adopting procedures that guarantee the fundamental rights of the holders of the securities issued by the ailing bank.

However, ABI retains that the approach adopted by the BCBS, if confirmed, is against basic legal principles insofar as it is represents an unwarranted constriction of investors' rights as well as having potentially distortive effects on the capital market.

Furthermore, the measures proposed should be contextualised within the more general process of reform of financial regulation, both with regard to the planned definition of the international crisis management framework outlined in the recommendations issued by the BCBS in March 2010 ([1]), and with regard to the measures that the BCBS is drawing up in collaboration with the Financial Stability Board (FSB) for the *Systemically Important Financial Institutions* (SIFIs) ([2]).

The proposal was issued to face the effect of the recent government intervention to rescue cross-border ailing banks: public funds injections, in fact, on one hand have diluted core Tier 1 financial instruments, and on the other, by avoiding the triggering of an insolvency procedure, have actually protected holders of non-core Tier 1 and Tier 2 financial instruments from losses.

Therefore, the BCBS proposes to apply a "gone concern" measure to banks that have not entered in formal insolvency proceedings and

([1]) *Report and recommendations of the Cross-border Bank Resolution Group - final paper*, Basel Committee on Banking Supervision, March 2010.
([2]) "The Committee and the Financial Stability Board are developing a well integrated approach to systemically important financial institutions. This could include combinations of a capital surcharge, bail-in debt and contingent capital", *A new regulatory landscape*, Nout Wellink, Chairman of the Basel Committee on Banking Supervision, Singapore, 22 September 2010.

that thus have remained in a “going concern” situation simply because they have been saved by public intervention.

In addition, ABI believes that the proposal requires further examinations to find appropriate solutions to avoid that the impact on the company, insolvency, accounting and tax law of the various jurisdictions may lead to undesired distortions and opportunities for regulatory arbitrage.

In particular, the BCBS should assess the potential impact of the proposal on the tax-treatment of non-core Tier 1 and Tier 2 instruments in the various jurisdictions to ensure a level playing field ([3]).

Lastly, the BCBS should assess the impact of the proposal both in terms of higher funding costs for the banking industry and as regards the market’s capacity to absorb the maturing non-core Tier 1 and Tier 2 instruments. It should not be assumed in fact, that investors – particularly those most averse to risk –would be willing to subscribe the non-core Tier 1 and Tier 2 instruments that the banks will issue to replace those maturing.

Such impact assessment is particularly important in the light of the costs and the capital needs that the banking industry will be requested to meet as a result of the reform of the Basel prudential framework (Basel 3) and of the planned tightening up of prudential requirements for SIFIs.

The following paragraphs illustrate several considerations on the most critical aspects of the BCBS proposal and some alternative solutions.

1. Trigger events

The Committee proposes a loss absorbency mechanism entailing the partial permanent write-off of non-core Tier 1 and Tier 2 instruments on the occurrence of specific trigger events.

([3]) “Revenue bodies should work constructively with the banking sector and regulatory bodies to gain a shared understanding of the commercial context and the links between tax and regulatory reporting”, *Addressing Tax Risks Involving Bank Losses*, Organisation for Economic Co-operation and Development (OECD), September 2010.

The BCBS states that individual jurisdictions will be free to choose whether the same result could be reached through a conversion into ordinary shares, as an alternative to the partial permanent write-off.

In the consultation document, the BCBS proposes two trigger events for the activation of the loss absorbency mechanism by the competent authorities:

- the first is linked to the decision of the competent authorities to make a public sector injection of capital, or equivalent support, to avoid the ailing bank entering a formal insolvency procedure.

- the second is instead associated to the discretional decision of the competent authorities to use the Tier 1 and Tier 2 financial instruments to avoid the bank becoming non-viable.

The first trigger event, the decision of the competent authorities to make a public sector injection of capital, appears to be in line with the objective that the BCBS intends to pursue by means of the consultation document: to avoid that non-core Tier 1 and Tier 2 instruments do not bear losses in the event of a crisis that does not evolve into a formal insolvency procedure because of the public intervention.

Indeed, in these cases public intervention actually “certifies” that the bank is in a “gone concern” situation and that it will not be wound up only because the competent authorities fear the potential impact on the financial stability of the markets.

The second trigger event, on the other hand, is based on discretional decision of the competent authorities, therefore is not necessarily linked to the existence of situations that “certify” the bank is in a situation of distress, even if informal.

In this way, BCBS would be establishing a new gone concern category, which appears to be halfway between absorbing losses in times of distress (going concern) and absorbing losses in the event of liquidation (gone concern).

The introduction of such a discretional trigger event is inadvisable for two important reasons: on one hand, it creates an overlap between the concepts of gone concern and going concern, making the relationship between the proposal and the early intervention measures unclear.

On the other hand, it is inconsistent with the objective to safeguard the taxpayer, insofar as it does not necessarily entail public intervention.

Furthermore, the introduction of a loss absorbency mechanism for non-core Tier 1 and Tier 2 financial instruments in the event of "non certified" crisis situations, if not appropriately calibrated, could end up creating an unjust advantage for ordinary shareholders. In these cases, a situation could even arise in which the holders of non-core Tier 1 and Tier 2 financial instruments end up bearing the permanent losses instead of the ordinary shareholders, leading *de facto* to a substantial inversion of the subordination ranking.

2. Transposition of the BCBS proposal into the various jurisdictions

The Basel Committee appears to be proposing the adoption of a legislative (statutory) approach to impose the write-off/conversion clause, with a retroactive effect to the existing stock of non-core Tier 1 and Tier financial instruments.

This approach, if confirmed, would be against the fundamental legal principles as it would lead to the unwarranted constriction of the investors' rights.

A solution that would respect investors' rights is represented by the addition of the clause proposed by BCBS only for new-issuance contracts.

In this context, the proposal must entry into force gradually, in order to avoid weakening the capacity of the banking industry to sustain the real economy to overcome the crisis.

3. The temporary write-off proposal

The Basel Committee sustains that the aim of the proposal to write-off/convert non-core Tier 1 and Tier 2 financial instruments into ordinary shares is to protect the taxpayer.

Considering that, as mentioned earlier, ABI believes that solutions should be sought within the project to establish a new crisis

management framework, if BCBS intends to forge ahead with the proposal, it could be opportune to explore alternative solutions that reduce the impact on the banking business.

In particular, as an alternative to a permanent write-off, the BCBS could envisage a temporary write-off with the option of a subsequent write-up of the nominal value when, for example:

- public intervention in the form of capital is entirely repaid or, in any event, the public shareholding passes into private hands

- the write-up of the nominal value is made *pari passu* with the ordinary shareholders and in the presence of profits.

The temporary write-off should take place in such a way that the investor receives (even in shares) the nominal capital portion of the residual interest which, in the event of liquidation, would not have been lost in any event.

Said payment could be made, if the shares have a positive value, through the allocation of a number of shares, whose value corresponds to the nominal value of the security.

If the shares have a negative value after the public intervention, on the other hand, the amount should correspond to that which subordinate creditors would have been owed in the event of the liquidation of the bank.

If, despite public intervention, the bank enters in an insolvency procedure, in order to protect the taxpayer, a 'claim in liquidation' could be allocated to non-core Tier 1 and Tier 2 holders; such claim should be junior with respect to the public capital injected in the bank. To this end, it could be envisaged to assign special shares to the public entity.

This solution is consistent with the objective of the BCBS to avoid situations in which non-core Tier 1 and Tier 2 holders could benefit from the recovery of a bank due to public intervention ([4]) and at the

([4]) "The original instrument holders cannot have any residual claim that is senior to a common equity injected and so a permanent write off is necessary", *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability*, Section 3: Proposal and an explanation of the mechanism, Basel Committee on Banking Supervision, August 2010.

same time would permit to avoid the negative effects of a permanent write-off.

Making non-core Tier 1 and Tier 2 financial instruments potentially subject to a permanent write-off could in reality lead to:

- the loss of the characteristics of a bond, and therefore the impossibility of being able to settle the same through clearing and settlement counterparties

- lower attractiveness for fixed income investors and consequently, the gradual reduction of an important source of capitalisation for banks.