Basel Committee Proposal on loss absorbency of regulatory capital at the point of non-viability (BCBS 174 of August 2010).

Key points of attention for KBC Group

- The Proposal aims at enhancing the entry criteria for regulatory capital to ensure that **all regulatory capital instruments issued by banks are capable of absorbing losses** in the event that a bank would not be able to support itself in the private market.
- The Proposal is based on a requirement for all non-common Tier-1 instruments and Tier-2 instruments at "internationally active banks" to have contractual terms requiring them to be written-off or converted to common shares in the event that the bank is unable to support itself in the private market. The trigger event for **write-off or conversion** would be the earlier of (1) "the decision to make a **public sector injection** of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority"; and (2) "a decision that a write-off, without which the firm would become **non-viable**, is necessary, as determined by the **relevant authority"**.

1. Overall consideration: legal certainty within the framework of overall regulatory reform.

We notice widespread consent among regulators and market analysts that the loss absorbency of regulatory capital instruments in the latest financial crisis was unsatisfactory. A combination of contractual clauses and mandatory triggers would appear to have created securities that were more debt than equity-like and not effectively loss-absorbing. It is therefore reasonable to consider ways of ensuring that regulatory instruments indeed bear losses in times where this is necessary to ensure viability of a bank as well as in a resolution scenario.

Interaction with overall regulatory reform.
However the debate on loss absorbency of capital instruments cannot be held in isolation. It must be set within the development of the overall Basel III capital framework and within the future international framework for resolution of financial institutions. The **hierarchy of subordination** of capital and subordinated debt instruments will have to be absolutely clear for banks and market participants. This includes answers to questions on how the treatment of Tier-1 instruments would differ from Tier-2 instruments and how instruments that qualify as "going concern" capital would relate to "gone concern" capital instruments.

It will then have to be clarified **for which purpose banks will be able to use these capital instruments**. Will they be eligible to meet Countercyclical Buffer requirements? And to comply with eventual capital surcharges for Systemically Important Financial Institutions?

Any uncertainty regarding these issues would further complicate capital planning for banks and would create undue difficulties for issuing new instruments going forward.

Transitional arrangements required.
Given the complexities of the issue of contingent capital it will undoubtedly require more time before a coherent package can be presented that interacts appropriately with other aspects of the regulatory reform. However, the Basel Committee's press release of 12 September has created an incentive for banks to consider redemption

of their existing subordinated debt. Meanwhile, the Committee has not yet created clarity about the requirements for the new instruments to qualify as capital. To reduce this uncertainty, we would strongly suggest for transitional arrangements to be put in place under which **new instruments would qualify under the new capital requirements, subject to supervisory approval,** when they approximate the intent of the Basel Committee as expressed in its Consultative Document of December 2009 ("*Strengthening the resilience of the banking sector*").

2. **Specific considerations as regards the functioning of the loss absorbency as proposed.**

- *Scope of the Proposal.*
  It is not clear to what type of banks the Proposal would apply. It states on the one hand that it will apply to all Tier-1 and Tier-2 instruments of "**internationally active banks**" whereas further reference is made to non-common capital instruments of "**systemically important banks**". The exact scope of the Proposal should be clearly defined.

- *Hierarchy of subordination.*
  Clearly defined subordination hierarchy is a prerequisite for a correct **pricing-in of write-down risk**. As a general principle, seniority principles based on corporate law and contract law should be respected. The Proposal remains unclear on this point and does not seem to take into account the possible conflicts of law and practices regarding definition of capital and ranking between the various categories of debt holders. Questions most notably arise with respect to the situation where instruments are written-down without conversion, e.g. because of contractual limits or obstacles under corporate law (see *infra*). **Tier-1 and even Tier-2 investors would then become junior to ordinary shareholders** and the traditional risk profile according to which such investors would only suffer permanent losses after the shareholders would be reversed. Would there be market appetite for such instruments and, if so, would the price for such write-down risk not make these instruments overly expensive for banks?

- *Usage of new capital instruments.*
  It would be expected that these contingent capital instruments will not only count as non-common Tier-1 capital and Tier-2 capital but that they will also qualify for the **Countercyclical Buffer** as well as for any add-on requirements that would be imposed on **Systemically Important Financial Institutions**. This should be confirmed explicitly.

- *Clear and objective definition of triggers for write-off or conversion.*
  - **Clear and objective criteria** for when "public sector injection of capital, or equivalent support" is deemed necessary and for when a bank would "become non-viable" without a write-off must be defined beforehand to minimize uncertainty as to when supervisors would trigger write-off. This includes defining and ring-fencing the notions of "**public sector injection**" and of "**equivalent support**". This would give guidance to supervisors as to when a write-off decision would be appropriate and would provide the minimum information required to allow for pricing and marketing the instruments.

- The Proposal seems to indicate that **write-off could only be triggered by supervisors and not by the issuing bank**. We would assume that this cannot be the intention and invite the Committee to provide more clarity in this regard.
- Conflicts of interest may arise between **home and host supervisors**. The respective roles of supervisors and of the College of supervisors in deciding whether or not to pull the trigger need to be given much more clarity.

- *Write-off: permanent and complete?*
  - We see no clear and convincing reason why write-offs would have to be permanent and why the possibility of a **write-up** should be excluded once a firm has returned to an appropriate level of solvency and after complete reimbursement of public funds that would have been injected.
  - In the same vein, no convincing arguments have been presented for not allowing **partial write-downs** within reasonable limits.

- *Conversion: conditions and limits.*
  Conditions and limits imposed by corporate law, notably on the number of shares that can be approved for issue under "authorized capital" or the percentage of shares that can be issued to new shareholders without offering preemptive rights to existing shareholders, **may severely restrict banks' possibility to offer a conversion option** to potential investors in hybrid instruments. This makes it all the more important to allow for an appropriate level of flexibility in the conditions for write-off, such as partial write-off and possibility for future write-up.

3. Conclusion

The Proposal provides a valuable contribution to the debate on how the loss absorption of regulatory capital instruments can be enhanced, thereby taking into account the lessons learned during the latest financial crisis. However, it needs **significant further development** notably in the context of existing contractual and corporate law and in the context of the overall new regulatory framework.

Meanwhile, **transitional arrangements** would need to be put in place that give appropriate guidance to banks that want to issue new instruments a.o. to replace existing instruments that would no longer qualify under new capital requirements.