MINISTRY OF FINANCE

27.09.2010

To: Basel Committee on Banking Supervision

Re: Consultative document August 2010

PROPOSAL TO ENSURE THE LOSS ABSORBENCY OF REGULATORY CAPITAL AT THE POINT OF NON-VIABILITY – RESPONSE BY THE MINISTRY OF FINANCE OF FINLAND

We welcome the efforts to find ways to mitigate the impact of financial crises to public finances and to reduce the moral hazard inherent in the current system. We therefore fully share the objectives of the work related to contingent capital. We also fully agree that if the proposed legislation will be adopted, its should in any case be limited to gone concern situations, where the supervisory or judicial authorities have established the non-viability of the bank in accordance with national legislation.

There are, however, a number of issues that need to be carefully assessed before introducing binding legislation. In particular, we would like to make the following points:

1) A bank becomes, by definition, non-viable when it no more meets the minimum capital requirements. In some jurisdictions, there may be additional insolvency triggers based on the company law, such as a threshold for the remaining amount of net equity but such parallel triggers would, however, be usually irrelevant because as a rule, a non-compliance with the minimum capital requirement, would trigger a mandatory liquidation of the bank long before any company based trigger would become applicable.[1] Therefore, a "gone concern" situation would normally be established as soon as it has become evident that the bank cannot restore its capital base by issuing new capital to the market to meet the regulatory minimum requirements.

   It follows that if contingent capital were to be used to ensure the continuity of the bank's operations after a gone concern situation has been established on the basis of

[1] For instance, according to the Finnish legislation the withdrawal of authorisation, whether based on non-compliance of capital requirements or on any other ground, is the only even triggering a mandatory liquidation of a bank (apart from the case where a judicial court declares a bank bankrupt because it is unable to pay its debts).

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lack of adequate regulatory capital, the bank would still need the same amount of regulatory capital to restore its capital base, albeit in different form (non-equity regulatory capital instead of equity). Therefore the proposed rules would affect only the *quality* of the capital but not the overall *quantity*.[2] We fail to see that the improvement of the quality of capital alone could significantly improve the situation of the bank, bearing in mind that it would continue to fail to meet the minimum regulatory requirements and therefore cannot continue its operations.

The resulting situation where (part of) the non core tier I instruments would have been converted into equity (or written down against losses) and there is a corresponding shortage in the lower classes of regulatory capital would be unsatisfactory for the following reasons:

- The need for capital injection by government would still remain as there is a shortage of non-equity capital; such capital injection would have to be made by similar instruments in order to maintain the existing capital structure or else the amount of equity would be excessive with regard to the what the management had considered to be the most cost effective capital structure; [3]
- If a bank has not been able to raise equity with voting rights in the market, it is not very likely to be able to raise lower classes of regulatory capital either (particularly as the investors would be likely to expect very high return for loss bearing non equity instruments of a bank that has just failed).

2) In any case, it should be clearly established that any new rules on regulatory capital do not have retrospective effect on existing contracts as financial contracts are protected by the constitutional right of property and the financial rights based on such contracts cannot be significantly reduces by new legislation.

3) It should also be made clear that to the extent non equity regulatory capital absorbs losses it takes place in the same priority order as in liquidation.

In conclusion, the Finnish authorities do not support the proposed loss absorbency features of non-equity regulatory capital at least as a sweeping mandatory rule.

As a possible solution, the loss absorbency feature could be introduced as call option for the bank after all losses have been written down against equity. In such a case the bank could decide whether it wants to maintain its capital structure by either issuing new shares without interfering with other classes of capital or by using the call option and issue new non-core Tier I capital or whether the bank wants to first use the call option and only then issue new equity, thus improving its capital structure. Moreover, in cases where public capital support is considered necessary, the government would be in a position to decide whether it wants to inject equity in the bank allowing the government to gain decision making powers in the resolution or reorganisation process or whether it is satisfied with injecting non-voting capital to the bank.

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[2] Unless there is an excess of non equity regulatory capital.

[3] It should be borne in mind that the higher the amount of equity is, the higher is also the required return on assets and, consequently, the more risks the bank needs to take to meet the ROA target; therefore the objective should be optimal, not maximum amount of equity.