From:	Philps, Daniel G.
To:	Basel Committee, Service
Subject:	Proposal to ensure loss absorbency of regulatory capital at the point of non-viability.
Date:	25 August 2010 16:01:05

Dear Sirs,

By way of an introduction, at Mondrian we manage $60bn of global fixed income and equity assets for a range of institutional clients and sovereign wealth funds. On behalf of our clients we invest in all tiers of bank capital except hybrids. (I.e. senior debt, lower tier 2 and equity). I approach your proposals from the perspective of investors, contagion and market stability. I also hope that the consultation process proves to be less "deaf" than it is reputed to be.

With regard to your consultation document on loss absorbency dated August 2010, the best option you mention is to leave the situation as it is or to derecognise tier 2 capital. Either would be far more preferable to the compromises you suggest otherwise. As regards what appear to be the two other principal options:

1. Large scale issuance of bond like instruments with "cliff loss" potential continues to be dangerous

From an investment risk perspective there is little distinction between old style hybrids (e.g. innovative capital) and the new tier 2 securities described in the consultation document. All bond like instruments with equity downside are flawed by the fact that they pertain to be something they are not - a bond. As a result they are extremely difficult to rate. Misrating of these securities has caused many to be erroneously included in mass-market investment grade bond benchmarks, such as the BarCap Aggregate which in turn has resulted in them being held by inappropriate investors, some with systemic importance. Insurers and under funded pension funds are two examples that spring to mind and came close to further destabilising the financial system in 2008/09 as a result of their holdings in securities with the same dangerous principal impairment features you propose. You will have observed, as we did, that such systemically important investors holdings of hybrids were part of the reason governments were prevented from taking the actions you are seeking to facilitate. A number of governments were well aware that had they impaired rescued bank's hybrids at the height of the crisis, they would have precipitated a solvency crisis across the global insurance industry which taxpayers would also have had to pay for. These proposals may have forced that event.

I also question whether it would be cost effective for banks to issue such hybrids in the quantity required, after inappropriate investors had been excluded from potential demand. By implication the only way it would be practicable is to introduce equity like downside into bond portfolios that should not contain this level of risk.

2. The worst and most dangerous suggestion made is to force the impairment/conversion of existing tier 2 instruments (as I understand it) should a bailout be required.

It would be perverse and ridiculous to impair tier 2 instruments (i.e. an event of default in the case of lower tier 2) before all common stock and tier 1 capital were wiped out first. Otherwise this would disregard the most fundamental point of bank capital structuring: the liquidation hierarchy, and its legality would be questionable as things stand.

Bear in mind this rule, if applied to lower tier 2, would result in big rating agency downgrades for all lower tier 2 bonds - many of them to junk. The market would mark down values as a consequence. Thus the introduction of this proposal alone would cause impairments which would, for example, hit the European insurance sector (which we estimate, holds up to 50% of outstanding € denominated tier 2 issues). Acceptance of this proposal would both damage the financial system and force up the cost of bank capital.

To conclude, it is clear that any compromise will either harm the financial system now or store up problems down the road. The market needs and demands clarity and without it everyone will be the worse off. The only way of achieving this clarity is to accept that: 1) unless governments are prepared to wipe out capital subordinate to tier 2, tier 2 should not be impaired, or if this is unacceptable tier 2 capital should be derecognised entirely.

Best regards,

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