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Subject: Nomura's input to the Basel Committee on Banking Supervision's proposal to ensure the loss absorbency of regulatory capital at the point of non-viability

We at Nomura would like to respond to the Basel Committee on Banking Supervision's *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability* published in August 2010. Our response comprises a letter to the BCBS in four parts:

- First, we discuss the three options highlighted in the Proposal;
- Second, we explain our principal concern with the idea raised by the Committee;
- Third, we comment on each of the questions in the Annex to the Proposal; and
- Finally, we conclude with certain issues we believe to be integral to the loss absorbency debate

Introduction

First, we would like to thank you for your '*Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability*'. We find the paper most interesting and we believe it raises a number of important issues. We agree with much of what you say and we understand the rationale behind the central point of your paper: to ensure that all regulatory capital instruments issued by banks are capable of absorbing losses in the event that a bank is unable to support itself in the private market. We do feel, however, that serious considerations arise from your proposals, which must be addressed head-on, if the banking industry is to emerge from the financial crisis stronger and more robust than it was before.

Your paper suggests that all regulatory capital instruments issued by banks should be capable of absorbing losses in the event that a bank is unable to support itself in the private market. And you highlight that when certain large banks, deemed too big to fail, were rescued by public money, investors in regulatory capital instruments benefited alongside depositors. As a result, Tier 2 capital instruments did not absorb losses in the way that they might have been expected to do, had the banks not been supported by the public sector.

This is all manifestly true. Perhaps there was always an implicit assumption on behalf of investors that Tier 2 capital instruments issued by major international banks would be protected in some way. But that protection was made explicit in the autumn of 2008, since when it can be said that these instruments are no longer as capable of absorbing loss as they were originally designed to be.

Three options

You offer three options to ensure that, in future, regulatory capital instruments are capable of bearing a loss. Like you, we believe that option three is preferable to options one and two (all reprinted below).

- Option 1: Develop national and international bank resolution frameworks that enable losses to be allocated to all capital instruments issued by internationally active banks that have reached the point of non-viability
- Option 2: Try to identify systemically important banks and prohibit them from including Tier 2 instruments in their regulatory capital
- Option 3: Require that all regulatory capital instruments include a mechanism in their terms and conditions that ensures they will take a loss at the point of non-viability

Developing national and international bank resolution frameworks that enable losses to be allocated to all capital instruments issued by non-viable international banks is an admirable aim but may be impractical in the short term for the reasons you specify.

Prohibiting systemically important banks from including Tier 2 in their regulatory capital runs the risk of irrational discontinuity. Defining 'systemically important' is a challenge in itself – does it depend on size of balance sheet or interconnectedness with other financial institutions? And even if it were possible to define the term, creating different rules for different types of banks may inadvertently provide an opportunity for sub-economic arbitrage.

This suggests that, of your three options, the third is most attractive. It is abundantly clear that regulatory capital instruments should have the potential to be written off, if the issuing bank is on the brink of non-viability. And we understand the logic, from a regulatory perspective, of creating Tier 2 instruments that can be converted into common equity if certain trigger events occur. What concerns us, however, is who might buy such instruments.

Who will buy?

Feedback from investors has suggested that appetite for genuine risk absorbing debt instruments is limited. The most desirable investors would be pension funds and insurance companies – long-term institutional holders, who may regard these securities as offering better value than equity or who may specifically need high-yielding instruments to match their liabilities. Such investors exist, undoubtedly, but so does another class of investors, whom we believe may, from time to time, find Tier 2 convertible instruments attractive. We refer here to the hedge fund community. Of course, there is nothing intrinsically wrong with hedge funds but they would, as a matter of course, seek to hedge their risk by shorting the underlying equity. And the closer an issuing bank came to a 'trigger event', the more these investors would need to sell the underlying equity, thereby creating a downward or even death spiral. Whether the trigger events were explicit or implicit would not materially matter. If it became clear that a bank was struggling, hedge funds would start shorting – and the more Tier 2 instruments they held, the more dramatic that shorting would be. In other words, they would be incentivised to act in a way that would hasten the demise of the issuing bank.

This creates something of a dilemma. While market dynamics preclude the possibility of investor pre-selection, if these instruments fell into the hands of investors with pro-active hedging strategies, they might precipitate the very events they are supposed to be helping to avoid.

This is our principal concern. But we would also like to comment on the questions raised in the Annex of your Proposal.

Questions one to 12

Question one: Would the development of effective bank resolution schemes be a better approach to ensuring gone-concern loss absorbency?
If the 'effective bank resolution scheme' were capable of unequivocally addressing cross border jurisdictional concerns such that there were no possibility of legal challenge to loss absorbency, we would agree.

Question two: Would it be simpler to de-recognise Tier 2?
In many ways, it would be simpler to de-recognise Tier 2. If, as you suggest, Tier 2 instruments could be converted into equity when certain trigger events take place, they are quasi-equity. They may not be treated as such by regulators but they would undoubtedly be treated as such by certain types of investors and perhaps by issuers too.

We certainly agree with you that de-recognising Tier 2 for systemically important institutions alone is hazardous (as we mention above).

Question three: Will this not impose unnecessary costs on small banks?
Small banks are already at a disadvantage because they do not have the protection of those deemed too big to fail. Your proposal may help to redress that anomaly.

Question four: Would the proposal change the investor base?
Investors in subordinated debt instruments have traditionally invested in them as debt, rather than equity, and recent experience has only strengthened that conviction, as your paper highlights. If your proposals were put into practice, the market would no longer perceive subordinated instruments as debt but as quasi-equity. Currently, some subordinated instruments are not loss-absorbing. If your proposals were introduced into the market, they would be. Therefore the investor base would undoubtedly change.

Question five: What if the holders of the capital instruments are not permitted to own shares in the bank?
If investors are not permitted to own shares in the bank, it would imply that they are buying loss absorbent capital under false premises.

Question six: Would it be better to have an automatic trigger for conversion/write-off linked to some market variable or regulatory ratio?
We understand your point regarding transparency. Against this however, the more obvious the trigger, the more hedging activity is likely to take place as the trigger event looms. So an automatic trigger may enhance the likelihood of a downward spiral emerging, hastening the demise of the issuing bank.

Question seven: How would the approach apply to capital issued out of subsidiaries? Could this not lead to the break-up of a group?
If the parent's ownership falls below 50% as a result of conversion of a subsidiary capital instrument, this may well lead to a break up of a group.

Question eight: Would you not be transferring the problem of a failing institution to the insurance companies and pension fund sectors that hold the bank capital?
These institutions are already accustomed to holding instruments, the value of which can rise or fall according to the health of the issuing bank. These subordinated debt instruments would be no different. A market would emerge and issuing banks would have to pay a coupon sufficient to compensate investors for the risk they are taking on. The real challenge, as we see it, is that insurance companies and pension funds would not be the only investors in this capital – hedge funds may also find it attractive.

Question nine: How can we be sure that the conversion/write-off is not considered a default?
It is imperative that conversion does not trigger cross-default. If the conversion of a hybrid instrument does trigger default clauses, then it will affect derivatives contracts and from there, chaos will ensue. As the demise of Lehman Brothers made clear, the interconnectedness between a defaulting institution and the rest of the financial system is facilitated by derivatives. If the conversion of a hybrid instrument into equity triggered cross-default clauses, it would precipitate the very event it was designed to avoid. The challenge here is that different legal jurisdictions may interpret conversion, write-off and default in very different ways. But these instruments would only serve their purpose if the language within the original documentation explicitly stated that conversion would not trigger default, and in no jurisdiction could that be challenged.

Question ten: Does conversion/write off improve loss absorbency even though it does not bring in new money?
This is an absolutely fundamental point. If a hybrid instrument has convertible characteristics, the capital is created at the point of issuance, not at the point of conversion. Conversion manifestly does not add new capital to the issuing bank: it merely changes the status of that capital from Tier 2 to common equity. So the notion that conversion *per se* will help a bank that is in trouble is driven more by regulatory accounting convention than reality. If these new hybrid instruments are genuinely loss-absorbing, they are quasi-equity; that is, if equity is defined as an instrument capable of absorbing losses without creating a default event. And, if these instruments are created properly with no possibility of cross-default, then they should be classified as quasi-equity and treated as such from the moment of issuance.

Question eleven: 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 highlights one of the key challenges within your proposal, namely, that different jurisdictions apply different rules to local banks, however international their scope. If a local jurisdiction does not permit convertible instruments to be loss-making, then those instruments should not count as regulatory capital. Trying to find a way around this by offering additional credit to banks to encourage them to issue such instruments would, we believe, create additional complexity and could, potentially, lead to sub-economic arbitrage.

Question twelve: Could the proposal reinforce moral hazard in relation to senior debt?
Yes, if senior debt holders (and depositors) are encouraged in the belief that, by making loss absorbency absolutely explicit to subordinated debt holders, they are thereby protected from loss absorbency.

Conclusion

Nomura firmly believes regulatory capital must be capable of bearing a loss. If subordinated capital is counted as regulatory capital, therefore, it should be loss-absorbing and should not be protected by public sector bail-outs.

But this raises several questions:

- *Who will buy these instruments?* We believe hedge funds could be buyers: they would undoubtedly short the underlying equity as a hedging strategy, creating a potential death spiral as a trigger event approached.
- *How will these instruments be perceived?* If subordinated debt is convertible into equity once certain trigger events take place, investors (possibly issuers) will perceive it as quasi-equity from the point of issuance.
- *Do these instruments strengthen a bank's capital position?* Conversion, following a trigger event, does not create new capital. That capital was created at the point of issue, not at the point of conversion. It is therefore a regulatory and accounting artefact to say that capital is created on conversion.
- *Why should we distinguish between equity and subordinated debt?* The real distinction should be drawn between regulatory capital and other debt instruments. Impairment of any regulatory capital instrument should not trigger cross default, while impairment of senior debt instruments should trigger cross default. The distinction between non-common Tier 1 and Tier 2 capital is a regulatory and accounting artefact.
- *Would your proposal affect senior debt?* We do not believe senior debt should be completely precluded from loss absorption, as this may create moral hazard.
- *Would your proposal be enforceable across all jurisdictions?* If not, then some banks could be unfairly disadvantaged.

In short, we absolutely concur that regulatory capital must be loss-absorbing. But we question whether the current proposals inject an extra layer of complexity into what is already a highly complex situation.

We hope our response to the BCBS Proposals is sufficiently clear and concise. We are delighted to be given the chance to respond and we look forward to being engaged in the debate on the loss absorbency of regulatory capital, as we work together to find a solution that protects those who need to be protected, encourages effective risk management within the banking community and offers a viable way forward for all market participants.

Sincerely,

David Benson
Global Chief Risk Officer