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OCBC Bank

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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Sirs

PROPOSAL TO ENSURE THE LOSS ABSORBENCY OF REGULATORY CAPITAL AT THE POINT OF NON-VIABILITY

1 Introduction

1.1 We refer to the consultative document by the Basel Committee on Banking Supervision (the "**Committee**") on the Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non-Viability published on 19 August 2010 (the "**Proposal**") and the invitation for comments on the Proposal. This letter sets out the comments from the Oversea-Chinese Banking Corporation Limited ("**OCBC Bank**").

2 Issues with Write-down Requirement

2.1 We note the Committee's rationale to enhance the entry criteria of non-common regulatory capital instruments ("**Capital Instruments**") to absorb losses before the public sector steps in to recapitalise a bank. Whilst we can understand the desire for Capital Instruments to be written off or be converted to common equity in the event of a public sector bail-out, the Proposal appears to have ignored the following:-

2.1.1 A fundamental reason for the existence of the different types of Capital Instruments is that there are investors who are prepared to accept no voting participation and lower returns in exchange for the rights to get a higher-ranking payout in the event of liquidation. If we change such a fundamental differentiating characteristic of these non-common capital instruments, and allow regulators to, at their discretion, trigger a write-down or conversion to common equity, we risk removing the reason for the existence of these Capital Instruments which goes against what the Proposal appears to like to avoid.

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2.1.2 Given that the write-down is permanent, it should be triggered only at the point of non-viability. However, public sector capital injection may be done not so much to restore viability, but more to boost public confidence. In a "crisis" or perceived crisis situation, the exact gone concern payout for each class of Capital Instrument is often difficult to ascertain, and write-down, which may not be necessary, once enforced, is irreversible. This is unfair to the holders of these Capital Instruments.

2.1.3 In some markets where the government owns certain banks or financial institutions, it may also be difficult for stakeholders of private sector banks not to be concerned over the possibility of a public sector's "acquisition" of banks by way of a bail-out which may not be necessary from a strict viability viewpoint.

2.1.4 Prescribing a formula in advance for the write-down and conversion into common equity upon occurrence of a trigger event is very difficult because of the large number of potential permutation of events. Investors, not knowing which events might prevail, will likely focus on the "worst case" scenario, with the result that either such instruments will not be well received by the market, or that their costs of issuance will be prohibitive which is clearly not the intent of this Proposal.

2.2 Given these concerns, we are of the opinion that the contractual terms of Capital Instruments should not be required to include a write-down feature in the way the Proposal has envisaged.

2.3 Further clarification of our views on the Proposal is given below:

2.3.1 **Inequitable to expect investors of Capital Instruments to support ordinary shareholders.** The Proposal is contradictory to the relative liquidation ranking of the different Capital Instruments, especially if the permanent write-down requirement is intended to be applicable on 100% of the outstanding principal or face value of instruments. It would also be inequitable if Capital Investors have to suffer losses or conversion before all existing ordinary shareholders' equity is wiped out. Furthermore, it would be inappropriate to force the Capital Investors to "downgrade" to common equity if ordinary shareholders still maintain their common shares and their same ranking and suffer no "downgrading". As much as it is not logical for public sector funds to bail out Capital Investors, Capital Investors should also not be expected to "bail out" ordinary shareholders.

2.3.2 **Proposal assumes all regulators can accurately identify point of non-viability.** The trigger event, as defined in the Proposal, is entirely up to the judgment of regulators. Given that the write-down is permanent, it should be triggered only at the point of non-viability, and not when the regulators merely wish to inject capital to boost public confidence. Practically, it is hard to imagine that anyone, including regulators, can be certain that they could accurately identify the point of non-viability for their banks. Therefore, compelling a bank to write down or convert non-common Capital Instruments before non-viability is established is potentially unfair to the holders of these instruments.

2.3.3 **Unlevel playing field given differing behaviour of regulators.** Given the different political/social considerations prevailing in each market, regulators in different jurisdictions may react differently with regard to the write-down trigger given any local or global stress situation. The Proposal allows compensation to be paid to Capital Investors, following a write-down, in the form of common stock. However, pre-determined conversion terms such as the number of new shares to be issued in such events will invariably be unfair to certain stakeholders given the large varieties of market scenarios, which may invite different intervention by different regulators. Such uncertainties may cause pricing differential for Capital Instruments issued by banks operating in different jurisdictions. Pricing of Capital Instruments which serve the function of "supplemental capital" should be a function of banks' credit strength and should not be affected by the differing behaviour of regulators or the implementation requirements in different jurisdictions.

2.3.4 **Inconsistent pricing of Capital Instruments.** Following the write-down requirement, banks with weaker credit ratings which are perceived to be systemically unimportant could well issue Capital Instruments at better pricing vis-à-vis banks with stronger credit ratings which are perceived to be systematically important. Clearly, such a result is anomalous, and would create a disincentive for banks to grow beyond a certain size. The banking industry clearly exhibits considerable economies of scale, and such artificial restriction on size (through imposition of higher capital costs) is not beneficial to the economy as a whole.

2.3.5 **High cost of write-down requirement could result in limited role of Capital Instruments and minimal excess capital in banks.** The permanent write-down feature virtually alters the fundamental characteristics of most non-common tier-1 and tier-2 capital instruments as investors of these instruments would have limited fixed returns but

disproportionate downside (vis-à-vis the risk and return of common equity investors). Such abnormal feature is expected to increase the cost of Capital Instruments significantly, result in greater volatility in the market values of such instruments, and could ultimately deter banks from using these non-common capital instruments (with write-down feature) to diversify their sources of secondary capital, thus potentially limiting their role in banks' capital structure. Scarcer capital, resulting from such regulatory reforms, may then result in either the perverse outcome of banks seeking to operate with minimal excess capital levels and buffers, i.e. banks could be operating with largely common equity capital at minimal levels, or the outcome of massive needs for new common equity capital which will depress the values of bank's equities and aggravate the demand situation as investors stay away from instruments of uncertain payout and uncertain rules.

2.3.6 **Superfluous to write-down preference shares from a loss absorbency perspective**. Preference shares, issued directly by a bank, in the form of a non-step perpetual instrument with no contractual obligation to make fixed payment, currently forms part of the bank's share capital, and requiring a write-down feature for such instrument is superfluous, in our opinion, given its ability to support the bank as a going concern. Writing down preference shares does not improve solvency. Reiterating our very first concern, writing down on preference shares before ordinary shareholders' equity is wiped out would be inequitable to holders of such instruments, and risk pushing such instruments to extinction.

3 Recognition and Operational Aspects of Capital Instruments with Write-down Feature

3.1 If the write-down requirement for Capital Instruments is to be implemented, in spite of the above fundamental issues, we propose the following with regard to the recognition and operational aspects of such Capital Instruments:

3.1.1 **Loss absorbency requirement inconsistent with applicability of regulatory adjustments.** Post the transitional period, regulatory adjustments will only be applied at the level of common equity. With the proposed write-down requirement for non-common Capital Instruments, regulatory adjustments should be applied to such Capital Instruments as well, since regulators can trigger the write-down to avoid bank failure. Otherwise, the justification for Capital Instruments with write-down feature

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as set out in the Proposal will be extremely limited given their significantly higher costs.

3.1.2 **Equitability of write-down process.** For a more equitable approach and to be more consistent with the liquidation ranking of Capital Instruments, there should be a mechanism in place to ensure that the write-down would not exceed the amount of losses which investors could lose following a liquidation, and the write-down would take place only after the existing ordinary shareholders' equity had been wiped out. To ensure that the process is equitable to all classes of investors, Tier 1 instruments (starting with common equity) should first be written down to reflect the losses and all existing and converted equity wiped out ahead of any write-down on Tier 2 instruments, just as in a liquidation process. To ensure independence and fairness, an independent financial advisor should be appointed to determine the conversion process so as to ensure that investors holding the different classes of Capital Instruments are compensated in an equitable manner, based on the liquidation ranking of the Capital Instruments and vis-à-vis new public sector funds during the equity conversion process post write-down. In the event the situation or financials are too uncertain for any financial advisor to be able to determine the exact written down values, one alternative that can be considered would be for the holders of Capital Instruments to be given the rights to purchase from the relevant public sector body within a reasonable period of time, the common equity that is issued pursuant to a bail-out on a cost-plus basis if subsequent to the bail-out, the written-down amount was found by the financial adviser to be more then necessary.

3.1.3 **Allow full recognition of existing capital instruments without write-down feature**: Given that the existing capital instruments were raised before the implementation of the Proposal and that they do provide good protection for depositors in the event of liquidation, they should be grandfathered and receive full recognition, particularly to avoid exacerbating any stress (e.g. in the form of significantly higher costs) on the capital market or the banking sector from the far reaching proposed regulatory changes.

4 Concluding Remarks

4.1 We thank you for taking time to review our comments. We sincerely hope the Committee would re-consider its Proposal to require a write-down feature for Capital Instruments in view of the potential anomalous consequences.

4.2 The write-down requirement for Capital Instruments together with the Committee's earlier proposal to maintain a predominant amount of common equity after regulatory adjustments would simply leave banks with very limited alternative sources of cost efficient capital and escalate the capital and business costs for banks as a result of the regulatory reforms. The abovementioned requirements if added to the Committee's other requirements for higher minimum capital adequacy ratios, capital conservation buffer, countercyclical capital buffer, as well as proposals for IRB capital adjustments which would result in higher risk weighted assets and increased funding requirements, will not be positive to the banking sector which is important to the health of the economy. We are of the opinion that all the proposed changes in totality are excessive and would therefore urge the Committee to weigh carefully the costs to society, as a result of implementing all the measures.

4.3 For information on OCBC Bank, please visit www.ocbc.com or refer to the Bank's comments on the December 2009 consultative package on capital and liquidity reforms.

Yours faithfully

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