Santander

<u>Santander's Comments to the BCBS Consultative Document "Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability"</u>

SANTANDER welcomes the proposal from the Basel Committee on ensuring the loss absorbency of capital instruments. We fully support the aim of the proposal to avoid that taxpayer money is used to bail out any financial institution in the future, and make it credible that any institution, no matter its size/shape/organisation, can exit the market in an orderly fashion.

We agree that it is worthwhile to explore ways to reinforce the loss absorbency of capital instruments in order to reduce the moral hazard and restore market discipline.

We share the view on the paper that, although these solutions could reduce the need for a bail-out and reduce the cost for taxpayers, they would not be enough to completely rule out this possibility. Thus, further work is needed to develop international standards and set up effective coordination mechanism on early intervention tools and national resolution regimes. However we would like to stress that advances in these areas would only be possible once the harmonisation of prudential rules, supervisory practices and sanctioning regimes takes place. A lot of progress is being made on the former, but more much work is still needed on the latter two areas.

We also support the conclusion reached in the paper that the option of prohibit the inclusion of Tier 2 instruments in the regulatory capital of systemically important banks suffers from significant drawbacks and thus is not worthwhile to be pursued. We completely agree in that identifying these institutions is not an easy task and has associated moral hazard issues. The value of these instruments in reducing the losses of common creditors (i.e. depositors), and thus contagion in case of liquidation should not be disregarded. What is important is work in ensuring that any institution could be liquidated.

As there are other forthcoming proposals in the pipeline closely related with this one, namely contingent capital and 'bail-in', only once the interrelationships between them are clear will a more definitive evaluation will be possible. A coherent overall picture, including clarity on the subordination hierarchy, the relationship between the different visions of contingent capital and between them and 'bail-in', in the context of an overall view about the supervisory dimensions of recovery and resolution plans is essential. Contingent instruments should feature prominently in these plans, but clarification is necessary to understand how they would fit in the recovery or resolution phases of that planning.

As a general comment we think that an evolutionary rather than a revolutionary approach should be more sensible given the far reaching consequences and the lack of experience with the proposals that are being discussed.

A combination of higher capital ratios, as already envisaged in the Basel III accord, and stricter requirements for capital instruments in terms of loss absorption would have less distorting consequences for the bank funding market than suddenly imposing a change in the legal status of all funding instruments *vis-à-vis* other sectors.

Finally, it is necessary to take into account other loss absorbent elements already existent, as generic provisions. These provisions already play a loss absorption role with a trigger well

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before the point of non-viability. The dialogue should include the regulatory treatment of these provisions as the first class of contingent capital.

We think that if properly designed this proposal could contribute to achieved the intended goal but if poorly designed it could have unintended consequences for the cost of bank funding and thus jeopardise the supply of credit on a prudent basis. An excessive deleverage in the banking sector could incentive sector arbitrage just shifting the risk from the strongly regulated banking sector to non regulated or less regulated parts of the financial system.

Specific comments

1. To ensure the marketability of these instruments, valuation uncertainty must be avoided. For any scheme to work it is essential that there is legal certainty on all relevant aspects:

    i. It is crucial to include all relevant features for valuation of the new capital instruments in the contractual clauses (e.g. an objective trigger, the extent to which these instruments would be penalised once the trigger is activated, amount of losses the instrument would absorb, compensation, conversion rate, etc…).

    ii. Clarity on the fiscal and on the accounting treatment of these instruments is important for investors and issuers. Some examples of issues that need to be clarified are:

        1. Whether and to what extent the haircut should be accounted for against retained earnings and not through profit and loss account (P&L).

        2. The possibility that interest payments do not go through the P&L account but through changes in the balance sheet account

        3. The tax deductibility of dividends/interest payments/net losses from debt holders

        4. Whether issued convertible instruments should or not be subject to indirect taxes.

        5. Whether positive and negative returns (in case of conversion) could be considered taxable capital returns.

    ii. It is also important to clarify how these instruments would be affected by investor's protection rules (in particular, if compensation with equity is applied).

2. The trigger should be objective and linked to the breach of minimum regulatory ratios.

    i. The trigger should be as objective as possible and it should not be activated if the relevant supervisor assesses that the institution is not breaching the minimum prudential requirements.

    ii. The trigger should be activated if the supervisor considers that the losses the institution has to absorb will be such that the institution is going to breach the

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regulatory minimum core capital if the trigger is not activated. In this regard, it should be considered whether the activation of the trigger should be accompanied by a restructuring plan based on the Recovery and Resolution plan.

iii. Supervision of these instruments should be the responsibility of the local supervisor, but colleges must play an essential role to ensure global consistency on the exercise of these responsibilities.

3. <u>Prudential requirements should focus on the amount of common equity these instruments could provide at the trigger point; flexibility should be given regarding other features.</u>

i. What is important to restore the institution's viability is the increase in common equity these instruments would represent at the trigger point regardless of whether this common equity comes from a debt write-off or from a conversion of these instruments into common equity as these alternatives do not make a difference from the point of view of the institution's viability[1].

ii. Conversion must consider the face value of the debt instrument and market price of equity. Conversion could be established in a way that no transfer of wealth at all is produced at the trigger point (face value is completely compensated by an equivalent amount of shares at market price) or could be settled in a way that implies partial transfer (only a percentage of the face value is compensated by an equivalent amount of shares at market value).

iii. The treatment of these instruments at the subsidiary level could include in the contract an optional clause that would allow the issuer to choose whether to hand in equity from the subsidiary or from the parent entity. Once the trigger is activated in one of the subsidiaries, before the conversion, to allow a period to restore the viability of the institution through selling part of the assets, or through a parent capital injection.

iv. Flexibility should be given to the institution to choose whether to use debt write-off or conversion clauses, helping to reach a broader funding base.

4. These new instruments including such clauses should be considered Tier 1 as they would preserve the institution's ongoing viability. Recognition as Tier 1 should depend on the level of write-off/conversion at the trigger point.

5. Some recognition of Tier 2 instruments in the capital framework should also be envisaged. They have a value as gone concern capital reducing the impact of any potential failure on common creditors therefore limiting contagion via depositors panic. These instruments should be subordinated to common creditors in case a bail-in

[1] These alternatives do not make a difference from the point of view of the institution's viability but only from the point of view of wealth transfer between former shareholders and debt-holders. In the case of debt write-off there is a transfer of wealth from the debt holders to the former shareholders, which remain to be the institution owners. In the case of conversion (and depending on the conversion conditions) there could be no transfer of wealth. The greater the ex-post compensation the lower the interest rates of these instruments. Shareholders will internalise the cost either by paying higher interest rates or through the process of dilution.

mechanism was implemented respecting the level of subordination they would have had in liquidation.

<u>Comments on other forthcoming regulatory proposals closely related with the proposal on this consultation</u>

6. Regarding **other forthcoming regulatory proposals**, Santander believes that more reflection is needed on to how to make the whole framework coherent.

<u>Contingent capital</u>

7. For example, if contingent capital should include a trigger well before the point of non-viability, it would mean that, depending on the conversion terms, this instrument could absorb losses at a point where common equity could still absorb losses without breaching the regulatory minima.

8. A natural trigger for contingent capital could be the conservation capital buffer. These instruments would therefore protect the institution's freedom on the dividend policies preserving the appeal of the institution's common shares to investors. This would depend on the exact clauses. If conversion is settled so as to fully compensate with shares at market price the face value of the debt, then shareholders would absorb the losses through the dilution of capital, while if no conversion at all is envisaged and just a write-off takes place, then shareholders will benefit the most.

9. In both cases, given that these instruments preserve the level of common shares well above the regulatory minimum, they should be considered Tier 1.

10. The mandatory issuance of this type of instruments would entail difficulties as demand for these products will be limited thus disproportionately increasing funding costs.

<u>Debt bail-in</u>

11. Regarding bail-in' mechanism they should only be a part of a broader set of tools which would include special resolution regimes and recovery and resolution plans.

12. It is necessary to preserve the level of subordination. Possibility should be given to the institution to issue instruments with clauses that define the level of subordination in case of "bail in" and this order should be respected when a bail is decided.

13. Bail in should only be activated if the supervisor considers that the losses the institution has to absorb will be such that the institution is going to breach the regulatory minimum core capital and after all the capital instruments have been converted into common equity or written off.

14. It would be very difficult to define by law which type of instruments could be subject to bail in. It is more advisable to let the institutions choose the issuance of these instruments including the relevant features in contractual clauses and that the supervisor establishes the minimum level of Tier 1 taken into account the institution issuance of these instruments.

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15. Private solutions, such as restructuring debt agreements with the bond holders, should be explored before any mandatory debt restructuring is required by the supervisor. We acknowledge that in general these types of agreements take more time than is usually available in a bank crisis. However, we think that further work is needed in order to explore how to facilitate these types of agreements through contingency plans where debtors' representatives could decide expeditiously. Of course, reliable and complete information must be available to all the interested parties in a timely manner.

Conclusion

In conclusion, we support the goal to restore market discipline and reduce moral hazard by withdrawing any implicit state guarantee enjoyed by the holders of capital instruments. Thus, we accept the increase in the funding cost derived from this withdrawal as something good for the stability of the financial system. However, for market discipline to work properly it is essential that the market is able to price these instruments correctly, for which transparency and objectivity are crucial features of these instruments. Instrumental to achieve this is consistency between these proposal and the forthcoming ones on contingent capital and bail in. It is also important to let institutions flexibility regarding the issuance of these instruments given its novelty and the need to ensure a broader base of investors.

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