Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability

The Basel Committee has requested feedback from investors in bank capital instruments on its Consultative Document "Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability". Schroders Investment Management is a global asset manager with £164bn of assets under management. This includes fixed income AUM of £29bn, including subordinated bank paper.

We agree with the Basel Committee that "a public sector injection of capital needed to avoid the failure of a bank should not protect investors in regulatory capital instruments from absorbing the loss that they would have incurred had the public sector not chosen to rescue the bank". As noted in the Consultative Document, a contractual requirement that regulatory capital should absorb losses in similar circumstances would remove a source of distortion from the market, and enhance the effectiveness of market price signals for these instruments.

In our view, the most significant aspect of the proposal is the definition of the trigger event as "the earlier of 1) the decision to make a public sector injection of capital without which the firm would have become non-viable, as determined by the relevant authority and 2) a decision that the write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority." This changes the going concern threshold from a breach of minimum BIS capital levels to a determination of non-viability by the relevant authorities. We recognise that the broader definition more accurately reflects the reality of a bank failure where a breach of minimum capital ratios may only be determined long after the point of non-viability. However, we believe objective criteria by which a regulator may determine non-viability need to be established to avoid regulators being granted too much discretionary power to declare non-viability.

We believe these objective criteria need to be developed in conjunction with efforts to develop improved bank resolution regimes. We are supportive of the "bail in" concept outlined in the recent AFME paper entitled "The Systemic Safety Net", and note that the Basel Committee agrees that an international bank resolution framework is desirable. We believe, however, that this proposal also requires clarification of how regulators would determine the non-viability of a bank, and we believe the trigger events for the operation of a "bail in" resolution regime and regulatory capital to absorb losses should be the same.

This would also resolve our main concern about the mechanism for loss absorption outlined in the Consultative Document. The two mechanisms suggested are that regulatory capital instruments should simply be written down and that the instruments be exchanged for common stock. The first option is undesirable from a bondholder perspective as it creates a loss for them without penalising common equity holders. The second option may not be practical from an equity holder perspective due to the requirement to have sufficient authorised but unissued shares outstanding. The bail in resolution regime maintains the relative subordination of the capital structure by ensuring that existing shareholders absorb the first layer of losses and ensuring that bondholders are not a source of non-dilutive equity. In the absence of this framework, we would want to ensure as bondholders that equity holders were not beneficiaries of write-downs of regulatory capital instruments, which would require either that the second option (conversion to equity) were made practical, or that the loss absorption mechanism also included penalties for existing equity holders.

We do not believe that the proposal would affect our ability to hold these instruments, providing the trigger event criteria are clearly outlined. This is in contrast to going concern capital instruments that convert to equity before a point of non-viability is reached, which we do not consider to be appropriate for bond funds (but which may have a place in equity income funds, for example). In terms of pricing, we do not see this proposal as having an impact on T1 pricing (although other proposals including going concern writedown of principal, and the lack of incentive to call features could separately have an impact on both pricing and our ability and willingness to hold the instruments). We see the impact on T2 pricing as being limited to a change in the loss given default assumption for the instruments.

We believe that recent new issue activity demonstrates that the market is differentiating significantly between banks based on perceptions of their viability as standalone entities. The ability to issue subordinated debt, or even longer dated senior paper is limited to certain banks, and there is a wide variation of new issue spreads within the sector. We believe that to some degree this differentiation reflects market anticipation of the development of new regulatory regimes, and the low likelihood of further taxpayer funded bailouts of holders of non-common regulatory capital instruments, so we believe that as long as proposals continue to be developed along current paths, the risk of disruption is limited.

Schroders PLC
3rd September, 2010