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September 10, 2010

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

BY EMAIL: baselcommittee@bis.org

Members of the Committee:

On behalf of Sandler O'Neill + Partners, L.P., I am commenting on the Committee's Consultative Document *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability*, issued for comment by October 1, 2010.

Sandler O'Neill is a full-service investment banking firm focused on the U.S. financial services sector, particularly insured depository institutions. Our clients include a wide variety of financial firms, among them almost a thousand banks and thrifts and their holding companies, including hundreds of community and regional depository institutions.[1] As a firm of financial professionals who work closely with many banking firms, Sandler O'Neill frequently comments on supervisory and other issues important to our clients.

Background

Given the unprecedented losses associated with the bank failures during the crisis of 2007 – 2010 and the remaining challenges facing the banking industry both in the United States and globally, the Committee's goal of guaranteeing the gone-concern absorbency of all non-common Tier 1 and Tier 2 regulatory capital instruments for systemically important banks is understandable. Clearly, systemically important and other regional and smaller banks in the U.S. benefited from the investment in these banks of public capital such as TARP, which enhanced the value of subordinated debt and other forms of Tier 1 and Tier 2 capital while exposing the government to the risk of loss.

To put the importance of government capital investments into proper context, we examined the total amount of private sector subordinated debt, trust preferred securities, and non-cumulative perpetual preferred stock issued by U.S. banks in the fourteen years from the time of approval of trust preferred securities as a form of Tier 1 capital in 1996 to today. The total amount of such

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capital issued approximates $496 billion, consisting of $210 billion of trust preferred securities, $129 billion of subordinated debt, and roughly $157 billion of non-cumulative perpetual preferred. In the two years since late 2008, over $240 billion of TARP has been issued, or roughly 50% of the total private sector issuance in the prior fourteen years.

To the extent that private sector investors view the government injection of capital as providing worst-case loss protection, there is a disconnect with the market discipline that would otherwise be imposed and the government is exposed to substantially more losses. The scale of the total government investment relative to the total private sector investment highlights the need for a framework to avoid this type of overdependence of government supplied capital in the future.

The Committee believes that non-systemically important banks are already providing loss absorbing capital because such banks are allowed to fail, thereby triggering the subordination clause in liquidation and protecting depositors and senior creditors. However, the Committee fears the explicit identification of systemically important versus non-systemically important banks creates a risk of moral hazard. For this reason, the Committee proposes that the gone-concern capital loss absorbency explicitly apply to all banks.

The Mechanics

The Committee proposes that all non-common Tier 1 and Tier 2 capital at systemically important banks (also referred to as internationally active banks) be gone-concern capital upon a triggering event. The triggering event would be the earlier of a public (government) capital injection or the decision that a write-off of the capital is necessary to prevent the bank from becoming non-viable as determined by the relevant regulatory authority in the jurisdiction where the capital treatment is requested. Issuance of new shares caused by the trigger event must be prior to the public capital injection and the bank must maintain approvals to issue common shares to the holders of non-common Tier 1 and Tier 2 capital upon a triggering event.

The Practical Reality

While the Committee's goal of ensuring that all non-common Tier 1 and Tier 2 capital elements become gone-concern capital is understandable, the implementation of the proposal raises significant practical concerns that must be addressed before adoption.

First, since non-systemically important banks are already being viewed by the Committee as providing gone-concern capital in liquidation, the formal imposition on all banks of the conversion and triggering mechanics proposed by the Committee is unneeded and harmful to non-systemically important banks because it will likely force a change in the investor base for subordinated debt and other forms of non-common regulatory capital. Our experience as one of the leading underwriters and placement agents for bank capital of mid-size banks indicates that

most debt investors are not interested in or permitted to own bank equity or face severe limits on how much they may own without becoming a bank holding company.

Thus, if non-common capital instruments are explicitly required to contain equity conversion provisions, such bank debt investors would likely withdraw from investing, thereby widening the spreads and increasing the cost at which such debt could be issued by non-systemically important banks. It is not clear whether the Committee intends for this proposal to be applied retroactively, assuming such was possible. However, if it were to be applied retroactively to outstanding non-common capital instruments, forced selling by current holders would likely put significant downward pressure on the prices of bank debt instruments.

Second, the triggering event must be unambiguous. The Committee's proposal implies that the conversion or write-off would be triggered by the relevant regulator's judgment. Absent a clear and objective measure of a triggering event, investors may assume the worst and be reluctant to invest in instruments that may be converted into common. Because the triggering event is within the sole discretion of the relevant authority in the jurisdiction wishing to receive capital credit for the instrument, such discretion could give rise to less than transparent decision-making by a local jurisdiction that may not care about the implications on the broader market of triggering a conversion/write-off.

While the Committee wants to avoid a specific triggering event ratio, there is precedent with other capital instruments for such as ratio. For example, REIT preferred stock is exchangeable into bank preferred stock upon the bank falling below adequately capitalized status. This explicit triggering mechanism has the benefit of providing transparency to bank, investor, and regulators as to the circumstances under which the REIT preferred would be exchanged. But it also has a downside and this has severely limited the market for investors in REIT preferred stock to investors who can, in the worst case, own the bank preferred stock and accept the associated ownership limitations. It is likely that a similar triggering event for subordinated debt and other non-common capital elements could have a similarly deleterious effect on the market for non-common capital.

Third, the Committee states that it does not believe that a conversion or write-off of gone-concern capital would trigger a default of all the bank's other obligations. The Committee's logic is that with the conversion/write-off of the debt, it would no longer be due and therefore not outstanding. This interpretation is counter to how most contracts are currently written and is therefore impractical. Typically, a default on one debt instrument triggers a cross-default on substantially all of a financial institution's other credit instruments. This could cause a major dislocation in the swaps or derivatives market if a significant counterparty were forced to convert or write off its hybrid capital, thereby triggering a cross-default on its other credit agreements. Credit providers would be highly unlikely to be willing to modify their existing agreements to exclude conversion/write-off as an event of default.

Summary and Recommendations

The large-scale use of government supplied capital in the current financial crisis has appropriately raised the issue of how to ensure that non-common capital investors take the first loss upon a triggering event. We support the effort to fashion a uniform solution, but have identified a number of practical concerns and offered three specific recommendations:

1. *Limit the requirement of the conversion/write-off provision to systemically important banks using defined criteria such as asset size or deposit market share.* The Committee acknowledges that non-common Tier 1 and Tier 2 capital issued by non-systemically important banks effectively functions as loss absorbing capital. Systemically important banks are easily identified and well known. If such banks are designated as systemically important during times of financial stability, there would be limited moral hazard risk. All constituencies would understand that the non-common capital instruments would convert into common upon a triggering event and impose pricing and market discipline accordingly. This would no doubt limit the buyers of non-common Tier 1 and Tier 2 capital and increase the cost of capital for such systemically important banks. However, it would be counterproductive to disrupt the market and raise the cost of capital issued by non-systemically important banks by imposing a conversion requirement that will likely exclude many investors when non-common capital issued by such banks already functions as loss absorbing capital.

2. *Include an objective triggering event to provide transparency for conversion/write-off, thereby enabling investors to impose market discipline as the bank moved closer to such a triggering event.* By specifying an objective triggering event, the Committee would provide certainty to bank management as well as investors, who would have a transparent metric they can use to evaluate and price risk. This will be particularly important for internationally active banks operating across multiple jurisdictions with varying levels of experience and expertise.

3. *Establish an industry task force to examine the ramifications of the proposed elimination of an event of default upon a triggering event.* It is highly unlikely that current creditors would agree to modify their existing credit agreements to exclude the triggering event as an event of default. There may be a possibility of reaching industry consensus on transition rules for cross-default language with the major swap counterparties and the International Swaps and Derivatives Association, Inc., which could then be incorporated more broadly into credit agreements.

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We believe that with these changes the Committee's goal of ensuring the gone-concern capital absorbency of non-common Tier 1 and Tier 2 regulatory capital instruments can be largely accomplished with greater transparency and less disruption to the capital markets. Minimizing such disruption is particularly important for non-systemically important banks, which already have limited access to the capital markets.

Sincerely yours,

Thomas W. Killian
Principal

cc: The Honorable Timothy F. Geithner
Secretary of the Treasury
U.S. Department of the Treasury

The Honorable Ben S. Bernanke, Chairman
Board of Governors of the Federal Reserve System

The Honorable Sheila C. Bair, Chairman
Federal Deposit Insurance Corporation

The Honorable John G. Walsh, Acting Comptroller
Office of the Comptroller of the Currency

The Honorable John E. Bowman, Acting Director
Office of Thrift Supervision