SPECTRUM
Asset Management

To:
The Basel Committee on Banking Supervision
From:
Spectrum Asset Management, Inc.

Comments on

Consultative Document:

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

Issued for comment by 1 October 2010

The consultative document named above outlines proposals to set the entry criteria of regulatory capital to ensure that all regulatory capital instruments issued by banks are sufficient to absorb losses in the event that a bank becomes a gone-concern. We begin with excerpts from the document (in *italics*) to help frame the Committee's views for all readers, then follow with our comments as they relate more specifically to capital regulation in the United States :

- *If gone-concern is defined as insolvency and liquidation, then all regulatory capital instruments are loss absorbent on a gone-concern basis. This loss absorbency is achieved through the subordination of the capital instruments, which means that they will only receive any repayment in liquidation if all depositors and senior creditors are first repaid in full.*
- *However, if we define gone-concern also to include situations in which the public sector provides support to distressed banks that would otherwise have failed, the financial crisis has revealed that many regulatory capital instruments do not always absorb losses in gone-concern situations.*
- *The Basel Committee is of the view that all regulatory capital instruments must be capable of absorbing a loss at least in gone-concern situations. Furthermore, it believes 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.*
- *The development of the proposal in this paper is driven by a desire to guarantee the gone-concern loss absorbency of all regulatory capital instruments (including cases when there is public sector support).*

- *The proposal does not offer any views on when and how public sector support should be provided, or the legal authority for providing such support. Instead it simply sets out a series of consequences that will ensure that losses can be allocated to regulatory capital if such support is provided.*

In order for instruments to be treated as regulatory capital, the Committee considers it a precondition that such instruments are capable of bearing a loss. ***Three options exist to ensure this outcome:***

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.*

2. *Try to identify systemically important banks and prohibit them from including Tier 2 instruments in their regulatory capital.*

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.*

Option 2 was deemed to have significant drawbacks by the Committee and as such, it believes that <u>there are advantages to pursuing Option 3</u>, with wider efforts to continue movement to achieve Option 1, the most desired outcome.

Mechanism requirements:

1. *All non-common Tier 1 instruments and Tier 2 instruments at internationally active banks must have a clause in their terms and conditions that require them to be written-off on the occurrence of the trigger event.*

2. *Any compensation paid to the instrument holders as a result of the write-off must be paid immediately in the form of common stock (or its equivalent in the case of non-joint stock companies).*

Trigger Events:

- *The trigger event is the earlier of: (1) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority; and (2) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority.*

Task:

- *Industry practitioners are asked to work with national authorities to determine how the terms and conditions of capital instruments could be drafted to fully comply with the proposal set out in this consultative document whilst respecting all relevant national constraints. The Committee is keen to assess whether there are operational or legal*

obstacles to implementation of the proposal. The Basel Committee would particularly welcome feedback from market participants, including the investors in bank capital instruments, on the potential effects of the proposal described above.

I. Spectrum Comments to the Committee:

- The Basel Committee issued a press release in 1998, discussing 'innovative capital instruments' to be included in Tier 1 capital. The entry criteria then included:
    1) permanence,
    2) payment deferral allowance
    3) non-cumulative payments, and
    4) loss absorption on a going-concern basis.
- The Committee's current entry criteria has a critical focus on the "gone-concern" which is an approach that is conventionally rational in liquidation, though problematic when the definition of gone-concern includes a write-off or public sector (or equivalent) support necessary to maintain viability.
- The paradox of a bailout is that the outcome means just what it says – "bailout".
- We agree with the Committee's broad objective to remove the bailout expectation in regulatory capital and replace it with more bail-under risk.
- Spectrum commends the Committee's sense of moral duty to solve a source of moral hazard, but we are fearful that its design only medicates the symptoms of the financial crisis rather than helping to inoculate the banking system.
- While the scope of this proposal is on the gone-concern elements of regulatory capital, we encourage the Committee to be mindful of the systemic issues that caused many institutions to become collectively non-viable. Three residual risk areas which still require mitigation are Fannie Mae, Freddie Mac and unfettered naked purchase of credit default swaps -- without effective reform, lasting financial stability will be improbable.
- We recommend that the mechanism requirement for a write-off clause should be drafted to provide scope to the definition of "write-off" which should include the issuer's best efforts to execute liability management exercises under the purview of regulatory authorities. These exercises should not be pre-determined, but left to the judgment of management, regulators and market opinion at such a time which is reasonably contemporaneous with the trigger event.
- We recommend that the compensation requirement of common stock be broadened to include cash, qualified non-common Tier 1 and Tier 2 capital to allow flexibility while not precluding an all common stock decision by the authorities. We have seen all three sleeves effectively used as liability management compensation during the recent crisis.
- We recommend that the trigger event to be exclusively (2) *a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority* because it implies stipulated regulatory clarity.

- We believe that passive compliance to a public rescue in trigger (1) could incentivize another run on capital and consequently fan fears of another credit freeze. Further, the concept of "equivalent support" is vague and could also lead to a run on capital.
  - ✓ If the FDIC-backed bonds were "equivalent support", then the good liquidity intentions that they provided could have been spoiled by the trigger event in the capital clause, thus exacerbating the bear raids on capital that were so pervasive at the time.
- The behavioral benefits of the deterrent mechanisms ingrained in investor psychology weigh against risk. The proposal concentrates exclusively on the event that a bank is unable to support itself in the private market. Spectrum would like the Committee to consider the merits of a more dynamic bank capital structure that increases the probability of the going-concern so that the gone-concern is more unlikely to happen.
- We recommend that these deterrents be deployed more strategically and actively among the regulatory capital stack.

II. Current Positioning of US Regulation v. Basel Capital Framework:

The United States is well down the road to having a framework in place that can meet the objectives of this proposal to enhance the entry criteria of regulatory capital. Importantly, the proposal allows each international jurisdiction the leeway to fulfill its mission in accordance with its own rules. *The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act")* clearly defines the rules. The intentions of the Act are "*to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes*".

The provisions of the Act that apply to the principles of this proposal are mainly:

1. A resolution framework is in place per *Title II – Orderly Liquidation Authority*
2. The trigger event (1) the decision to make a public sector injection <u>is not available</u> because *Sec. 214. Prohibition on Taxpayer Funding* requires liquidation through the resolution framework without any use of taxpayer funds.
3. The trigger event (2) a decision that a write-off is necessary as determined by the relevant authority is covered in *Sec. 203. (c)(4)(B) Default or in Danger of Default* where the company has incurred or is likely to incur losses that will deplete all or substantially all of its capital.

The implications are:

- The definition of "gone-concern" cannot be broadened to *include situations in which the public sector provides support to distressed banks that would otherwise have failed* because there is a prohibition on taxpayer funding – instead, the bank goes into receivership per Title II.
- The definition of gone-concern in the US is insolvency and liquidation.
- The Act indirectly satisfies the desire to have a contractual write-off clause in all Tier-1 and Tier-2 instruments because the trigger events are either not applicable or covered in Title II. Consequently, there would be no need to have such a clause as it would be redundant to (or superseded by) the losses discovered through the resolution framework of the Act.
- Criteria for inclusion in Tier 2 (gone concern capital) as delineated in *Consultative Document, Strengthening the resilience of the banking sector, December 2009* provides substantive rulemaking guidance to US authorities.
- Lower Tier 2 capital can play a significant role in US bank regulatory capital minimums (perhaps more so than suggested by Basel III) because Tier 2 is fully loss absorbent and available to support depositors within the resolution framework.
- Criteria for inclusion in Tier 1 Additional Going Concern Capital as delineated in *Consultative Document, Strengthening the resilience of the banking sector, December 2009* provides substantive rulemaking guidance to US authorities.
- Non-common Tier 1 capital can play a strong supplemental role in US bank regulatory capital minimums (perhaps more so than suggested by Basel III) because hard capital triggers can be used to under more of a hazard insurance dynamic to instill a market based discipline to offsetting risk.

III. Supplementary Thoughts on What Bank Capital Should Do:

- Foster stability to the aggregate financial system with characteristics that are useful to every bank that is a member of the system.
- Foster cost flexibility to management through multiple choices.
- Be reasonably straightforward and standardized.
- Offer strong going-concern features that build capital and preserve cash.
- Offer gone-concern priority sufficient to make depositors whole, at a minimum.
- Be self-regulating with objectively supportive features (e.g. "triggered safety").
- Attract deep & diversified buyer bases with balanced motivations.
- Further balance risk motivations with deterrent cost mechanisms.
- In aggregate, behave like a packaged hazard insurance plan to assure that catastrophe does not happen – bank capital should be an "Anti-Title II Plan".

A "capital-complex" is stabilizing, but "complex capital" is not.

IV. Suggested Bank Capital Tools ~ A Dynamic U.S. Approach:

Spectrum recommends that the Committee review the four capital instruments discussed below within the constructs of its minimum capital standards. We believe that these four products (among others) have merit in the US bank capital complex and could also have merit in certain international jurisdictions, though our discussion here is primarily based on the US jurisdiction. Our intent is to use triggers that foster motivational deterrents that are transparent and serve to support the capital stack in a complementary way from the bottom up. We believe that these structures can manage the buffer channels and offer aggregate cost savings to banking institutions. Ultimately, our recommendations are intended build stronger and more complimentary capital constructs to preserve stability and foster economic growth.

A. Junior Subordinated Debt as Upper Tier-2 Capital:

- Triggered interest deferral if common equity declines under 4.5%.
- 10 yr. term (institutional); 10yr. term, non-call 5yr. (NYSE ~ retail); matches off with the depth and term of existing 10yr. subordinated debt.
- Interest deferral up to 5 yrs. (no acceleration) with automatic maturity extension of 5 yrs. upon an interest deferral with a discreet call option at the time of original maturity.

Junior subordinated debt as Upper Tier-2 (UT2) opens a new capital class for banks that is already globally developed through the trust preferred market. The interest deferral feature would be of marginal cost (e.g. 25-50bps) and act as a hard dividend stopper on junior capital payments. It would buffer liquidity risk (e.g., forestall a replay of FDIC backed bonds) and be a liquid monitor of the quality risks to Tier-1 capital (e.g., the spread differential between LT2 subordinated debt and UT2 junior subordinated debt would give live signals about the market's views on the quality of a bank's Tier-1 capital). Overall, a deep sleeve of US bank UT2 with this these features can foster liquid market based signals about the health risks to and effectiveness of the going-concern elements of a bank's Tier-1 capital.

B. Preferred Stock as a Conservation Buffer

- Perpetual, non-cumulative.
- Callable only with replacement capital (covenant to UT2 sleeve).
- Discretionary payments
- Pays dividends in cash when common equity ratio is greater than 5.5%
- Pays dividend in common stock when common equity is less than 5.5%

Buffer preferred stock would help to serve as an advanced warning track and buffer for the junior subordinated debt and fit comfortably in the non-common Tier-1 sleeve. By setting the dividend at 1% over the 4.5% minimum common equity capital requirement, it allows a bank to marginally reduce its common equity cost within the conservation buffer zone while allowing the dividend

switch trigger to service the buffer requirement with more common equity. There would be no tax implication to the dividend being paid in common stock because preferred stock is classified as equity.

C. Tax-efficient Contingent Capital as a Countercyclical Buffer

- Non-callable 30yr. cumulative subordinated debt.
- Cash interest payments would switch to payments made in common stock only when the total Tier-1 ratio falls below 7.5%.
- Becomes callable at par after 2 payments have been made in common stock and returns to non-callable if cash payments are restored.
- Replacement capital must be in Tier-1 and satisfy the aggregate conservation buffer of 2.5%.

Buffer subordinated debt with these features would allow banks to manage the countercyclical buffer with some tax-efficiency because the product is debt. We assume that the minimum Tier-1 ratio is 6% and the conservation buffer is 2.5% making the minimum Tier-1 total 8.5% after the conservation buffer. By setting the interest payment cash-to-common switch-trigger to 1% below the minimum total Tier-1 requirement of 8.5% (or 1.5% more than the 6% minimum Tier-1 before the conservation buffer) the capital serves to replenish the conservation buffer when it declines by more than 1% – it also allows some trigger cushion to the subordinated debt holder and even more if total Tier-1 is higher. We believe that the instrument would lose its tax-efficiency once it pays in common stock which would motivate the issuer to maintain adequate Tier-1 capital. As an interest payment in common stock would trigger a call option trigger, the bank would have flexibility to replace the instrument with 1) a potentially cheaper Tier-1 alternative if the tax penalty on the coupon is uneconomic or 2) supplemental Tier-1 issuance sufficient to re-switch the payments back to cash (turning back on economic tax efficiency). The 30yr. term fosters a duty of permanence to the countercyclical buffer and its protective service to the aggregate conservation buffer. The issue has creditor remedies.

D. REIT Preferred Stock as Non-common Tier-1

- Perpetual, non-cumulative
- Discretionary payments
- Income stream from the mortgages is paid out to the REIT without tax implication to the supported bank.

This product is currently being used today. It has tax efficient elements to the issuer. Nonetheless, it is tax flow positive to the government tax base because the dividends on the REIT preferred are fully taxable to the holders.

We see this product as being an increasingly useful Tier-1 capital source to the US banking system. Moreover, it can provide further usefulness if our banking system is to retain the risk of residential mortgages rather than transfer it to the existing government sponsored "system". We see a large role in this product for the private banking system to help capitalize the wind down of Fannie Mae and Freddie Mac.

Conclusion:

Spectrum believes that there are innovative opportunities in bank capital given the thoughtful improvements in bank capital standards that the Committee has underway and the improvements legislated under the Dodd-Frank Act. We also believe that properly structured and transparent capital triggers in bank capital can support the integrity of the financial system as a whole. Gone-concern capital with going-concern support properly ordered into the capital stack can supportive bank safety from the bottom up. We are happy to discuss this more as our aim to help the Committee foster safety & soundness in a way that attracts broad private investment and economic growth.

Cordially & Sincerely,

Phil Jacoby

Chief Investment Officer

Spectrum Asset Management, Inc

October 1, 2010.

Spectrum Asset Management

Comments
on

Bank for International Settlements

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

October 1, 2010

Overview

Spectrum Asset Management appreciates this opportunity to provide market-sensitive input to the Committee's proposals on this important banking topic.

Comments to the Committee

1. Spectrum agrees with the Committee's broad objective "to enhance the entry criteria of regulatory capital 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." Investors losing money on their investments in failed institutions is a basic idea with which no one disagrees. Losses are imposed via a standard bankruptcy-type work-out, under clear processes and procedures. This wind-up system happens every day and works well.

   In designing loss-absorption characteristics for regulatory capital instruments, the Committee should ensure that common stock holders (or equivalent for non joint-stock companies) do not become effectively senior to holders of senior regulatory capital instruments. This would not only be unfair, but it would also directly oppose common juridical practice regarding the priority of claims and sanctity of contracts. This might not even be enforceable in many jurisdictions, and certainly would be resisted by the securities market, thereby impairing banks' access to all forms of capital.

   Should a bank receive a publicly assisted bailout, and this requires a write-down of non-common Tier 1 instruments (as proposed by the Committee), all existing common

shareholders would need to be written down as well – and at least as severely as more senior layers in the capital stack -- due to their position as the most junior investors.

2. Under *Option 1* in the BIS consultative document, it states that regulators should "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."

   Spectrum agrees, and further believes loss allocation should be at the discretion of the relevant sovereign government, the local regulator, and/or central bank to decide whether non-common Tier 1 capital is: a) written down to a partial or total degree, b) written down permanently or with the potential for "writing back up" should the bank's condition sufficiently improve, or c) convert into common equity or some other regulatory capital instrument. Again, any such write-down must recognize the relative seniority of different capital instruments.

3. Under *Option 3* in the BIS consultative document, it states that in order for instruments to be treated as regulatory capital, such instruments must be capable of bearing a loss, and should "include a mechanism in their terms and conditions that ensures they will take a loss at the point of non-viability" of the bank. Such non-viability would be deemed to include a bank's receipt of public sector assistance to prevent its collapse, with the idea generally being that such assistance would achieve the policy goal of helping return the bank to stand-alone health. Furthermore, if a bank's senior regulatory capital securities (such as preferred stock) are structured as proposed under the emerging BIS-led bank capital regime, these senior regulatory capital securities could suffer a significant – perhaps 100% -- write-down, thus satisfying the Committee's desire for such security holders to incur losses. In addition, any write-down could be permanent. However, because the bank remains open and has not passed through a bankruptcy-type purging of all contingent claims (such as those that are inherent in common stock), these contingent claims of common stock holders remain alive. Should the bank return to health as hoped, these common stock claims would have economic value – perhaps substantial economic value -- whereas investors in more senior regulatory capital securities could get nothing. Even if the write-down of the senior regulatory capital securities is less than 100%, any write down, especially if permanent, could still result in a larger economic loss for senior regulatory capital securities holders than that incurred by common stock holders.

   The Committee should ensure that such a harmful, upside-down loss scenario cannot occur. This scenario could not only face legal challenges in various jurisdictions, but also impair banks' capacity to access non-common stock forms of capital. Such forms of capital have long played key roles in banks' capitalization, and the Committee's present capital proposals specifically recognize their ongoing utility. This scenario's ill effects would be exacerbated by a permanent write-down of senior regulatory capital securities.

   Spectrum recommends that the Committee ensure that forms of regulatory capital that are *de jure* senior to common stock are *de facto* just that – Senior, and in all stress scenarios. Thus, the present value of any losses imposed on senior-level regulatory capital investors *must* be less acute than those imposed on common stock investors.

4. It seems clear that formal "write-downs" of regulatory capital securities bear all manner of formidable technical and fairness problems. How do you permanently write down common stock, without a formal bankruptcy-type winding up? How do you "box" such losses? How do you ensure that the present value of losses imposed on diverse seniorities of capital instruments are respectful of those seniorities? Would some sort of a "non-bankruptcy bankruptcy" regime need to be created so that the perpetual, contingent claims inherent in common stock ownership are purged, without the collateral costs and issues embodied in a formal insolvency proceeding? These issues are complex and fraught with challenges.

   Write-downs effectively put a cap on senior-level regulatory capital securities values, whereas no such cap exists for common stock investors. Such write-downs even help common stock investors. However, market-based tools do exist that can address the goal of loss incurrence for senior-level regulatory capital securities investors. Liability management exercises (such as tenders at less than par for non-common stock regulatory capital instruments, perhaps payable in common stock) are tested, effective solutions. Many such liability management exercises have occurred during the present Financial Crisis, with much success in improving banks' financial health.

   Spectrum recommends the Committee consider including a bank's best efforts to execute liability management exercises, under the direction of regulatory authorities, as an accepted form of 'loss absorption". Such exercises would fulfill the goal of senior regulatory capital instrument impairment in times of distress. These liability management exercises should not be pre-determined, but left to the judgment of management, market opinion and ultimately regulators at such a time which is reasonably contemporaneous with the trigger event.

5. Forced conversion of senior regulatory capital securities into common stock (via so-called "Contingent Convertible" securities) is another method to impose losses on such securities. However, the fundamental fairness constraint of ensuring that any senior regulatory capital securities losses are less than those losses incurred by common stock holders needs to be kept in the forefront. A properly set conversion ratio would accomplish this. This ratio would need to be set at a level that would ensure substantial dilution for common stock holders, while also imposing some losses on senior regulatory capital securities holders. Where to stick the pin? In the absence of a 'live' exercise, the honest (albeit unsatisfactory) answer is "No one knows." However, if we assume a $100 par senior regulatory capital security that converts into $90 worth of common stock at the point of conversion, there would be both a loss on the part of the senior regulatory capital security investor, as well as substantial dilution for the common stock holder. True, the bank could revive, and senior regulatory capital security investors (now, common stock investors) who held on could end up with an economic gain, but that outcome is inherent in the core optionality of common shares. All one can do is attempt to attenuate that optionality via conversion ratios.

   Spectrum recommends that "Contingent Convertible" securities be considered, along with liability management exercises, as the core means for senior regulatory capital security investors to meet the Committee's goal of loss incurrence, assuming public sector support is provided to prop up an otherwise insolvent bank.

6. The Committee has addressed concerns of public sector assistance in its September 12, 2010 release on higher minimum capital standards for banks. The announcement recommends the grandfathering of existing public sector capital infusions until January 1, 2018.

   Spectrum agrees with the proposed 2018 grandfathering period and would point out how it complements the recently legislated Dodd-Frank bill in the US. One of the central tenets in the US legislation is to not allow the bailout of US banks with public (government/taxpayer) funding. Spectrum believes all banks should follow this principle, and allow for the natural process of liquidation to take place, thus assuring that all regulatory capital functions in a "going concern" manner and can be supportive in a "gone concern" manner.

Conclusion

Spectrum agrees with the Committee that a key role of bank capital is to absorb losses. However, it is important to remember that efficient and fair capital markets require that the relative seniority of such instruments is honored. Spectrum believes that its suggestions reviewed *supra* will go far in meeting these goals we all share.

We are available to discuss these matters in more depth with the Committee.

Cordially,

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Managing Director

John J. Kriz
Senior Vice President

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