The Clearing House

October 1, 2010

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

Re: Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non-Viability

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("The Clearing House"), an association of major commercial banks,[1] is pleased to comment on the Basel Committee on Banking Supervision's (the "Committee") August 2010 consultative document, *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability* (the "Proposal"). The Proposal outlines a proposed requirement that all non-common Tier 1 and Tier 2 regulatory capital instruments have contractual write-off (or a forced conversion into common stock)[2] clauses that may be triggered by certain actions or decisions made by national authorities. We agree that regulatory capital holders—and not taxpayers—should occupy a first-loss position in a public-sector bailout scenario. Accordingly, we commend the Committee for its efforts toward devising a way to accomplish this objective. However, we have a number of concerns with the Proposal as a means of ensuring that all regulatory capital instruments be capable of absorbing losses on a gone-concern basis, briefly summarized below under "Executive Summary" and addressed in more detail under "Detailed Comments." The Clearing House would be pleased to work with the Committee to craft a solution that achieves the desired result.

[1] Established in 1853, The Clearing House is the United States' oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Clearing House Association is a nonpartisan advocacy organization representing through regulatory comment letters, amicus briefs, and white papers the interests of its member banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org

[2] References herein to a "write-off" of a regulatory capital instrument include a forced conversion into common stock.

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EXECUTIVE SUMMARY

Our primary concerns fall into three categories:

- First, we believe the Proposal is redundant with the new resolution framework imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") in the U.S.
- Second, we believe the Proposal is somewhat premature in relation to other on-going initiatives to design regulatory capital standards and promote an orderly cross-border resolution framework for systemically important financial institutions.
- Finally, we foresee materially higher costs to issuers of non-common Tier 1 and Tier 2 capital instruments and decreased access to common equity markets in times of stress, particularly if the write-off trigger is not defined with a high degree of specificity.

DETAILED COMMENTS

BACKGROUND

As described in sections 1 and 2 of the Proposal, the write-off requirement aims to ensure that all regulatory capital instruments are capable of bearing losses in situations where the public sector provides support to distressed banks that would otherwise have failed. Aside from promoting greater fairness in burden allocation between investors and taxpayers, the Committee argues that the write-off requirement will reduce the moral hazard associated with public-sector support. Furthermore, the Proposal explains that the write-off requirement should reduce the frequency of public-sector rescues, since a write-off of non-common Tier 1 and Tier 2 capital instruments may itself recapitalize an institution sufficiently to restore its viability. These dual purposes are reflected in the two proposed "trigger events." The first trigger event—a decision to inject public rescue capital "or equivalent support," without which the firm would become non-viable—addresses a scenario where a public-sector rescue enables an institution to avoid insolvency. The second trigger event—a decision that the firm is not viable without the write-off—addresses a scenario where the relevant authority does not (yet) deem public-sector support necessary. The comments below address each of these triggers in turn.

TRIGGER 1

1. The First Trigger Has No Clear Application in the U.S., Since the Dodd-Frank Act Does Not Permit Public-Sector Bailouts Without Eventual Liquidation.

Because the first trigger does not appear relevant to the new financial regulatory framework recently introduced in the U.S., we urge the Committee to clarify that this trigger may not be necessary in every national context. The Dodd-Frank Act, recently signed into law by President Obama, creates an "orderly liquidation authority" under which a financial firm whose failure could have serious adverse effects on U.S. financial stability may be resolved in an orderly fashion by the Federal Deposit Insurance Corporation ("FDIC") using special tools and

authorities provided by law (including authority to provide temporary financial assistance). Critically, this liquidation regime does not permit the FDIC to rescue a failing financial firm; all firms that enter the process must be liquidated, with costs imposed on owners, investors (including holders of non-common Tier 1 and Tier 2 capital instruments), and creditors. The recent legislation likewise precludes public-sector rescues of insolvent financial institutions through Federal Reserve System emergency lending authority or other channels. Thus, in the U.S., losses will be imposed on all regulatory capital through the orderly liquidation authority, removing the need to accomplish this objective through a mandatory write-off feature.

To be sure, lawmakers in the U.S. remain free to amend current law, but the Dodd-Frank Act represents a legislative consensus that the orderly liquidation regime can effectively remove any need for such measures. We agree with this consensus and look forward to cooperating with the FDIC and the other U.S. regulators, through recovery and resolution plans (often referred to as "living wills") and otherwise, to ensure that the liquidation regime is credible. In the meantime, any effort to overlay a write-off requirement on this existing regime will introduce needless confusion for investors, thereby increasing the cost to financial institutions of issuing certain regulatory capital instruments.

2. The First Trigger Seems Premature Relative to Numerous other International Resolution Initiatives in Train

The Proposal appears to suggest that possible limitations in the effectiveness of national resolution frameworks might justify the write-off requirement even in jurisdictions like the U.S.: "[I]t may be the case that no jurisdiction can always make subordinated debt holders share losses in the event of a failure of an internationally-active systemically-important bank, where capital may have been issued beyond the legal jurisdiction of the home authority." We encourage the Committee to further explore the extent to which limitations in the ability of national authorities to ensure loss absorption across borders truly pose a problem. We believe the Committee should also consider the full range of initiatives underway to address and improve cross-border bank resolution before resorting to a contractual write-off requirement. While supervisory colleges, recovery and resolution plans, and information sharing, not to mention the significant increase in required minimum common equity, may not solve the problem completely, we believe that they will meaningfully reduce it.

We therefore believe that the Committee should explore whether more can be done now to facilitate necessary changes to national insolvency laws.

3. The Meaning of "Or Equivalent Support" Is Unclear.

Aside from a public injection of capital to avert failure, we do not understand what other forms of "equivalent support" the Committee refers to in the first trigger. We think clarification on this point is important in order to minimize uncertainty associated with the use of the trigger.

4. Narrower Contractual Solutions Should Also Be Considered.

If the Committee ultimately concludes that a contract-based solution is necessary, we hope that the Committee will consider the full range of possible solutions, including a narrow application of the write-off requirement, or some other functionally equivalent contractual requirement, to regulatory capital instruments issued in "problematic" jurisdictions. Given the potential for unintended consequences inherent in any proposal to modify terms of widely held capital instruments, we trust that the Committee will define the problem at hand with maximum precision, taking into account the existence of strong national resolution regimes in the U.S. and elsewhere, and then proceed with a scalpel and not a hammer.

TRIGGER 2

5. The Second Trigger Serves a Different Purpose From the First Trigger and Merits a Separate Analysis.

Unlike the first trigger, the second trigger—a decision that a write-off is necessary to maintain viability—does not further the objective of ensuring that all regulatory capital instruments are capable of bearing losses in a public-sector-bailout scenario. Rather, the second trigger aims to reduce the likelihood of failure and, accordingly, the need for a public-sector rescue in the first place. However, the Proposal does not clearly state this fact or separately discuss the justification for the second trigger. While we agree that a well-designed "bail-in" regime may advance the interests of both taxpayers and private stakeholders, we believe a fuller examination should be undertaken so that alternative solutions can be explored. This examination should consider, among other things: (1) the Proposal's relation to other bail-in concepts currently under discussion in other forums, (2) the Proposal's relation to possible capital surcharges and contingent capital requirements for systemically important financial institutions, and (3) the potential costs of the Proposal, including the costs of market uncertainty surrounding the circumstances in which national authorities might trigger a write-off.

6. The Committee Should Explore Alternative "Bail-In" Proposals.

The Proposal's second trigger constitutes a form of "bail-in," whereby a troubled institution is recapitalized through write-offs or conversions of debt to equity (essentially removing the distinction between going-concern and gone-concern capital). Bail-in proposals have received considerable interest in recent months among bankers, supervisors, and other policy makers because they promise to greatly reduce or eliminate the need for public-sector support in the event that a systemically important financial institution faces a crisis that threatens its survival. The Proposal differs from other bail-in proposals in that the write-off or conversion of non-common Tier 1 and Tier 2 instruments would not be preceded by a write-off of existing common equity. This creates a possibility that more senior portions of a firm's capital structure will absorb losses before the claim of common equity holders is eliminated, a reversal of the normal order of priority in liquidation. While this outcome may have benefits, the Proposal does not explain what they are or compare them with the costs of this feature to hybrid equity and subordinated debt holders or the banking system as a whole.

In general, bail-in proposals present a complex set of issues. While they may reduce the risk of a taxpayer bailout, they significantly change the risks and returns for holders of regulatory capital instruments. As noted in section 8, below, bail-in clauses in hybrid equity and subordinated debt instruments could significantly raise the costs of issuing such instruments. We encourage the Committee to conduct a full analysis of the various bail-in options that could further the interests of investors and counterparties in maximizing value when a large financial institution's condition deteriorates.

7. The Committee Should Formulate Capital-Related Proposals Relating to Systemically Important Institutions as a Unified Package.

More broadly, we encourage the Committee to coordinate this portion of the Proposal with other efforts to augment the going-concern loss absorbency of systemically important financial institutions. The Group of Governors and Heads of Supervision stated in its September 12, 2010 release (announcing higher global minimum capital standards) that the Committee and the Financial Stability Board "are developing a well integrated approach to systemically important financial institutions which could include combinations of capital surcharges, contingent capital and bail-in debt." The Proposal's second trigger amounts to a partial bail-in proposal, but the Committee has not indicated how this proposal will fit together with possible capital surcharges or contingent capital requirements. We strongly believe that capital-related requirements for systemically important institutions must be approached holistically, as these requirements aim to address the same basic risks. While the Proposal would affect all large, internationally active banks, its stated purpose is to manage risks associated the subset of these institutions that pose systemic risks. As such, the advisability and calibration of the second trigger simply cannot be determined without reference to the Committee's broader "integrated" approach to systemically important institutions. Therefore, we urge the Committee to consider delaying further consideration of the Proposal so that related proposals that remain in development may be considered simultaneously.

8. The Proposal Will Materially Increase the Cost of Issuing Non-Common Tier 1 and Tier 2 Instruments, Significantly Reduce the Amount of These Instruments that Firms Can Issue, and Decrease Access to Capital Markets in Times of Stress, Particularly if the Trigger is Not Defined With a High Degree of Specificity.

Finally, we anticipate that investors in non-common Tier 1 and Tier 2 instruments that include a loss-absorbency feature like the Proposal will demand substantially higher returns (through the applicable interest or dividend rates) in order to compensate for uncertainties as to whether national authorities will decide to trigger write-offs. We also anticipate that the investor base for these instruments, a significant portion of which consists of investment vehicles that are prohibited by their charters or investment guidelines from investing in common stock or other participating instruments, will substantially shrink as compared to the existing investor base for non-common Tier 1 and Tier 2 instruments, resulting both in a lower volume of issuances as well as higher cost for those instruments that are issued. (The Committee suggests that the latter problem might be addressed by transferring shares to a trust, which would then issue transferable notes to the investor. We remain concerned that many investors would be deterred by the

potential costs and complexity of conversion in these circumstances.) Furthermore, we are concerned that debt instruments subject to possible write-off under the Proposal may no longer satisfy U.S. rules governing their tax deductibility, a result that could contribute to an unlevel international playing field for U.S. institutions in particular.

The additional cost of issuing non-common Tier 1 and Tier 2 regulatory capital instruments could force some institutions to rely almost entirely on common equity. As the Committee observes in section 1 of the Proposal, elimination of subordinated debt funding, whether *de jure* or *de facto*, would bring highly undesirable consequences. Subordinated debt funding counterbalances possible incentives of common shareholders to take excessive risks near the point of failure, as the value of their investment diminishes. Spreads on subordinated debt also provide a transparent check on risk-taking. Finally, banks can generally issue subordinated debt at lower cost, due partly to these instruments' seniority in the funding structure and partly to their tax-deductibility.

With respect to common shareholders, the potential for dilution under the Proposal will likely interfere with an institution's ability to raise additional common equity from outside investors in times of stress. At such times, potential common equity investors would be concerned that national authorities will decide to trigger debt conversions, thereby impairing the value of their investments almost from the start. A period of stress when this concern is most present is also, of course, a period when the institution is likely to find it difficult, if not impossible, to issue non-common Tier 1 or Tier 2 instruments for the same reason—a potential write-down. The simultaneous specter of being unable to raise either common or non-common Tier 1 or Tier 2 capital, and the link between the two, is a significant concern. Any potential benefits of the Proposal must be weighed against this concern.

Many of these negative consequences would be exacerbated by a vaguely defined write-off trigger. For this reason, we believe the Committee should reconsider its application of the "minimum necessary" approach to the Proposal's second trigger. As explained in the Proposal, the Committee seeks to define minimum requirements that must be complied with at the international level in order to address the problem at hand, while allowing each jurisdiction room to implement the Proposal consistently with national law or other constraints. With respect to the second trigger, the Committee proposes to leave the question of when authorities should require a write-off to the discretion of national authorities. Although different national institutional arrangements necessitate deferral of certain procedural aspects of this question to national authorities, the question also involves a significant substantive component. That is, what does it mean to be "non-viable," and what standards should national authorities employ when deciding whether a forced write-off is appropriate? For instance, must the institution face imminent danger of default? Must the national authority make a determination that a write-down will best conserve value for certain parties? Furthermore, should a trigger event require not only a determination of non-viability but also a determination that, after giving effect to the write-down, the institution will be "viable"? Interrupting the normally applicable resolution regime through a loss-absorbency provision appears to serve no purpose unless the consequence is a viable institution.

From a practical standpoint, the effect of the second trigger on the costs of issuing non-common Tier 1 and Tier 2 capital instruments depends heavily on investor perceptions of the likelihood that a trigger event will occur. This in turn depends heavily on the standards to which national authorities are held accountable, as well as relevant procedural safeguards to prevent authorities from exercising their discretion too loosely. We recognize that automatic triggers may not permit authorities sufficient flexibility to manage unforeseen events. Nevertheless, we would support efforts to find a reasonable middle ground between absolute prescription and unbridled discretion. Furthermore, we believe these efforts should be integrated with other aspects of the Proposal's second trigger. The absence of clear criteria for this trigger constitutes a major gap in the Proposal, rendering the policy merits of the second trigger difficult to evaluate. Accordingly, we urge the Committee to consider specifying more robust criteria to govern the exercise of national discretion vis-à-vis the second trigger.

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The Clearing House appreciates your consideration of the views expressed in this letter. If you have any questions, or if the members of The Clearing House can assist you in any way, please contact me at (212) 612-9234 or joe.alexander@theclearinghouse.org.

Very truly yours,

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