THE RISK MANAGEMENT ASSOCIATION
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October 1, 2010

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
Delivered via e-mail to baselcommittee@bis.org

RE: Response to Consultative Document, *"Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability"*

Ladies and Gentlemen:

Thank you for providing The Risk Management Association (RMA) the opportunity to comment on the Basel Committee on Banking Supervision's Consultative Document "*Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability"* " (BCBS 174) published in August 2010. RMA, a member-driven professional association, helps banking and nonbanking institutions identify and manage the effects of credit, operational, and market risk on their businesses and customers. The Capital Working Group (CWG) of RMA prepared this response. Since its inception in 1999, the CWG has been providing independent analysis of matters pertaining to risk and capital regulation.

BCBS 174 appears to focus on the case in which a government is about to bail-out a systemically-important financial firm and wants the non-equity capital instruments to absorb losses prior to such a bail-out. Because the recent Dodd-Frank legislation does not permit this type of bail-out in the U.S., we have focused our response on the case in which a government-mandated trigger of the write-off/conversion of a non-equity instrument is made *in lieu of* a bail-out. First, although the government mandated write-down of such instruments is attractive, we strongly urge the Committee to continue the recognition of some amount of traditional subordinated debt as Tier 2 capital, for the reasons given in BCBS 174 itself (and which we repeat in the body of our response). Second, the new, convertible instruments should have some specific terms associated with their introduction, to handle some very specific possible unintended consequences. For example, these terms should include conversion to some form of equity at the point of write-off or write down, so as to protect the traditional seniority of the instruments over that of ordinary common equity. Such a conversion also is necessary to allow the convertible instrument holders to participate in a possible recovery of the troubled firm as would ordinary shareholders.

We are also concerned that, because of the attractiveness of a write-down to the government, the government might err in mandating the trigger for a specific financial firm – that is, the government might trigger the conversion when, in fact, no conversion was really needed. Therefore, the Committee should specify some very specific guidelines for when a write-down/conversion might be triggered.

These and other concerns are discussed in some detail in the body of our response. As always, we urge the Committee to continue to recognize the significant legal and tax differences across Basel countries when finalizing the proposal.

Please feel free to contact Ed DeMarco via email at edemarco@rmahq.org or Sue Wharton via email at swharton@rmahq.org.

Sincerely yours,

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October 1, 2010

Response to BCBS 174 (loss-absorbency proposal) by the RMA Capital Working Group

I. Introduction and main concerns.

The RMA Capital Working Group (CWG) appreciates this opportunity to comment on the August, 2010 Consultative Document dealing with the Basel Committee on Banking Supervision's (Committee's) proposal to ensure loss absorbency of regulatory capital at the point of non-viability. The CWG consists of senior officers in the fields of risk measurement and the management of capital positions at major U.S. financial institutions.[1]

The consultative document (BCBS 174) appears to focus on the case in which a government is about to bail-out a systemically-important financial firm and wants the non-equity capital instruments to absorb losses prior to such a bail-out. Hence, the Document's title includes the words ...."at the point of non-viability."

We believe that any de-recognition of current Tier 2 capital instruments, such as traditional long-term subordinated debt, and their replacement with government-initiated convertible instruments, should reflect specific legislation aimed at financial crisis resolution, bail-outs, and capital reforms passed in specific Basel countries. In the U.S., the new Dodd-Frank legislation prohibits such a bail-out aimed at an individual financial firm. Moreover, should the U.S. government decide to provide aid to a significant number of firms, as permitted in the new legislation, such aid would be made senior to any traditional Tier 2 capital instruments such as ordinary long-term subordinated debt.

Thus, in the U.S., and possibly in other Basel countries, current Tier 2 instruments would indeed absorb losses prior to any government losses. In the U.S., the usefulness of the new, special instruments proposed by Basel, therefore, would be limited to the case in which the government believes that a mandated conversion of these special instruments would likely *prevent* an insolvency/resolution or, at the least, would be a step that should be taken *in lieu of* a government injection. Viewed in this light, special Tier 2 capital instruments that would absorb such a loss upon a government trigger are highly desirable, but such instruments present certain difficulties and hurdles that we discuss below. We discuss these issues in the context of the U.S. banking framework. We urge the Committee to continue to recognize these legal (and tax) differences across Basel countries.

II. Concerns and recommended modifications to the Basel proposal on loss-absorbency.

A. Not all instruments that now qualify as Tier 2 capital should be de-recognized. Ordinary long-term subordinated debt plays an important role within the process of keeping banks sound, and banks should retain an incentive to keep issuing such debt. The

[1] An appendix lists the names of institutions and staff that assisted in the preparation of this response. Individual institutions may disagree with specific points made in this response and/or may be providing a separate response to the Consultative Document.

Consultative Document itself gives four reasons why subordinated debt should NOT be derecognized (page 2):

- Sub-debt can be expected to take a significant loss at the point of failure, and so such debt provides an efficient market mechanism for constraining excessive risk-taking.

- For non-systemically-important banks (those unlikely to ever receive any assistance), sub-debt is already loss-absorbing in the event of failure (because the instrument is subordinated). De-recognition of such debt as Tier 2 would reduce the market-mechanism benefit described immediately above.

- For a conservative bank not taking excessive risk, subordinated debt is less expensive than equity and disallowing such debt would increase the cost of a balanced funding structure.

- Spreads on subordinated debt can be an important market indicator of soundness.

We agree with these points and also note that long-term subordinated debt is an important tool for managing liquidity and duration matching. In addition, sub-debt is a cost-effect instrument for providing protection against loss for insured depositors in the evident of failure of a banking institution. Thus, we believe that some amount of long-term subordinated debt should continue to be permitted and recognized as Tier 2 capital, in order to provide the proper incentive for banking companies to continue to issue such debt.

We suggest that such traditional sub-debt might be limited to 2% of RWA at banking institutions; that is, traditional sub-debt might be limited to a level equal to no more than 1/2 of the Tier 2 capital that has been permitted as included within Total Regulatory Capital. We note that if a government can conclude that triggering a write-down will prevent insolvency, it is highly unlikely that the level of such a write-down would amount to something on the order of 4% of risk-weighted assets (the maximum amount of Tier 2 that could meet the minimum Basel total capital requirements under BII). That is, if the bank needs an immediate capital injection of, say, 4% of RWA to remain solvent, it is highly probable that it should be placed immediately in receivership or conservatorship under the terms of the U.S. legislation dealing with resolution of failing systemically important financial institutions.

By limiting the amount of ordinary subordinated debt that can qualify as Tier 2 capital, while requiring new instruments that contain a government-triggered convertibility feature, the Committee would be achieving a dual objective – a) allowing the new instruments to serve a loss-absorbency role both prior to and at the point of non-viability, and b) continuing to allow ordinary subordinated debt to play a role in moderating risk-taking by banks, presenting a pure measure of the market's view of a bank's riskiness (in the form of debt credit spreads), and playing a loss-absorbency role in the event of insolvency. We strongly urge the Committee to take such a moderate view of the role of the old and the new instruments.

B. Any requirement for the new instruments should be viewed in the context of the other increased capital requirements being put forth by the Committee (e.g., the September 12 announcements).

- The issuance of the new instruments, in our view, will prove to be extraordinarily expensive; indeed some banks in some countries might only be able to respond to such a requirement by issuing common equity. When coupled with the proposed capital buffers and the new, higher minimum capital ratio requirements, the new instrument proposal may result in too much capital being required of regulated banks (both from the perspective of financing the recovery but also in terms of maintaining bank soundness). [2]

- No matter the final rule chosen by the Committee, any new instrument requirement should be phased in over at least a decade or more, both from the point of view of not jeopardizing the recovery and in not creating an impediment in which regulated banks can no longer compete with unregulated lenders.

C. Because the idea of a mandated write-off/conversion is so attractive to the government, we face a problem of government possibly overusing this tool. That is, when a particular, systemically-important financial firm becomes troubled, it would be quite compelling for the government to sign-off on triggering a conversion, since there is no downside to the government. Yet, a full-blown crisis might not truly be imminent for that banking company in question (the government might be wrong), or, the trigger itself might cause a crisis for the firm. To reduce the potential for such events,

1. The government must not be given full carte-blanche to mandate the conversion. The decision to use the trigger should involve some specific guidelines, not just a completely subjective determination by the government. Some combination of market indicators and regulatory capital ratios might be specified by Basel as being a necessary condition to permit the trigger (e.g., the common-equity to RWA ratio falling below x%). The government naturally will not want these specifics to be completely determinative, but guidelines would likely reduce the chances of an adverse market response.

   Note that market indicators alone may have significant problems (such as the possibility that a market sell-off of stock could be initiated by the view that a

[2] The September 12, 2010 announcement, along with the financial press' response to the announcement, implies that regulators believe that high capital ratios are synonymous with bank soundness. This is not the case. Indeed, if the minimum capital ratio requirement (under the risk-based capital standard or under the leverage ratio, whichever is binding) is too high (relative to a best-practice estimate of needed capital), banks cannot afford to invest in low-risk assets (the rate of return on equity for such assets is simply too low, given market spreads for such assets). Thus, a capital requirement that is too high can deprive banks of achieving a steady flow of net interest margin, which adds to retained earnings (adds to capital) with little risk. Too-high capital requirements can harm soundness just as too-low requirements can be detrimental to soundness.

mandated trigger is shortly forthcoming, thus causing a share-value guideline to be violated). Thus, any Committee guidelines on when to mandate a conversion should be carefully crafted to avoid self-fulfilling prophecies or false positives.

2. The government should be required to prepare a full documentation of its decision process. This documentation, which could be made available to the public with a considerable lag, would help force the government to develop and follow guidelines on when a trigger might be mandated.

D. The Committee should make clear that a full or partial write-down of the convertible instrument should be accompanied by a conversion to equity of the instrument. This point is cloudy in the Document's text.[3]

Our concern is that only through a write-down/conversion combination can the new instrument holder be protected from the possibility of a government mistake in triggering the write-down/conversion, or the possibility that the holder of the new loss-absorbing Tier 2 instrument could become effectively subordinate to the equity holders.

In the case of a government mistake, the firm in question might quickly recover and its share price rebound fully. Absent some form of recovery device, the instrument holders that incurred the government-mandated write-down might lose significantly more than the firm's equity holders. This possible condition might make issuance of such an instrument extremely difficult.

The write-down-coupled-with-conversion, however, provides a built-in mechanism for the new instrument holder to recover in step with equity holders. Moreover, if the conversion price is determined by share prices immediately prior to the government-mandated conversion, the debt-holders likely will have lost less than the equity holders after the firm's recovery is completed. This may preserve the historic seniority of subordinated debt holders over equity holders, and may make the sale of such new instruments easier to accomplish. Nevertheless, as we argue in Section E, immediately below, the terms of the conversion, including a) whether the conversion price should be set when the new instruments are issued or should be determined by share prices at the time of the government trigger, and b) other terms of the instrument (such as whether conversion should be into common shares or preferred shares), should be determined by the market, not by the Committee. This market determination of best terms should also be coupled with Committee concern that share-price determinants of government action be viewed with caution. We would probably want to avoid a requirement that a government trigger occurs when share price falls to a certain value, since a share-price

[3] Note that the Consultative Document, in the text prior to the bottom of p. 4, refers to the new features of Tier 2 instruments as allowing government to trigger the instruments to "be written-off OR converted into common shares" (emphasis ours). Then, at the bottom of p. 4 the proposal is described as the triggering event causing a write-off, while the next sentence (top of p. 5) says that any compensation for the write-off must be paid immediately in the form of common shares. Thus, the proposal really seems to be pointing to conversion in all cases. We believe such conversion is quite necessary to make the new instruments saleable to the market.

downward spiral could be caused by, for example, convertible debt holders shorting the stock to trigger a conversion at a favorable conversion price.

We recommend only that the Committee insert language in its proposal that makes a conversion part of the requirement for the new instruments.

E. We agree with the Committee's apparent decision to refrain from specifying the exact terms of such new instruments. That is, the Consultative Document allows the marketplace to determine the details of the instruments, including the manner in which conversion takes place, the conversion rate, etc. Only through market trial and error will regulated banking companies be able to determine the least-cost method of designing such instruments while meeting the goals of regulators. At the extreme, new instrument terms on a case-by-case basis might need to be pre-approved by the country's banking regulators. But by refraining from being too specific on the terms of the new instrument, the Consultative Document preserves the very useful tradition of principles-based regulation. As stated in Section C1 above, however, it is incumbent upon the Committee, however, to be fairly specific in defining the process by which an institution would be declared "non-viable" so the market can construct the appropriate financial instruments.

F. Since loss-absorption prior to insolvency is assured (if needed), the new convertible debt instruments need not have the kind of maturity criteria applied to ordinary long-term sub-debt instruments that classify as Tier 2. That is, given the specific objective of these new instruments, there is no need to specify minimum maturities or to require the straight-line amortization within the last 5 years of the term of the instruments (as is now required for ordinary sub-debt). The bank will continuously have the ability to issue new such instruments as older ones mature, or, depending on the relative cost of the instruments, to issue new equity rather than new convertible subordinated debt. Moreover, even if a particular instrument has only a few months remaining maturity, the government still has the option in an emergency to require its conversion.

G. Tax deductibility of interest payments on new instruments. A major concern of banking companies is whether the new class of Tier 2 capital instruments can qualify for the deductibility of interest payments. This will of course depend on rulings of individual countries' tax authorities. Thus, the ability of banks to issue the new instruments at favorable spreads will differ across Basel countries.

The Committee should be sensitive to not requiring terms of the new instruments that would impede their favored tax status. For example, tax rulings might be favorable to the extent the maturity of the instruments is not extremely long. While the instruments would be convertible debt, the conversion is not *mandatory* in the usual sense of the word. That is, the debt is not to be mandatorily converted upon reaching some date in the future or some specific financial condition. Rather, the decision to require conversion is the government's and the expectation should be that, over some reasonably short horizon such as the next 5 years, the banking firm will not be troubled enough to force the government to require the conversion. If such an expectation were NOT in place on the part of the government, then the government should be considering resolution, not forcing the issuance of new capital instruments.

Thus, it is important for the Committee to allow tax authority decisions to affect the terms of these new instruments without disqualifying them from use as Tier 2 instruments.

H. <u>Finally, in the U.S. and possibly in other Basel countries, conversion with write-off features should be required only for systemically important institutions, not smaller banks</u>. As noted in the Consultative Document, subordinated debt, preferred stock, etc., are already fully loss-absorbent on a gone-concern basis. Recent U.S. law, moreover, makes it extremely unlikely, if not impossible, for the government to bail-out a systemically unimportant bank or group of such banks. Therefore, to require a loss-absorbency feature for small banks is not necessary. Such a requirement would unnecessarily drive up the cost of funding and the cost of meeting capital requirements for such banks -- institutions that have never been the cause of this or any past financial crisis and whose insolvency would not significantly deepen any future crisis

In the context of a cross-border Basel agreement, we also wish to point out that a size-alone determinant of systemically important banks may be insufficient. That is, we believe that each country should be permitted to define for itself the term “systemically important”, and also should define for itself the process of making a determination as to which banking companies would be subject to the issuance of the new instruments. In particular, the new U.S. legislation allows for a determination of systemic importance based on other factors such as risk, capital structure, etc. We praise the Committee for not suggesting any global standard for such procedures.

Appendix

RMA Capital Working Group institutions participating in the preparation and/or review of this response:

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