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LOSS ABSORBENCY OF REGULATORY CAPITAL

A Response by the UK Building Societies Association to the Basel Committee's August 2010 consultative document (CP 174)

The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 49 UK building societies. Mutual lenders and deposit takers have total assets of over £365 billion and, together with their subsidiaries, hold residential mortgages of almost £235 billion, 19% of the total outstanding in the UK. They hold more than £245 billion of retail deposits, accounting for 21% of all such deposits in the UK. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

The Association fully understands the issue the Committee's proposal attempts to address, namely that holders of non core tier 1 and tier 2 capital instruments issued by **systemically important banks** do not share in losses where public authorities step in and rescue such a bank with an injection of capital. Our response approaches this from the standpoint of the UK's mutual and cooperative banking sector – which is purely domestic in operation, and in which the majority of our member societies are small by international and even UK standards. However, any final measure resulting from the current proposal, if accepted by the European legislative process, would be expected to apply to all credit institutions including all of our members. Accordingly, our members face the negative impacts of this measure, in terms of cost and availability of lower forms of capital, while in general gaining no direct benefit.

Our first point is that although this proposal has appeared fairly late in the overall Basel 3 development process, it does represent a major change from the design principles on definition of capital in the original consultation. CP 164, in calling for a substantial increase in the common equity / core tier 1 component of banks' capital, envisaged distinct roles for core tier 1, non-core tier 1, and tier 2 instruments, with a clear hierarchy of subordination and loss-bearing. Moreover, it was quite explicit that the objective of tier 2 is to provide loss absorption only on a gone-concern basis. These distinctions and hierarchy are essentially subverted by the latest proposal, which in effect requires all bank capital to provide, either actually or contingently, going-concern loss absorption. The notion that "gone concern" can be "redefined" to mean situations where the public sector supports banks that otherwise would have failed is not remotely persuasive – this is a poor camouflage for a fundamental moving of the goalposts.

At least in the case of systemically important banks, the proposal should mitigate the cost of taxpayer rescue and ensure that this does not operate primarily to benefit other capital holders. However, since the proposal is to make the write-down an obligatory feature of all non-core tier 1 or tier 2 bank capital instruments, there seems every reason to expect that the activation of the trigger – since this is deliberately not made conditional on public sector support actually being provided – will also happen in all non-systemic cases where the write-down could, on its own, secure ongoing viability. (Paragraph 4 in the minimum requirements text box on page 5 of the consultation document states that the trigger event is the earlier of (i) the decision to make a public sector capital injection ; *or (ii) a decision by the regulator that a write-off, without which the firm becomes non-viable, is necessary*. This means that for a non-systemic bank at the point of non-viability, where public sector capital is not being provided, the authorities have an alternative tool of recapitalising the bank at the expense of writing off the other capital holders.) It is unlikely in the extreme that a regulator, faced by a failing non-systemic bank that could be stabilised at no public expense by invoking the trigger, would deliberately leave the bank to fail in order to make the point that non-systemic

banks do fail. So the net result of the proposal is, in fact, to make all bank capital contribute to going concern loss absorbency even for non-systemic banks. This may well have other merits, but it is a very different proposition from that advanced in CP 164.

Bearing in mind the foregoing analysis, the impact on our members – who are for the most part credit institutions that are individually non-systemic (though possibly regarded by the regulator as collectively systemic) – will be that their tier 2 capital in particular will be required, for the first time, to show going concern loss absorbency. This increases the overall risk of loss to the corresponding investors, increases the cost of that capital, and may reduce its availability (as some investors decide not to invest in bank capital at all). Moreover, as mutual and cooperative banks, our members' access to core tier 1 instruments is limited. The proposal therefore immediately puts our members at a disadvantage as against joint stock banks, as the only realistic option may be permanent write-off without compensation in the form of core tier 1 instruments. This would be viewed unfavourably by investors. So, the overall result is that our members' ability to raise any form of capital may in fact be damaged (or at least, its cost will go up) even though the great majority of our members fall outside the category for which the proposal is arguably needed.

We mentioned above that the proposal subverts established hierarchies. This is because at the trigger point the whole amount of all non core tier 1 and tier 2 instruments is immediately written-off, regardless of the quantum of loss absorption actually required. The language used in the proposal ("write-off of the original instrument") makes quite clear that this is not talking about partial write-down. So, whereas in a gone concern situation, loss absorption would first affect the core tier 1, then the non-core tier 1, and only then the tier 2 instruments, under this proposal, non-core tier 1 and tier 2 instruments would immediately be written off in full and pari passu with each other. Subject to any "compensation" available in the form of common equity/core tier 1 instruments, this process benefits the core tier 1 holders (who may only suffer dilution) at the expense of the other capital providers (who are 100% written off). The tier 2 holders, in particular, may be demonstrably worse off.

The Annex to the consultative document attempts to answer the question as to whether the proposal will impose unnecessary costs on small banks (which term would include the majority of our members). The suggested answer posits that the "market" would expect a non-systemic bank to fail without public sector intervention. However, as explained above, the terms of the proposal in fact provide the authorities with a new tool to preserve the viability of a failing non-systemic bank, at no public expense, by requiring a total write-down of the other capital. Where this step would be sufficient to restore viability, the authorities will have every incentive to take it – as from their perspective the capital created by the write-off is a free good. The only uncertainty would be whether the write-down on its own would be sufficient to restore viability. Moreover, even where this is not so, the amount of capital write-down will also mean that the minimum quantum of public sector capital needed to ensure viability is greatly reduced. So the cost-benefit equation of rescuing a particular bank is shifted in the direction of intervention. Logically (and we would expect the rating agencies to carry out this analysis at an early stage and amend their methodology accordingly) the markets should expect non-core tier 1 and tier 2 instruments to be written down in any of the three scenarios described below :

(i) where the bank is systemic and requires public sector support anyway ;

(ii) where the bank is non-systemic but can be restored to viability at no public expense solely by the full write-down of its non-core tier 1 and tier 2 instruments ;

(iii) where the bank is non–systemic, and can be restored to viability by a combination of write-down of non-core tier 1 and tier 2 together with a small amount of public sector capital, such that the cost-benefit equation as regards the public purse still favours intervention.

The evidence from the UK authorities' behaviour in the recent crisis amply reinforces the foregoing analysis. The only scenario in which the non-core tier 1 and tier 2 instruments would suffer loss in a true gone-concern situation, rather than premature write-down, is in a non-systemic bank whose failure is so complete that even after total write-down, either the

amount of public sector capital needed for viability is greater than the authorities are prepared to contemplate, or the underlying business is so bad (i.e. a bottomless pit) that any such move would only be throwing good money after bad.

All these may well be desirable outcomes from a public policy perspective. But the consultation document misleads in presenting the likely effects of this measure. As explained above, the proposal will allocate *a priori* to capital holders in all banks a major part of the cost of any recapitalisation of that bank, whether or not systemic. This added risk will be reflected in a significant increase in the cost of capital. This could be argued to reflect a better alignment of the risks and rewards of the various levels of stakeholder in a bank. But to suggest that it will not impose significant costs on small banks is entirely unconvincing. Indeed, recent soundings among typical institutional investors in bank capital confirm the point we made above – that the effect of this proposal, even at this early stage, is leading some to deciding either to discontinue, or to massively scale back, their investment in bank capital.

Finally, we reiterate the specific disadvantage this proposal brings for mutual and cooperative banks. Access to issued core tier 1 capital is already more difficult than for proprietary banks, but mutual and cooperative banks rely more on internal capital generation from retention of earnings, which could then be supplemented by non-core tier 1 or tier 2 issuance. But this proposal amplifies their existing disadvantage in relation to core tier 1 capital by extending its effect to all lower forms of capital – as explained above, unless mutual and cooperative banks have suitable core tier 1 instruments in which to "compensate" written-down investors, their lower forms of capital will be less attractive, or even unattractive, to prospective investors, and therefore such capital would become both scarcer and more costly for mutual and cooperative banks compared with proprietary banks.

30 September 2010