Basel Committee on Banking Supervision

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

Consultative Document (August 2010): Request for Comments

Western Asset is engaged in investing in diverse fixed-income products (please also see footnote). Historically, we have evaluated almost all types/forms of bank-issued instruments across the fixed-income capital spectrum and have held them all to varying degrees on behalf of our diversified investor base.

We have read the consultative paper and note the overriding goals that the Basel Committee is seeking to achieve in the context of loss absorbency of regulatory capital at the point of non-viability.

We would like to make the following observations regarding the proposals – proposals we believe may meaningfully limit the size and/or scope of new market capacity, especially in relation to the peak issuance levels of the existing "old style" Tier-1 and Tier-2 markets. These market capacity limitations are expected to be shaped by the forces described below.

Broad Interpretation of a "Non-Viable" Bank

The desire for greater regulatory flexibility of future instruments introduces a significant degree of ambiguity, in particular since markets will find it harder to price the risks if the key parameters are perceived as fluid. In the absence of exclusively defined trigger points, non-viability may be assumed to further evolve and change over the lifetime of any future Tier-1 or Tier-2 capital. One potential means of addressing such market concerns in the absence of clear trigger definitions might be for regulators to publish and adhere to an objective set of criteria under which triggers would be exercised. We believe that the more ambiguous the trigger point(s), the more limited the fixed-income investor willingness to consider these asset classes, and in any event, all things being equal, the more expensive (from a bank's perspective) the cost of issuing and relying on such instruments.

Permanent Loss Absorption

By proposing to replicate more equity-like language, the pool of fixed-income investors is likely to be far more finite. It is possible that some forms of equity conversion may marginally widen the market's capacity to invest relative to any outright permanent write-down. This capacity will be driven by the defined magnitude of a permanent write-down compared to the specific equity conversion characteristics.

In contrast, temporary loss absorption, which could certainly be structured so as not to immediately impede a recapitalisation effort—for instance, where write-backs are conditional on some form of sufficient recovery of distributable reserves—should widen the market capacity (if indeed this were to be a desirable consideration by the Basel Committee). Assuming that temporary write-down features on some classes of future instruments are deemed to continue to play a regulatory role, consideration should be given to interaction (danger of risk/reward distortion) of future dated capital instruments versus future perpetual ones—specifically in relation to any write-back features.

Public Ratings

We would expect that the major rating agencies would have great difficulty (if they could assign "credit" ratings at all) to such new capital instruments, particularly as more equity-like characteristics are introduced. Many of our investment mandates require public ratings. Unrated instruments severely limit our ability/willingness to consider such capital instruments.

Instrument Features Linked to an Issuer's Market Capitalisation or Some Form of Common Dividend Multiple

We anticipate that such linked features would take such instruments too far away from the fixed-income attributes that the fixed-income investor base generally seeks and with which this base would be comfortable. Consequently, such features are likely to limit fixed-income investor appetite.

We also wish to make one additional observation.

Identifying Systemically Important Banks

The consultative document itself highlights the challenge in identifying systemically important institutions (stated in connection with the significant drawback faced from the proposal to prohibit such banks to include Tier-2 capital in their regulatory capital). Given this acknowledged challenge, should such a discovery process be left solely to the markets? One possible solution is that regulators be more clear and consistent when identifying and communicating to the market those specific systemically important elements of the diverse (often cross-border) activities at various/diverse banking groups that they actually regulate.

…………………………………………………………………………………………

Western Asset is one of the world's leading investment management firms. Its sole business is managing fixed-income portfolios, an activity the Firm has pursued since 1971. From offices in Pasadena, New York, Sao Paulo, London, Singapore, Hong Kong, Tokyo and Melbourne, Western Asset's 895 employees perform investment services for a wide variety of global clients. The Firm's clients include charitable, corporate, health care, insurance, mutual fund, public and union organizations, and client portfolios range across an equally wide variety of mandates, from money markets to emerging markets. Western Asset's client base totals 562, representing 42 countries, 1,137 accounts, and $457 billion in assets under management.

Western Asset has been managing corporate bonds since its inception with its first dedicated US Corporate portfolio established in 1974. The Firm's global credit capabilities were enhanced in 1996 with the opening of the London office and furthermore with the establishment of dedicated Euro and Global corporate products in 2002 and 2003, respectively. Western Asset currently manages $101.99 billion of credit assets.