POSITION PAPER

WSBI-ESBG comments on a 'Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability' (BCBS 174)

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WSBI ESBG

The World Savings Banks Institute (WSBI) and the European Savings Banks Group (ESBG) herewith provide comments on the Basel Committee on Banking Supervision (BCBS)' consultative document on its *'Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability'* (BCBS 174).

I) Introduction:

Overall WSBI-ESBG welcomes the opportunity to comment on the consultative document of the BCBS. WSBI-ESBG agrees with the overall objective in theory, that non-core Tier 1 capital instruments and Tier 2 capital instruments (mainly subordinated debt) issued by banks should be capable of absorbing losses in the event of non-viability. Furthermore WSBI-ESBG feels that the BCBS is right in its criticism of the fact that, during the recent financial crisis the instruments in question did not absorb losses in a number of instances. However, the proposal from the BCBS raises a number of important concerns, which are addressed below.

Nonetheless, before addressing these concerns, WSBI-ESBG would like to stress that in relation to the three 'Options' outlined in the consultation document which could be considered to ensure that instruments treated as regulatory capital are capable of bearing losses, that 'Option 1' is not neglected. In WSBI-ESBG's view, this 'Option' – to develop national and international bank resolution frameworks that enable all losses to be allocated to all capital instruments issued by internationally active banks that have reached the point of non-viability – is more favourable than pursuing 'Option 3'; requiring 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, which the document from the BCBS focuses on.

Having said this, WSBI-ESBG recognises that the consultative document in question aims at gaining feedback on a proposal in relation to 'Option 3', and will thus focus our more specific comments, on the proposal in question. However, WSBI-ESBG suggests that the Basel Committee seriously considers undertaking further work on 'Option 1' as opposed to 'Option 3', and outlines the main reasons for this in the response below.

In relation to the proposed mechanism outlined in the consultative document, WSBI-ESBG has significant concerns of a general and a more specific nature as well as doubts about its workability in practice. This position paper will firstly outline the more general concerns and comments of WSBI-ESBG, and will then highlight more specific areas where in WSBI-ESBG's view, the proposal necessitates further development.

II) General remarks/concerns:

- Whilst WSBI-ESBG recognises that the BCBS outlines in its proposal and explanation of the mechanism that it applies to *'internationally active banks'*, the proposal lacks a concrete definition of what actually constitutes an internationally active bank. In addition, further

clarification is needed as to how the proposal ties in with the current debate concerning systemically important financial institutions (SIFIs).

- WSBI-ESBG would also like to stress that the present proposal from the BCBS is not neutral in respect of banks' organisational forms, and should be compatible with a wider range of ownership structures, such as non-joint stock companies. Compliance with these guidelines should not entail any obligation for banks to alter their organisational form.

- Concerning the listed alternatives to the debt to equity conversion, WSBI-ESBG acknowledges that the BCBS has highlighted in the consultative document that 'Option 1' – the development of national/international bank resolution frameworks that enable losses to be allocated to all capital instruments issued by banks, would be the most desirable option. As outlined in our introductory remarks, any proposal from the BCBS in relation to 'Option 3' should not hamper current efforts to explore the possibility of increasing the compatibility and ultimately the convergence of national bank resolution frameworks, and as already stated, the BCBS is urged to consider pursuing this as an alternative to 'Option 3'.

  Even though the Basel Committee's justification for focusing on 'Option 3' is that 'Option 1' presents difficulties with near-term implementation, WSBI-ESBG argues that 'Option 3' would also require a lengthy implementation period. This is because in relation to 'Option 3', the terms of existing capital instruments cannot be amended unilaterally because legitimate expectation must be protected.

- In WSBI and ESBG's view the proposal also softens the clear distinction between a 'going concern' and 'gone concern' situation for banks. In fact it makes provisions for a scenario where, depending on the discretion of national governments, a bank ultimately can neither be classified as 'going concern' or 'gone concern'; but is situated in between these two possibilities. Unless great care is taken, this may impede the future clarity and straight forwardness of prudential regulation.

  In addition the proposal as it currently stands also appears to blur the difference between Tier 1 and Tier 2 capital. WSBI-ESBG views this with concern, as in our view Tier 2 capital is, and should continue to be a useful completion of a diversified capital structure of any given credit institution. Thus there has to be a clear distinction between additional Tier 1 and Tier 2 instruments giving both the possibility to be accepted by market participants.

- As a final general remark, WSBI-ESBG would like to highlight that there are currently numerous discussions taking place across jurisdictions concerning improving crisis resolution and crisis management, and also exploring alternatives for the extremes of 'bail outs' on the one hand and 'pure' bank liquidation on the other. We therefore call on the BCBS in their capacity as international regulators to bear these developments in mind and ensure that compatible approaches are taken wherever this is possible.

III) More specific concerns/comments:

As outlined above, whilst WSBI-ESBG welcomes the objective of the proposal in question, there are some rather specific concerns and areas in which the proposal requires further development. If left unaddressed, these impracticalities could lead to unintended consequences.

i) Effect on instruments concerned:

WSBI-ESBG has significant concerns on whether the proposal as it currently stands will prove practical in reality. In particular, the marketability of the 'reformed' Tier 2 capital instruments is unclear for several reasons.

Firstly, the implementation of the proposal would make 'subordinated debt' a much less attractive asset for investors: as regards risk, subordinated debt will become more like common equity, i.e. it will become riskier, however as regards returns, it will remain a fixed income investment. Hence investors will only share the downside of the institutions risk taking, but not benefit from its upside (i.e. higher profits). Secondly, there will be many investors, and especially institutional investors such as pension funds or insurance companies, who will need to reconsider whether holding subordinated debt is still compatible with their own risk profile and regulatory framework.

As a result, it is very likely that demand for the instruments concerned will be low, and there is no certainty whether these instruments will be sufficiently marketable. Furthermore, even if there will be markets for these instruments, those investors prepared to hold these instruments will demand significantly higher returns, as compared to the existing 'Tier 2' instruments. While this is compatible with the general goal of reducing moral hazard of creditors, the price increase may be excessive, if for instance the trigger is not carefully designed (please see below).

Last but not least WSBI-ESBG would like to point out that in the next years there will already be significant demand for fresh capital as worldwide banks will need to adjust to the revised Basel III capital requirements. Should the present proposal be adopted, an even longer transition period would be necessary, otherwise the issuances of common equity instruments and reformed (more common-equity-like) Tier 2 instruments may not find acquirers at a reasonable price.

ii) Trigger event:

In its proposal the BCBS outlines that *'all non-common Tier 1 and Tier 2 instruments [...] must have a clause in their terms and conditions that requires them to be written-off on the occurrence of* ***the trigger event'****,* and goes on to further explain the elements of the trigger event. However, despite this explanation, WSBI and ESBG would like to call on the BCBS to clarify exactly what constitutes a trigger event.

As it currently stands, in WSBI and ESBG's view the determination of a 'trigger event' is left too much in the hands of the relevant authority. As opposed to leaving this determination purely at the discretion of the relevant authority, WSBI and ESBG urge the BCBS to ensure that a transparent and quantitative test is developed, the criteria for which, if fulfilled, will determine the occurrence of the trigger event. Only if this test is failed should the regulator be allowed to exercise discretion in determination. The existence of such a test will hopefully help to tackle the blurring of the lines between a 'going concern' and 'gone concern' situation, as outlined above.

iii) Financial stability concerns:

In WSBI-ESBG's view it is necessary that the Basel Committee puts its present proposals in context with the experiences of the crisis, and mainly with the extraordinary circumstances which motivated governments to intervene and recapitalise several financial institutions. Here WSBI-ESBG points out that a decisive factor for such decisions was the need to avoid inter-bank contagion and a further spreading of the crisis. Considering the present proposal, it is important to understand that the efficacy of individual bank recapitalisation in stabilising the wider financial system may be undermined if it entails the automatic write-down or conversion of capital instruments held by other banks as assets on their balance sheets. This is particularly acute if the main holders of banks' subordinated debt are other financial institutions. Here it is furthermore important to take into account that bank rescues are much more likely in a wider crisis situation, i.e. in a scenario where financial markets are already undergoing significant stress. Therefore WSBI-ESBG finds that regulators have to acknowledge that, if they pursue the present proposal, there will be an inevitable trade-off between 'fairness' and 'efficacy' of government support measures in crisis situations, which is likely to have an impact on their ability to preserve the stability of the wider financial system.

iv) Interplay with other state-aid measures:

At the moment the focus is on state intervention by recapitalisation in order to restore bank viability. Yet, during the peak of the crisis liquidity problems arising from a breakdown of inter-bank lending were at least as problematic as bank insolvency. Accordingly, especially in the EU, bank recapitalisation was very often combined with guarantees for a financial institution's debt. In the context of the present discussion, WSBI-ESBG is apprehensive of a lack of compatibility/consistency between different state aid measures, if from now on state aid in form of recapitalisation will trigger (subordinated) debt-write offs and if on the other hand, governments may be forced again to also launch guarantees for a bank's liabilities in order to restore market liquidity for bank debt.

About WSBI-ESBG (World Savings Banks Institute – European Savings Banks Group)

WSBI-ESBG – The Global Voice of Savings and Retail Banking

WSBI (World Savings Banks Institute) is one of the largest international banking associations and the only global representative of savings and retail banking. Founded in 1924, it represents savings and retail banks and associations thereof in 90 countries of the world (Asia-Pacific, the Americas, Africa and Europe – via ESBG, the European Savings Banks Group). WSBI works closely with international financial institutions and donor agencies and facilitates the provision of access to financial sectors worldwide – be it in developing or developed regions. At the start of 2009, assets of member banks amounted to almost € 9,000 billion, non-bank loans to € 4,300 billion and non-bank deposits to 4,600 billion. Together the member banks conducted operations through 160,000 outlets.

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of over € 6.000 billion, non-bank deposits of € 3.100 billion and non-bank loans of € 3.300 billion (all figures on 1 January 2009). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

WSBI and ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. WSBI and ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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