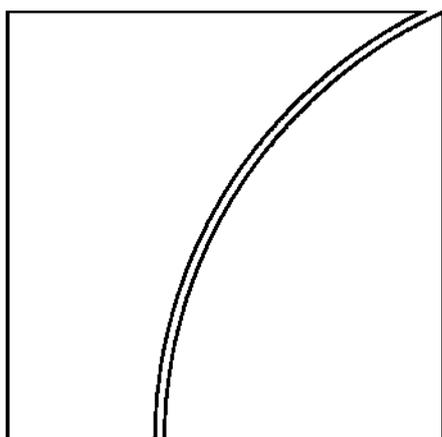


# Basel Committee on Banking Supervision

Consultative Document



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

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

## Section 1: Introduction

In the December 2009 consultative document *Strengthening the resilience of the banking sector*<sup>1</sup>, the Basel Committee on Banking Supervision noted that “[the Committee] continues to review the role that contingent capital and convertible capital instruments should play in the regulatory capital treatment. The Committee intends to discuss specific proposals at its July 2010 meeting on the role of convertibility, including as a possible entry criterion for Tier 1 and/or Tier 2 to ensure loss absorbency, and on the role of contingent and convertible capital more generally both within the regulatory capital minimum and as buffers.”

This consultative document outlines a proposal to enhance the entry criteria of regulatory capital to ensure that all regulatory capital instruments issued by banks are capable of absorbing losses in the event that a bank is unable to support itself in the private market.

During the recent financial crisis a number of distressed banks were rescued by the public sector injecting funds in the form of common equity and other forms of Tier 1 capital.<sup>2</sup> This had the effect of supporting not only depositors but also the investors in regulatory capital instruments. Consequently, Tier 2 capital instruments (mainly subordinated debt), and in some cases non-common Tier 1 instruments, did not absorb losses incurred by certain large internationally-active banks that would have failed had the public sector not provided support.

In order for instruments to be treated as regulatory capital, the Committee considers it a precondition that such instruments are capable of bearing a loss. Three options exist to ensure this outcome:

1. Develop national and international bank resolution frameworks that enable losses to be allocated to all capital instruments issued by internationally active banks that have reached the point of non-viability.
2. Try to identify systemically important banks and prohibit them from including Tier 2 instruments in their regulatory capital.
3. Require 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.

Option 1, while highly desirable, is unlikely to solve the problem in the near term as it relies on the convergence of national insolvency law and bank resolution schemes. However, the March 2010 report of the Committee’s Cross-border Bank Resolution Group (CBRG) reported that:

*“Existing legal and regulatory arrangements are not generally designed to resolve problems in a financial group operating through multiple, separate legal entities. This is true of both*

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<sup>1</sup> The consultative document is available at [www.bis.org/publ/bcbs164.htm](http://www.bis.org/publ/bcbs164.htm).

<sup>2</sup> The proposal does not offer any views on when and how public sector support should be provided, or the legal authority for providing such support. Instead it simply sets out a series of consequences that will ensure that losses can be allocated to regulatory capital if such support is provided.

*cross-border and domestic financial groups. There is no international insolvency framework for financial firms and a limited prospect of one being created in the near future.”*

Nonetheless, reform of national insolvency law and bank resolution schemes is needed to create strong incentives for private sector solutions of failing systemically significant financial institutions. Effective bank resolution schemes can achieve more than the allocation of losses to regulatory capital and so the proposal in this consultative document does not diminish the need for these reforms.

Option 2, while apparently simple, suffers from some significant draw-backs:

- De-recognising subordinated debt funding for systemically-important institutions suffers from the problem that we first need to identify such institutions, which is not an easy task and potentially has associated moral hazard issues. Consequently, this option would likely mean prohibiting all banks from including Tier 2 instruments in their regulatory capital.
- The presence of subordinated debt funding that can be expected to take a significant loss at the point of failure of a bank can provide an important market mechanism that leans against excessive risk taking. This should work as a counter-balance to the common shareholders’ incentives, which could lean towards excessive risk taking, as a result of their unlimited upside, but limited downside (limited liability) at the point of failure and liquidation.
- Capital instruments issued by banks that are not systemically important are already fully loss absorbent on a gone-concern basis, as their subordination clause will be triggered in liquidation. De-recognising these instruments may reduce incentives to issue these instruments and thus reduce the benefits of the market mechanism described above and the protection for depositors.
- For a bank that is not taking excessive risks, subordinated debt should be cheaper than common equity. Thus, disallowing such funding is likely to increase the cost of a balanced funding structure for these banks.
- Spreads on a bank’s subordinated debt can be an important market indicator of the bank’s financial health and, thus, can provide a source of market discipline on undue risk-taking by the bank.

Given the arguments set out above, there are advantages in pursuing Option 3 in parallel with wider efforts underway regarding Option 1.<sup>3</sup> As a consequence, the Basel Committee has developed a proposal based on a requirement that the contractual terms of capital instruments will allow them to be written-off or converted to common shares in the event that a bank is unable to support itself in the private market.

The rest of this paper is structured as follows:

- Section 2: Background
- Section 3: Proposal and an explanation of the mechanism

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<sup>3</sup> Since an orderly resolution of an internationally active institution requires an internationally harmonised framework, one jurisdiction having a comprehensive resolution framework is not sufficient. Thus, until there is an internationally effective resolution framework, there will be a role for this proposal to play in terms of allocating losses to regulatory capital providers. However, as mentioned above, the adoption of this proposal does not diminish the need for an internationally effective resolution framework, and should not be viewed as its substitute.

- Section 4: Potential impact of the proposal on incentives
- Annex: Common questions and answers regarding the proposal

As set out in Section 3, the proposal is specifically structured to allow each jurisdiction (and banks) the freedom to implement it in a way that will not conflict with national law or any other constraints. For example, a conversion rate is not specified, nor is the choice between implementation through a write-off or conversion. Any attempt to define the specific implementation of the proposal more rigidly at an international level, than the current minimum set out in this document, risks creating conflicts with national law and may be unnecessarily prescriptive.

Industry practitioners are asked to work with national authorities to determine how the terms and conditions of capital instruments could be drafted to fully comply with the proposal set out in this consultative document whilst respecting all relevant national constraints.

The Committee is keen to assess whether there are operational or legal obstacles to implementation of the proposal. If respondents identify such obstacles they are asked to be as specific as possible in their submissions.

The Basel Committee welcomes comments on all aspects of the proposal set out in this consultative document. Comments should be submitted by 1 October 2010 by email to: [baselcommittee@bis.org](mailto:baselcommittee@bis.org). Alternatively, comments may be sent by post to the Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements, CH-4002 Basel, Switzerland. All comments may be published on the Bank for International Settlements' website unless a commenter specifically requests confidential treatment.

## **Section 2: Background**

If gone-concern is defined as insolvency and liquidation, then all regulatory capital instruments are loss absorbent on a gone-concern basis. This loss absorbency is achieved through the subordination of the capital instruments, which means that they will only receive any repayment in liquidation if all depositors and senior creditors are first repaid in full.

However, if we define gone-concern also to include situations in which the public sector provides support to distressed banks that would otherwise have failed, the financial crisis has revealed that many regulatory capital instruments do not always absorb losses in gone-concern situations. The numerous public sector injections of capital during the crisis and other forms of public sector support have had the indirect consequence of ensuring that in many instances capital instruments issued by banks that have been bailed out have not taken any losses at all.

The Basel Committee is of the view that all regulatory capital instruments must be capable of absorbing a loss at least in gone-concern situations. Furthermore, it believes that a public sector injection of capital needed to avoid the failure of a bank should not protect investors in regulatory capital instruments from absorbing the loss that they would have incurred had the public sector not chosen to rescue the bank.

To achieve this objective the Basel Committee has developed a proposal that would ensure all regulatory capital instruments are able to absorb losses in the event that a bank is unable to support itself in the private market including situations when the public sector steps in to recapitalise a bank that would otherwise have failed. Under this proposal gone-concern loss absorbency would continue to work through subordination in liquidation for failed banks when

the authorities allow them to enter liquidation. However, if the authorities choose to rescue a bank, then the proposal would give the regulatory authorities the option to require regulatory capital instruments (other than common shares) to be written-off or converted into common shares.<sup>4</sup>

The development of the proposal in this paper is driven by a desire to guarantee the gone-concern loss absorbency of all regulatory capital instruments (including cases when there is public sector support). This should also help in reducing a source of moral hazard<sup>5</sup>, seen by some as an underlying cause of the current financial crisis and a potential cause of future crises. In the absence of a presumption of public sector intervention, subordinated forms of funding should impose significant incremental costs on shareholders of firms that pursue increased rewards by assuming additional risk. This incremental cost is a direct consequence of the limited upside of subordinated forms of funding combined with their potential to receive little or nothing in insolvency. However, this deterrent mechanism, which should lean against excessive risk taking, is broken if the holders of subordinated funding see their downside as limited due to an expectation of a public sector bailout. The proposal in this paper should help revive this mechanism. Furthermore, by making the private sector the first source of new common equity to revive a bank that has become non-viable, this proposal should reduce the number of circumstances in which public sector rescues are deemed to be necessary.

### **Section 3: Proposal and an explanation of the mechanism**

The complete proposal is set out in the following box. It sets out the minimum that needs to be complied with at the international level in order to address the problem of instruments that do not bear losses when a failed bank is rescued by the public sector. The aim of this 'minimum necessary' approach is to allow each jurisdiction the freedom to implement the proposal in a way that will not conflict with national law or any other constraints.

Each element is explained in more detail in section following the box.

#### **Proposed minimum requirement**

##### **Scope and post trigger instrument**

1. All non-common Tier 1 instruments and Tier 2 instruments at internationally active banks must have a clause in their terms and conditions that requires them to be written-off on the occurrence of the trigger event.<sup>6</sup>

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<sup>4</sup> For non-joint stock companies the conversion could be into an instrument deemed to be fully equivalent to common shares in terms of capital quality, as provided for in footnote 19 on page 18 of the December 2009 consultative document *Strengthening the resilience of the banking sector*.

<sup>5</sup> As discussed in the annex, the proposal does not address all sources of moral hazard, eg the allocation of losses to senior debt, but does provide a mechanism that could be considered in this context.

<sup>6</sup> In Japan, preferred shares, together with common shares, are subject to write-down as stipulated in Article 106 of the Deposit Insurance Act. This mechanism would satisfy these requirements.

2. Any compensation paid to the instrument holders as a result of the write-off must be paid immediately in the form of common stock (or its equivalent in the case of non-joint stock companies).
3. The issuing bank must maintain at all times all prior authorisation necessary to immediately issue the relevant number of shares specified in the instrument's terms and conditions should the trigger event occur.

#### **Trigger event**

4. The trigger event is the earlier of: (1) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority; and (2) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority.
5. The issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

#### **Group treatment**

6. The relevant jurisdiction in determining the trigger event is the jurisdiction in which the capital is being given recognition for regulatory purposes. Therefore, where an issuing bank is part of a wider banking group and if the issuing bank wishes the instrument to be included in the consolidated group's capital in addition to its solo capital, the terms and conditions must specify an additional trigger event. This trigger event is the earlier of: (1) the decision to make a public sector injection of capital, or equivalent support, in the jurisdiction of the consolidated supervisor, without which the firm receiving the support would have become non-viable, as determined by the relevant authority in that jurisdiction; and (2) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority in the home jurisdiction.
7. Any common stock paid as compensation to the holders of the instrument can either be common stock of the issuing bank or the parent company of the consolidated group.

#### **Explanation of the elements of the proposal**

1. *All non-common Tier 1 instruments and Tier 2 instruments at internationally active banks must have a clause in their terms and conditions that requires them to be written-off on the occurrence of the trigger event.*

It is only by requiring a permanent write-off of the original regulatory capital instrument that a public sector injection of common equity will not have had the unintended consequence of bailing out the capital instrument holders. The original instrument holders cannot have any residual claim that is senior to the common equity injected and so a permanent write-off is necessary (conversion to common is still possible, see below). This necessity rules out any temporary write-down mechanism, which would by definition entail a contingent claim that would remain senior to any public sector injected common equity.

2. *Any compensation paid to the instrument holders as a result of the write-off must be paid immediately in the form of common stock (or its equivalent in the case of non-joint stock companies).*

This allows banks to immediately issue common stock on the trigger event as compensation to the instrument holders. Paragraphs 1 and 2 in combination therefore allow either a write-off or conversion to common stock on the trigger event. Jurisdictions are free to require banks to use either approach as they deem it to be appropriate.

It is important to note that it is the write-off of the capital instruments (required under paragraph 1 of the proposal) that increases the common equity of the bank and removes the possibility of the capital instrument holders remaining senior to any common equity injected by the public sector. The issuance of new shares simply affects the ownership structure of the bank after the trigger event.

Neither this requirement, nor any other requirement of the proposal, imposes a single method of calculating the number of shares to be issued on the trigger event. Each jurisdiction is free to impose such a method, or establish caps or minima on the number of shares to be issued, if they feel this is appropriate or necessary in their national context.

3. *The issuing bank must maintain at all times all prior authorisation necessary to immediately issue the relevant number of shares specified in the instrument's terms and conditions should the trigger event occur.*

This requirement is only relevant when the terms of the instrument include a conversion mechanism on the occurrence of the trigger event. This requirement should be read to mean that the terms and conditions of the instrument, especially those related to the conversion rate, should be set in a way that the conversion will not conflict with the relevant legal environment. It looks to avoid the situation where a bank promises to deliver a number of common shares, but when the trigger event occurs it is not in a position to deliver them. For example, the bank may not have sufficient authorised share capital to issue the shares specified in the contract. Therefore, the contractual terms need to work within the confines of what is permissible under national company law and the bank's articles of association. For example, if there is a legal cap on the number of authorised but unissued shares that a bank may have, as there is in many jurisdictions, all of the contracts of the capital instruments combined cannot be capable of requiring the issuance of new shares that exceed this cap.<sup>7</sup>

4. *The trigger event is the earlier of: (1) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority; and (2) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority.*

This links directly to the objective of the proposal, specifically identifying the circumstances under which the existing gone-concern mechanism (subordination) fails to work as intended. The design of this mechanism is such that it will not be triggered if the authorities deem it not to be necessary.

There are different views on whether a direct reference to a public sector injection of capital is appropriate, as it could give rise to expectations of such an outcome. An alternative version of the trigger would simply rely on the discretion embedded in part (2) of the trigger. The Basel Committee would welcome views on these options, particularly from investors in securities issued by banks.

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<sup>7</sup> This condition to specify a specified number of shares does not preclude the applicability of common contractual anti-dilution provisions.

5. *The issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.*

The dilution of the public sector rescue capital that could occur if conversion happened after the funds were injected would undermine the objective of ensuring that the public sector funds do not support the capital providers. It is therefore required that the issuance of any new shares occurs prior to any public sector injection of capital.

6. *The relevant jurisdiction in determining the trigger event is the jurisdiction in which the capital is being given recognition for regulatory purposes. Therefore, where an issuing bank is part of a wider banking group and the issuing bank wishes the instrument to be included in the consolidated group's capital in addition to its solo capital, the terms and conditions must specify an additional trigger event. This trigger event is the earlier of: (1) the decision to make a public sector injection of capital, or equivalent support, in the jurisdiction of the consolidated supervisor, without which the firm receiving the support would have become non-viable, as determined by the relevant authority in that jurisdiction; and (2) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority in the home jurisdiction.*

The combination of Paragraphs 1 to 5 and Paragraph 6 means that if Tier 2 is issued out of a subsidiary in a foreign jurisdiction and the issuing bank wishes it to be included in group Tier 2 capital, its conversion/write-off will need to be triggered by the earlier of the trigger event occurring at the home jurisdiction and the host jurisdiction. However, if the bank only wishes the Tier 2 capital to be included in regulatory capital at the subsidiary level, and not at the consolidated level, it would only need conversion/write-off to be triggered by the host jurisdiction. Similarly, the host regulator could preclude the issuance by any banks under its supervision of non-common tier 1 and tier 2 capital instruments with trigger events based on non-viability that are linked to events or decisions outside of the host jurisdiction or which would convert into shares of a foreign bank. The consequence of this decision would be that these instruments issued out of the subsidiary will not be recognised as regulatory capital at the consolidated level.

In simple terms, the conversion/write-down needs to be capable of being triggered by the jurisdiction in which it is given credit as regulatory capital. Therefore if it is issued out of a foreign subsidiary and is given recognition at both the solo level and the group level, both jurisdictions need to be capable of triggering conversion/write-down. The Basel Committee would particularly welcome feedback on this aspect of the proposal.

7. *Any common stock paid as compensation to the holders of the instrument can either be common stock of the issuing bank or the parent company of the consolidated group.*

As already highlighted, it is the write-off of the capital instruments (required under paragraph 1 of the proposal) that increases the common equity of the bank and removes the possibility of the capital instrument holders remaining senior to any common equity injected by the public sector. The issuance of new shares simply affects the ownership structure of the bank after the trigger event.

Banking groups, or jurisdictions implementing the proposal described in this consultative document, may wish to avoid the possibility that the conversion of subordinated debt capital in a subsidiary of a group removes full ownership of the subsidiary through creating new shareholders of that subsidiary. Paragraph 7 therefore allows the trigger event to lead to conversion into shares of the parent company of the group as an alternative to shares in the subsidiary bank. Under this alternative the same amount of common equity is created by the

trigger event, the only difference is that the instrument holders now receive shares in the parent company as compensation for the write-off of the capital instrument.

## Section 4: Potential impact of the proposal on incentives

Set out below is a summary of the potential impact of the proposal on incentives. It considers the incentives of both the common stockholders and the capital instrument holders.

### Common stockholders

- In the absence of a presumption of public sector intervention, subordinated forms of funding should impose significant incremental costs on shareholders of firms which pursue increased rewards by assuming additional risk. This incremental cost is a direct consequence of the limited upside of subordinated forms of funding combined with their potential to receive little or nothing in insolvency. However, this deterrent mechanism, which should lean against excessive risk taking, is broken if the holders of subordinated funding see their downside as limited due to an expectation of a public sector bailout. The proposal in this paper may help to revive this mechanism and reduce incentives for excessive risk taking.
- The mechanism by which the shareholders suffer the incremental costs of risk taking under the proposal depends on the conversion rate. The conversion rate could be considered to be a spectrum, on the one end zero shares are issued to the capital instrument holders on the occurrence of the trigger event (write-off), on the other end a high number of shares are issued:
  - **Zero shares (ie write-off):** the investors in an instrument that will have their claims wiped-out on the occurrence of the trigger event could be expected to charge the bank a higher coupon rate relative to an instrument that receives shares. Therefore if a bank issues a write-off instrument, common stock holders will suffer the consequence of increased risk taking through higher coupon rates on their non-common capital instruments.
  - **High number of shares:** the investors in an instrument that will receive a high number of common shares on the occurrence of the trigger event will be compensated for the write-off of their original instrument. In theory the number of shares could be high enough for the investor to be fully compensated in some cases, which will have implications for potential market discipline these investors impose. Relative to the write-off instrument, the investor could be expected to charge a lower coupon rate, as they receive something of value (some shares) at the trigger point rather than nothing. However, although the shareholders benefit from paying a lower coupon on such instruments, they will suffer more in terms of dilution should the trigger event occur.

So in both cases above, the shareholders of banks will suffer the cost of increased risk taking: In the case of the write-off mechanism this happens through shareholders having to pay high coupons on the bank's non-common capital instruments, and in the case when a high number of shares are issued, this occurs through dilution of ownership at the trigger event. In practice if a bank issues an instrument with a fixed or capped number of shares to be issued on the trigger event, the cost to shareholders will be borne through a mixture of higher coupon rates and dilution. It should not be surprising that ultimately shareholders will

bear any additional cost of the proposal with either a write-off or conversion approach, as they are the current beneficiaries of the expected public sector support.

A write-off can be viewed as a transfer of wealth from the instrument holder to the common shareholders, as the common shareholders escape the liability and the net assets to which they have a claim grow. So in the case when a write-off instrument has been issued it could be argued that the common shareholders may have an incentive to try to trigger conversion. However, the proposal is for a trigger based on the bank being labelled non-viable. It is likely that a bank's shareholders would be reluctant to try to get the bank to be labelled non-viable in order to trigger conversion.

### **Capital instrument buyers**

The proposal will help to ensure that the non-common capital instruments of a systemically important bank are capable of taking a loss when, or immediately after, the issuing bank becomes non-viable. Relative to the status quo this will make non-common capital instruments more expensive at banks that are, or are perceived to be, subject to a public sector guarantee. This will occur as the investors in these instruments charge higher coupon rates in response to being exposed to losses if the bank becomes non-viable.

The increased downside risk will provide an incentive for the investors in capital instruments to monitor the risks taken by the issuing bank. If a bank takes more risk, and the risk of loss to investors increases, buyers of existing instruments in the secondary market, or new instruments in the primary market, will demand a higher coupon. This sequence of events should help impose additional market discipline on banks.

The Basel Committee would particularly welcome feedback from market participants, including the investors in bank capital instruments, on the potential effects of the proposal described above.

# Annex

## Common questions and answers regarding the proposal

In the course of the development of the proposal set out in this consultative document, several common questions were raised. These questions, along with tentative answers, are presented below. This Annex identifies some specific issues on which the Basel Committee would welcome feedback from industry participants. Respondents should not feel limited to commenting on these specific items.

### **Would the development of effective bank resolutions schemes be a better approach to ensuring gone-concern loss absorbency?**

Introducing a global bank resolution framework is the ideal solution. A strong bank resolution framework achieves more than just imposing losses on non-common capital instruments, so even if the proposal set out in this consultative document is adopted, the necessity of having a strong resolution framework does not diminish. However, as the proposal is based on contract law it can be implemented over a shorter time-frame and serve as an option for authorities to impose losses on capital instruments prior to the introduction of comprehensive resolution frameworks that can impose losses on a wider variety of funding.

In terms of the possibility of imposing losses on subordinated debt holders, the greater the effectiveness of wider efforts to reduce the extent to which systemically-important banks exist, or can be effectively resolved without public sector intervention, the more the cost of the proposal will trend to zero, in terms of the risk premium subordinated debt investors would require. This is because if such efforts are successful, the market will no longer expect a public sector bailout that triggers write-off/conversion. Furthermore, the mechanism may help ensure that banks in jurisdictions that already have effective bank resolutions schemes are not at a significant disadvantage in terms of cost of capital to banks in jurisdictions without such schemes (ie all banks would be able to compete at a more equal footing without some banks benefiting from the perception of public support).

### **Would it be simpler to de-recognise Tier 2?**

While de-recognising Tier 2 capital has the advantage of simplicity, the proposal in this paper may have certain key advantages over this approach:

- Generally speaking, the presence of subordinated debt funding, which can be expected to take a significant loss at the point of failure of a bank, can provide an important market mechanism that leans against excessive risk taking. This should work as a counter-balance to the common shareholders' incentives, which could lean towards excessive risk taking, as a result of the limited liability of shareholders.
- Capital instruments issued by banks that are not systemically important are already fully loss absorbent on a gone-concern basis, as their subordination clause will be triggered in liquidation. These banks should be allowed to fail without conversion being triggered. De-recognising these instruments may reduce incentives to issue

these instruments and thus reduce the benefits of the market mechanism described above and the protection for depositors.

- De-recognising Tier 2 for systemically-important institutions suffers from the problem that we first need to identify such institutions, which is not an easy task and potentially has associated moral hazard issues.
- For a bank which is not taking excessive risks, Tier 2 subordinated debt should be cheaper than common equity. Thus, disallowing Tier 2 is likely to increase the cost of a balanced funding structure for these banks.
- Spreads on a bank's subordinated debt are an important market indicator of the bank's financial health and, thus, can provide a source of market discipline on undue risk-taking by the bank.

### **Will this not impose unnecessary costs on small banks?**

If the market expects a bank to be allowed to fail without public sector intervention, it will not expect the conversion of the capital instruments to be triggered (as conversion is only triggered for banks which the authorities decide need to be rescued). So, although it is proposed that the conversion/write-off term be included in all capital instruments issued by all banks subject to the Basel capital regime, this change could be expected to only impose additional costs on those banks that are benefiting from market expectations of a public sector bailout.

Banks that the market perceives as being small and simple enough to be allowed to fail are likely to be currently at a significant competitive disadvantage in terms of cost of funding relative to larger banks with perceived public sector backing.<sup>8</sup> The proposal could significantly level the playing field between small and big banks.

### **Would the proposal change the investor base?**

Traditional debt instruments pay a pre-specified rate of return in normal times, but give a variable return (equity risk) in certain times of extreme stress, such as liquidation or restructuring inside of bankruptcy/resolution proceedings (eg Chapter 11 in the US). Under bankruptcy proceedings the holders may negotiate a conversion to common stock in return for writing-off their fixed debt claim.

The proposal simply requires that any conversion to equity under a failure situation is able to occur as an alternative to the bank entering bankruptcy/resolution proceedings and without the need for protracted negotiation - which may not be possible for a systemically-important or internationally complex bank during a crisis. As the proposal retains the essential debt characteristics of the relevant instrument and does not give the holder equity risk outside of a failure situation, it should not be viewed as traditional convertible debt by investors, accountants or tax authorities. The Basel Committee would welcome feedback from investors in bank capital, accounting firms and tax experts on these issues. Finally, even if

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<sup>8</sup> The proposal in the paper does not seek to address the competitive equity issues associated with public sector bailouts of small banks which could fail without systemic consequences.

the investor base did change, it could be questioned whether it is desirable to continue relying on a certain investor base if the implicit or explicit public sector guarantee is needed to attract them.

### **What if the holders of the capital instruments are not permitted to own shares in the bank?**

Some potential owners of shares after any conversion may not be able to receive them (eg they may not be considered suitable owners of a bank, or they may be a fund which is not able to invest in equities).

A possible solution to this problem, if we wanted to avoid changing the investor base, could be to issue the new shares into a public sector-owned or charitable trust and immediately cancel the obligations of the bank to the capital holders. The owners of the relevant capital instruments get a transferable note issued by the trust which entitles the holder to the delivery of the shares conditional on the holder being entitled to receive them. If the owners of the transferable note can take delivery of the shares, then they will do so, if they cannot they can sell them to someone who can. Until such a time that the new owners take delivery, the trust has the voting rights on the shares. This is just one possible solution, and there may of course be others and the Basel Committee would welcome feedback from banks or their advisors on ways that these issues could be best addressed.

### **Would it be better to have an automatic trigger for conversion/write-off linked to some market variable or regulatory ratio?**

An automatic trigger for conversion/write-off, such as when credit spreads or share prices hit certain specified levels, or when regulatory ratios fall below certain levels, have the advantage of transparency. However, these triggers have a number of potential problems, particularly in relation to the proposal in this paper.<sup>9</sup> Firstly, we do not know what the future crises will be like and so we will not be able to design conversion triggers that are robust to all possible outcomes and which do not have, as facts actually unfold, unintended and hard-to-manage consequences. Secondly, we do not want all banks to be rescued via the conversion/write-off mechanism, as many should be allowed to fail and enter the traditional insolvency/resolution procedures.

### **How would the approach apply to capital issued out of subsidiaries, could this not lead to the break up of a group?**

If conversion was triggered in relation to capital issued out of subsidiaries it could create minority interest, or even result in a change of control in relation to a subsidiary. Therefore in theory the option, similar to any insolvency or resolution procedure, could lead to the break-

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<sup>9</sup> The balance between the pros and cons may be different in respect of other contingent capital proposals, such as proposals to improve the going-concern loss absorbency of regulatory capital or proposals to allow contingent capital to meet buffer requirements.

up of a group. If the national supervisor and/or public sector wanted to avoid the change in control, it could, in addition to the minimum requirements set out in this document, set a cap on the amount of common stock to be issued on the trigger event, or could require a simple write-off. Another option would be to have the subordinated debt convert into common stock of the parent, which is typically the level that has issued publically traded stock.

### **Would we not be transferring the problem of a failing institution to the insurance companies and pension fund sectors that hold the bank capital?**

Regulatory capital must be capable to taking a loss, otherwise it should be given no credit as regulatory capital. Insurance or pension fund supervisors should ensure that these entities are capable of withstanding losses on their holdings of bank capital instruments. The Basel Committee will work with these other supervisory agencies to ensure that they are aware of the impact of any changes in the loss absorbency of bank capital instruments.

### **How can we be sure that the conversion/write-off is not considered a default?**

The issuing contract will need to establish clearly that conversion/write-off is not an event of default. Furthermore, banks should be prohibited from including cross default clauses in other contracts. Under the ISDA Master Agreement with common amendments, initial analysis suggests that conversion/write-down would not lead to events of default or trigger cross-default clauses in derivatives. The triggering of the conversion/write-down would not amount to a failure to pay when due, since the contract would state that payment is no longer due after the trigger point. Meanwhile, an event of default is in turn required to trigger cross-default clauses. There have also been cases where conversion or write-off of certain capital instruments was forced upon by law or by the power of the authority which have not triggered the cross-default clauses in some jurisdictions. It will of course not be possible to determine precisely what interpretation the analysts and the financial industry would give to such a conversion/write-down, but the Basel Committee would welcome the views of analysts and wider financial industry on this point and the proposal more generally.

### **Does conversion/write-off improve loss absorbency even though it does not bring in new money?**

It is important to distinguish between capital and liquidity. Conversion/write-off will transfer debt instruments into higher quality common equity capital with better loss absorption characteristics. The result will be an increase in the institution's ability to withstand further losses. As a consequence, the room for new issuances of non-common instruments in the future is enlarged. Conversion/write-off can be seen as having the direct and immediate consequence of improving the quality of capital. This should have the indirect consequence of improving the bank's access to private sources of additional capital and liquidity and may, in fact, facilitate private sector rescue reducing the likelihood that a public sector bail-out would be necessary.

## **Could banks be encouraged to issue instruments with a conversion/write-off feature by giving some additional credit, rather than by making this feature a requirement?**

It has been shown that in many jurisdictions it is not always possible to make Tier 2 instrument holders share losses in public sector bailout scenarios of systemically important banks. Encouraging banks to issue instruments that will bear losses could reduce this problem if the incentives were big enough, but it would not eliminate it.

In order to ensure that all regulatory capital is capable of bearing losses, it is necessary to make the conversion/write-off feature a requirement for all non-common Tier 1 and Tier 2 regulatory capital instruments. In jurisdictions that can make Tier 2 holders share losses, eg through a bank resolution framework, the relevant supervisory authority can clarify that the conversion/write-off feature is not likely to be triggered and that the losses will be visited upon such Tier 2 capital through the resolution framework. However, it 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.

## **Could the proposal reinforce moral hazard in relation to senior debt?**

The proposal set out in this document aims to solve one very specific problem, which is that there is no internationally consistent mechanism by which all capital instruments at all internationally active banks can be made to suffer a loss in the event that a failed or failing institution is rescued through a public sector capital injection. Parallel efforts are ongoing to ensure that all banks that fail are capable of being effectively resolved and losses allocated to both senior and subordinated instruments. The proposal in this document should not be viewed as an alternative to effective resolution schemes, but rather a complement.