Basel III - Regulatory capital

The Austrian Federal Economic Chamber, Division Bank and Insurance, as the legal representative all Austrian credit institutions, welcomes the opportunity to comment on the BCBS Consultation Paper on ensuring the loss absorbency of regulatory capital at the point of non-viability. We would like to provide our comments as follows:

1. General Remarks and Concerns

As its starting point the Consultative Document looked to the experience gained during the current financial crisis, according to which recognised regulatory capital did not contribute to the compensation for losses incurred. The aim is to ensure this for future crisis situations using the discussed measures, which in essence involves reducing the use of subordinated capital instruments and compulsory conversion into hard capital, thus avoiding or reducing the strain on public budgets, on the one hand, and heightening the pressure for market discipline, on the other.

We are especially critical of the fact that the present proposal challenges the concept involving going-concern and gone-concern capital put forward by the Basel Committee. It is unclear whether this is an approach to prevent capital subsidies of the state in systemic banks or whether the definition and set-up of the capital structure is to be modified.

We are opposed having the Consultative Document anticipate the definition of “systemically important/internationally acting bank”, which is of such significance in the overall concept of Basel III to be anticipated.

These proposals would also need to be examined within the framework of an overall concept for crisis management. This topic alone gives rise to a plethora of problems and issues.

Level of Detail

The present consultation paper is held on a very much aggregated level. Although the approach of the BCBS is well understood that interference with national laws should be
avoided anyway, more detailed guidance is necessary to ensure the envisaged level playing field.

Furthermore we would like to point out that despite this approach there will occur legal constraints implementing these principles - especially in corporate law (e.g. legal limits of approving/creating new shares) and tax law (e.g. regarding tax deductibility). This might cause difficulties in the national implementation and lead to different, not convergent implementations. Especially to avoid the latter case more detailed guidance is needed.

“Non-Viability”

Although the declared objective of the paper is to ensure loss absorbency in the case of “non-viability” and one of the triggers for the write off/conversion mechanism is to avoid “non-viability”, a definition of “non-viability” is missing. Furthermore we would like to highlight that according to our knowledge “non-viability” is already used under different definitions and meanings in various jurisdictions.

We are of the opinion that to ensure level playing field another clear defined term instead of “non-viability” would be sensible. If BCBS decides to stick to the term “non-viability” at least a comprehensive definition of “non-viability” is necessary to ensure convergent usage over all jurisdictions.

Furthermore we would like to point out that not every case of “non-viability” can be solved by write off-features and/or conversion-features. Thus it should be made clear that the write-off/conversion-features can only be triggered in cases, where the write-off/conversion-feature is appropriate and adequate to achieve sustained “viability”.

Scope

Regarding the scope we would like to point out that it is not clear
• why the paper focuses on “internationally active bank” and
• what the definition of an internationally acting bank is.

The scope doesn’t cover all systemically important banks due to the fact that systemically importance is not necessarily conjunct with cross border business. Thus an appropriate clarification regarding the scope seems to be necessary.

Capital Structure - Trigger

Regarding the trigger events and the write off/conversion-mechanism we would like to highlight as a general concern that the relationship between the write-off/conversion factor ensuring loss absorbency in a gone-concern/"non-viable" situation and going-concern capital (common equity, retained earnings and additional Tier-1-capital) is not clear and the until known system - as also maintained in the December-Paper by the BCBS - is mixed up.

The realization of a trigger-event leads to the result that additional Tier-1 and Tier-2-capital become junior to common equity, which impedes the system of the capital structure of the BCBS-December-Proposal. Due to this result we are of the opinion that the range of investors willingly to invest in instruments without a conversion-mechanism, where these instruments will (at least partly) be swapped into common equity, will be very tight. Thus we fear that the acceptance by investors of instruments with only a write-off-feature implemented will be low.

The purpose of trigger (2) remains completely unclear. Regarding trigger (2) the Consultation Paper states as trigger event: “a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority”. In our view this
trigger implemented in a Tier-2-instrument contradicts the BCBS-December Paper. According to the BCBS-December-Paper Tier-2-capital should bear losses in only “gone-concern” situations, e.g. liquidation. But according to this Consultation Paper Tier-2-instruments should be written off to avoid a gone-concern-situation or a non-viability-situation. Thus trigger event (2) would make Tier-2-capital loss absorbent in going-concern-situations, when decided by the competent authority.

We are critical of the view taken by the supervisory authorities that a bank would be unable to survive without these measures, since this would imply supervisors having have a high level of discretionary decision-making. This uncertainty for investors would require a marked premium on the necessary yield. What is more, there is the risk of significant distortion in competition if individual national supervisors were not to act consistently in this context.

Thus the proposed draft Consultation Paper would furthermore diminish the differentiation between additional Tier-1-capital and Tier-2-capital. This would be a result we strongly oppose. We are of the opinion that Tier-2-capital is and should also be in the future a useful completion of a diversified capital structure of a 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 the market participants.

Furthermore we would like to point out that - in any case - the hierarchy of loss absorbance of regulatory capital has to be maintained also in situations of “non-viability”. It has to be ensured that in a first step the going-concern-capital is used to cover losses before gone-concern-capital is used. This hierarchy has to be also incorporated accordingly in any required trigger events.

Contingent Capital
The above mentioned fact that under certain circumstances additional Tier-1-capital and Tier-2-capital becomes junior to common equity in going concern situations should also be beard in mind regarding the eligibility for common equity. In our opinion additional-Tier-1 and Tier-2 capital instruments with conversion features should be eligible (with defined haircuts) as common equity. If these instruments are not recognized as common equity, they should in any case be eligible for fulfilling the capital conservation and/or countercyclical capital buffer requirements. Lastly the BCBS should give some guidance on how these instruments should be treated under Pillar 2.

Furthermore we would like to highlight that neither the BCBS-December-Paper nor the present Consultation Paper give guidance, if and to what extent the overspill of additional Tier-1-instruments is at least eligible for fulfilling Tier-2-requirements. In our opinion additional Tier-1-instruments complying with all regulatory requirements of Tier-2 should be eligible due to the fact that the Tier-2-requirement would be fulfilled by capital of higher quality.

Questions raised by the BCBS
Coming to the questions raised by the BCBS we would like to comment on these as follows.

Would the development of effective bank resolution schemes be a better approach to ensuring gone-concern loss absorbency?
This concept is very unclear and the thus the answer depends on the details.

Would it be simpler to de-recognize Tier 2?
We oppose the option of de-recognizing of Tier-2. Different banking structures allow different capital- and funding-structures (as also highlighted in the Consultation Paper itself). Thus
Tier-2 is a useful and necessary element within capital allocation and funding-strategies of all banks. But we also refer to our remarks and concerns under 1.4. A clear and significant differentiation between additional Tier-1 and Tier-2-capital will be essential for the investor’s and market’s acceptance of Tier-2-instruments.

**Will this impose unnecessary costs on small banks?**
It is unclear what is meant by “unnecessary costs”. If small banks will need to implement those loss absorbing features as well (please see page 11of the Consultation Paper: “...although it is proposed that the conversion/write-off term be included in all capital instruments issued by all banks subject to the Basel regime”) they will have to bear the higher costs for this features. On the other hand side these features will provide no upside potential as a government bail out is highly unlikely.

In general the level playing field between all banks has to be ensured.

**Would the proposal change investor base?**
Even including the proposed write-off/conversion features, the instruments still will be acknowledged as fixed income instrument. Given those features however the debt investor universe will initially be reduced significantly given that this type of investors have been most against convertible and permanent write-off features. Additionally any trigger based on regulatory discretion will not easily find the acceptance of capital markets (both investors and rating agencies). One big rating agency has already stated that it will currently not rate instruments where the trigger is left exclusively to regulatory discretion.

When and if an active market develops for these instruments, it is very like to be highly volatile, because the instruments are potentially linked to rumours on any particular name.

The exact determination of the trigger event and the degree of discretion of regulators therefore will be from essential importance.

**What if the holders of the capital instruments are not permitted to own shares in the bank?**
We think that the BCBS proposal to install a public sector owned fund might be a suitable solution. Furthermore this solution could help to bridge any time consuming fit&proper tests which have to be conducted by the competent authorities. Especially in crises situations adequate measures have to be taken promptly. Legally stated fit & proper tests of new (qualified) owners of a bank might lead to harmful delays with regard to conversion of regulatory capital into common shares. Thus e.g. a legal presumption that the public sector owned fund is a suitable owner for a bank could be a solution to effectuate the conversion clause without delays.

**Would it be better to have an automatic trigger for conversation/write-off linked to some market variable or regulatory ratio?**
First of all we would like to highlight that investors are highly reluctant to invest in debt-instruments with write-off-conversion-triggers dependent exclusively on regulatory discretions. Furthermore rating agencies have already expressed concerns and reservations regarding the evaluation of such instruments. One big rating agency even rejects the evaluation of such instruments.

Thus although the approach of the BCBS is well understood that every crises in the past was different and therefore the definition of a for all cases suitable market variable and/or regulatory ratio seems to be very difficult. Once again for defining such market variables a clear and comprehensive definition of “non-viable” will be crucial to ensure level playing field.
How would the approach apply to capital issued out of subsidiaries, could this not lead to the break up of the group?
We would like to point out one specific home/host issue with regard to the conversion into common stock. If the conversion is done into common stock of the parent company there is no risk of breaking up the group, but the loss absorbency on subsidiary level might be not that effective - especially in cases where the trigger event is realized only on subsidiary level (and the new common equity capital is realized only on parent level). On the other hand side if the conversion is done into common stock of the subsidiary, the group could break up or at least minority interests would occur. Due to the fact that according to the July-Annex of the BCBS regarding the new definition of capital the excess capital assigned to the minority interest will not qualify for Core-Tier-1 on parent level, the common equity capital base on consolidated level will be weakened and thus loss absorbency effect on parent level will be diminished.

How can we be sure that the conversation/write-off is not considerer a default?
The definition of "non viability" and its positioning against "gone concern" and "default" is the key. Thus we firstly refer to our general concern regarding the missing of a comprehensive definition of the term “non-viability”. If such a clear definition is provided we see no danger that conversion/write-off could be seen as a default.

However we would like to point out that BCBS presented concept entails many critical points which have to be considered, such as dependency from complex technical definitions which have to be found and controlled, dependency from a (local) regulator's discretion, challenge of an appropriate risk assessment for potential investors (and consequently reluctance to buy such products), valuation problems, accounting problems, only to name a few.

Does conversation/write-off improve loss absorbency even though it does not bring new money?
In general we agree with the arguments of the BCBS. But we are not convinced that - especially when the trigger event (2) is realized - in any case an improvement of the bank's access to private sources of capital and liquidity will be reached.

Could banks be encouraged to issue instruments with a conversion/write-off feature by giving some additional credit rather than making this feature a requirement?
We would prefer an effective and encouraging incentive structure rather than a mandatory requirement. One possible credit to be taken into account for banks, which include the write-off/conversion clause in their terms and conditions of regulatory capital, could be to liberate them (fully or partially) from payments to possible resolution funds. Furthermore haircuts regarding the (pre-funding) contributions to the deposit guarantee schemes could be an effective incentive. The quantification of possible incentives should reflect the significantly reduced possibility of failing because of the write-off/conversion clause included in regulatory capital.

Yours sincerely,

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