Dear Sir/Madam:

Re: **IBFed Comments on the Basel Committee’s Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability consultative document**

The IBFed appreciates the opportunity to comment on the Basel Committee’s consultative document entitled *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability*.

We understand the view that contingent and convertible capital instruments can play an important role in ensuring that banks are capable of absorbing losses and we welcome the Committee’s interest in alternative regulatory capital. We support the fundamental premise of the paper, that holders of regulatory capital instruments should absorb losses at the point of non-viability. We are supportive of the concept of contingent capital as one possible vehicle for providing a loss absorbing cushion in times of stress.

However, we believe that there is a need for further study and analysis of these instruments in light of the full range of systemic risk proposals under consideration. Moreover, different corporate law, insolvency legal regimes and accounting approaches may need to be reconciled and accommodated in order to avoid significant competitive distortions across countries. For example, if tax deductibility would not be achievable in some jurisdictions, this would deserve particular attention. Without deductibility, the cost of these instruments may approach that of common equity, which would put further pressure on cost of capital. That said, it is important to avoid asymmetric implementation of any contingent capital scheme that could create competitive inequality among banking institutions in different jurisdictions.
depending on the timeline and scope of implementation or structural inconsistencies across instruments.

It needs to be observed, finally, that regulatory capital instruments that are loss absorbing at the point of failure are not the only answer. They are one of a range of techniques, and perhaps not the principle one, that can be deployed to mitigate the impact on society of the failure of a bank. These techniques should seek to reduce the risk of a bank’s failure as well as the impact of its failure. Gone concern capital has a role to play in reducing the public impact of a bank’s failure but a far more important tool will be the development of effective resolution schemes that will properly address the failure of an internationally active bank, operating across international borders via branches and subsidiaries. As the Consultative Paper does not fail to highlight, “effective bank resolution schemes can achieve more than the allocation of losses to regulatory capital” (page 2).

Our specific Comments on the Consultative Paper are as follows.

We are concerned about the fragmented approach which the Consultative Paper adopts. The Consultative Document merely covers gone concern capital. Whilst we await with interest the forthcoming proposals which the Committee is preparing in the area of going concern contingent capital, we believe that presenting both proposals together would have been far more appropriate as an analysis of the whole package would have allowed adopting a more encompassing approach and would, moreover, have contributed to avoiding blurring the distinction between “gone concern” and “going concern” capital, including their conceptual foundations.

We also note that it is critical to the sound health of a bank to maintain access to a diversified and deep investor base to support capital issuances. Against this backdrop, we believe that banks should have the option to issue “gone concern contingent” capital instruments as one element of a capital structure, if they best meet the needs of the bank and its investors. For some banks, the issuance of such capital instruments may be a good option for meeting capital buffer requirements. Other banks may find gone concern contingent capital issuances inefficient or ineffective for a variety of reasons – tax considerations if dividend payments on the instruments are not deductible, restrictions under their chartering instruments, or insufficient investor interest. So there should be no compulsion for banks to hold a certain proportion of such capital.

The crucial question that needs to be answered first and foremost is whether market participants will indeed be prepared to accept the proposed mechanism and, if so, whether there will be a sufficient market appetite to meet the demand. Our understanding is that a trigger which would involve an element of supervisory discretion would not be marketable as market participants require that a trigger is predictable. This implies that the trigger needs to be transparent and objective. Moreover, the market capacity for gone concern contingent capital is untested and may be inadequate. It would be essential to have the support of a broad investor base, particularly fixed income investors, in order for banks to issue benchmark sized transactions that are cost-effective. However, the conversion feature conflicts with the investment mandates of many debt investors who are precluded from investing in instruments that could be converted to equity. This is especially significant from a market capacity perspective since the purchasers of these instruments are predominantly institutional investors which make larger issuances possible and are a fundamental driver of market capacity for bank capital instruments generally.
Finally, our understanding is that the proposed measure would not have a retroactive impact and, therefore, only apply to future issuances of non-common Tier 1 and Tier 2 instruments.

We would like to thank you for considering our comments and would be pleased to supply additional information at your request.

Yours sincerely,

Mrs Sally J Scutt
Managing Director