Dear Sir or Madam,

We are pleased to provide our response to the Basel Committee on Banking Supervision’s (“BCBS”) consultative document “Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability” (BCBS 174). We are generally supportive of the BCBS’s efforts to reform banking regulation and much of the progress made to date, although we are concerned about the undue emphasis being placed on regulatory capital as part of the Basel III reform package and disappointed about the delay in implementing the proposed new liquidity standards given the lessons of the crisis. Indeed, we expressed grave concerns and our opposition to the countercyclical capital buffer proposal in our recent response to that consultation.

We strongly believe that there needs to be a greater focus on improving the effectiveness of banking supervision, and on developing a viable resolution regime which enables the orderly wind-down of all failing institutions, not just internationally active banks. Furthermore, we believe that the losses of a failing bank should be shared by all holders of its capital instruments at the point of non-viability in accordance with the subordination hierarchy that would apply during liquidation. There was a missed opportunity during the recent financial crisis to ensure that the capital holders of the failed institutions bore their share of the losses incurred. We believe that the bail-in concept, which has been the subject of much debate in recent months, has a lot of merit and could be an important component of a workable resolution regime, although it would only be effective when the institution in question is effectively determined as a gone concern. Any assumption that a bail-in might work separately from a much broader restructuring would be misconceived. In isolation, as a measure, a bail-in would only accelerate the immediate market withdrawal of liabilities (retail and wholesale) from the institution in question.

We have a number of observations to make on the Committee’s proposal to ensure the loss absorbency of regulatory capital at the point of non-viability, i.e. when a bank would become a gone concern without public sector support, which we will set out below but it is important that this proposal is considered in the context of how best to address bank resolutions. We also need to recognise that the proposal in itself is unlikely to result in public sector support being avoided or even the amount of support needed being reduced.
Developing an Effective Resolution Regime

The latest BCBS consultation describes the development of national and international bank resolution frameworks as one of three options that could be used to ensure that regulatory capital instruments are capable of bearing losses, the other options being the exclusion of Tier 2 instruments from regulatory capital for systemically important banks and the inclusion of provisions in the terms and conditions of regulatory capital instruments that ensure that they take a loss at the point of non-viability. We believe that the development of an international resolution regime is the only effective way of dealing with failing firms, addressing the moral hazard issue and avoiding recourse to the taxpayer. Such a regime should maintain traditional hierarchies of subordination, as far as possible, based on corporate and contract law. Whilst the development of a resolution regime on an internationally harmonised basis will be challenging, this should not be a reason to pursue other less effective avenues, and it is important that responsibility for undertaking this work is allocated now so that the work can begin. It is essential that the development of other regulatory proposals do not distract policymakers from this objective.

There has been considerable work undertaken in the past year by policymakers and the banking industry to develop a suitable resolution regime, including the development of recovery and resolution plans, bail-ins and new forms of regulatory capital instruments. We have been actively supporting this work as we feel that it draws upon many of the lessons of the crisis, including the need for banks and supervisors to be better prepared for future crises, for banks to develop suitable capital and liquidity contingency plans, and for regulatory capital to be available to absorb losses on a going and gone concern basis, as intended.

Observations on Key Aspects of the Proposal

1. **Scope**

   It is not clear why only internationally active banks should be captured by the proposal. A number of domestic banks failed during the crisis with a significant impact on their national banking industry and economy. Furthermore, requiring only certain banks to have the proposed capital instruments would increase moral hazard – these banks and their stakeholders would assume that public sector support would be provided in a crisis. So we would argue that any proposal should apply to all banks. In addition, the proposal does not differentiate between non-equity Tier 1 and Tier 2 capital instruments, although in the Committee’s December 2009 BCBS 164 consultative document, the former is required to absorb losses by conversion to equity or through a write-down mechanism. Given that the Committee is working on other ideas for going concern capital instruments, it is important that the respective role of each type of instrument is made clear.

2. **Triggers**

   We have serious concerns about the potentially negative impact that triggers for conversion in regulatory capital instruments can have on individual institutions and the broader industry. They can send negative signals to the market, especially when a trigger is
approached, which could exacerbate the problems faced by a bank in distress and reduce confidence in its peers. Furthermore, the fact that the trigger event is to be determined at the discretion of the relevant authority is likely to increase investor uncertainty and reduce the appetite for such instruments. Investors have advised that triggers should be transparent, measurable and objective which is difficult to reconcile with the desire of resolution authorities to have a significant degree of discretion. Certainly, the second component of the BCBS’s proposal that a decision that a write-off is necessary, determined by the relevant authority in the home jurisdiction, should trigger conversion or write-off appears too subjective. We believe that the trigger event needs to be linked to the statutory triggers that would be applied to enable resolution powers to be executed in the jurisdiction of the failing bank, e.g. where powers are granted to put a failing bank into temporary public ownership or establishment of a bridge bank.

It is not clear whether the conversion ratio or the extent of any write-off is intended to be set at the time that the capital is issued or at the point at which conversion or write-off occur. It is critical to evaluate the various trigger options available to ensure that unintended consequences are not introduced. The Committee should consult closely with the investment community to understand their concerns and requirements, and not rely solely on the written responses to this consultation, as these may not include comprehensive responses from the full spectrum of investors in bank capital.

3. **Cross-Border Banking Groups**

It is not clear how the proposal will work for a cross-border banking group or how supervisors will interact and cooperate through the auspices of the supervisory colleges and crisis management groups. There is a considerable risk that international banking groups would end up being significantly over-capitalised and this would adversely impact on their ability to support international trade, financing and investment flows. The role of Pillar 2 needs to be reviewed to ensure that it operates effectively in a Basel III world, particularly for cross-border and complex groups. It is essential that such groups are closely involved in the development of these supervisory processes as we can play a pivotal role in helping to align regulatory thinking across jurisdictions and ensuring that new approaches are workable and do not have unintended consequences.

The proposal provides host regulators with the scope to prevent non-equity Tier 1 and Tier 2 capital issued by a subsidiary from being recognised as regulatory capital at the consolidated level. This has considerable implications for the efficient deployment of capital across an international banking group and we are very concerned about the impact on the cost of these instruments. Conversion of capital instruments issued by a subsidiary to equity could result in the creation or increase in minority interests at the consolidated level which could have a negative impact on the capital position at the group level. We are also concerned that the proposal’s focus on international banking groups will adversely impact the subsidiaries of such groups when raising capital in their local markets relative to local competitors, as investors are likely to be more attracted to the capital issues of local and other banks that are not required to meet these proposed requirements, particularly in respect of Tier 2 capital. The proposals would appear to increase the attractiveness of
branches over subsidiaries and the implications on the debate on banking structures needs to be considered.

4. **Investor Appetite**

The investment mandates of the major holders of debt capital instruments, i.e. pension and insurance funds, and the composition of the indices used to assess the performance of these funds, need to be carefully considered. Fixed income investors have expressed doubts about whether they would be able to invest in capital instruments capable of converting to equity. They have even suggested that the returns on such instruments would have to be higher than for equity capital to incentivise them to invest in them, given the potential downside and no upside after a trigger event, and the increase in funding costs would have a knock-on effect on customer pricing. Even if fixed income investors were able to resolve the issues with their investment mandates, they have advised that their appetite for the proposed new instruments would be substantially lower than for existing fixed income instruments. We also understand that fixed income investors do not have suitable resources for evaluating the risks and issues associated with equity-like investments, so would need to build this capability if they were to invest in such instruments in the future.

Whilst we accept the arguments made by the BCBS for write-offs on the occurrence of the trigger event to be permanent, this would mean that the holders of such instruments would be worse off than the original equity holders in the event that the bank recovers, and would compromise the objective of providing a counter-balance to excessive risk-taking by existing equity shareholders referred to in the BCBS’s consultative document. Temporary write-offs should improve the marketability of the proposed instruments. It is also important to consider the credit rating implications of the proposed new requirements.

5. **Implementation Challenges**

Considerable work will be required to understand and address the legal, accounting and tax issues arising from the proposals. We would like these to be considered in detail, including the tax efficiency of the proposed instruments. There will be issues around the pre-emption rights of existing equity holders in certain jurisdictions and changes would be required to European corporate law to enable the issue of more than 10% equity capital to new investors. The need to have prior authorisation to be able to issue new shares immediately may not be possible in practice, particularly if the conversion rates are not set at the time that the instruments are issued. In a banking group, the conversion of a subsidiary’s Tier 2 capital to its parent’s equity may not be permissible under local statutory or regulatory requirements. In addition, conversion of these instruments to equity would limit further capital raising options and there will be challenges in accounting for them.

**Conclusion**

The proposal has some merits but needs to be developed in the context of an effective resolution regime, capable of being implemented on an international basis. Progress has been
made in the development of the bail-in concept as a key component of a broader resolution regime, and we would encourage the BCBS to support this initiative. We would also request that the Committee articulates its views on the respective roles of the various forms of regulatory capital in both going and gone concern situations, as it is not quite clear how the current proposal is intended to operate in conjunction with the revised definitions of regulatory capital (as outlined in the proposals published in December 2009 and affirmed in the “broad agreement” of the Group of Governors and Heads of Supervision of 26th July 2010). Clarity should also support a return to more normal activity in the capital markets.

We will continue to engage in what we trust is seen as constructive dialogue to improve the resilience and sustainability of the banking industry and to enable it to continue supporting economic recovery and growth.

Yours faithfully,

Pam Walkden
Group Treasurer