Comments by the Zentraler Kreditausschuss on the Basel Committee’s Consultative Document “Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability”

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The rules proposed by the Basel Committee on Banking Supervision are designed to ensure, in the event that a bank reaches a point of non-viability which can only be averted by a public “bail-out”, e.g. injections of capital, that losses are allocated to all the capital instruments (both Tier 1 and Tier 2) held by the bank. The Basel Committee rightly criticises the fact that, during the financial crisis, losses were not absorbed by all capital instruments (notably Tier 2 instruments) held by banks that were rescued with the aid of public resources.

Option 1 in the consultative document from the Basel Committee proposes developing national and international bank resolution frameworks that enable losses to be allocated to all capital instruments negotiated by internationally active banks that have reached a point of non-viability. The Committee considers another approach (Option 2), which would be to prohibit all systemically important banks from including Tier 2 instruments in their regulatory capital. A third and last possibility (Option 3) set out by the Committee envisages a mechanism to be included in the contractual terms of all instruments whereby, when a bank faces non-viability, these will be permanently written off or converted to common shares.

The Zentraler Kreditausschuss (ZKA) supports the view of the Basel Committee that Option 1 is preferable to the other two. The ZKA does not take the view that Option 1 should, due to the difficulties of near-term implementation, initially give way to Option 3 – the inclusion of appropriate terms in the contractual conditions for capital instruments employed as non-common Tier 1 or as Tier 2 capital.

The ZKA argues that Option 3 should be rejected. For one thing, implementing this option would take at least as long as implementing Option 1. For another, Option 3 gives rise to a range of problems which this response will discuss in detail. First of all, the time scale for implementing Option 3: the terms of existing capital instruments cannot be amended unilaterally because legitimate expectation must be protected. This means a very lengthy transition period of at least 10 years before new instruments can be issued on the basis of the required terms, following the expiry of existing instruments. Furthermore, we take it for granted that new requirements will not apply to capital instruments that have already been issued and that new issues will be affected after appropriate transition periods.

Moreover, it is worth recalling that some Member States, such as Germany and Denmark, have already initiated legislative procedures on bank restructuring and resolution which essentially reflect Option 1. In Germany, this Act on bank resolution will enter into force on 31 December 2010. Likewise, early in 2011 the European Commission is expected to present...
proposals for legislation with a similar thrust to Option 1.\(^1\) We would therefore emphatically support the Basel Committee in pushing for rapid implementation of Option 1 rather than pursuing Option 3.

If Option 1 – or any other scenario – is applied, it must be ensured that losses are absorbed in the proper order by the various components of regulatory capital. Losses must first be allocated to core Tier 1 investors, then to other providers of Tier 1 capital, followed in future and as appropriate to the owners of contingent capital – only then, if a bank faces failure, to investors of Tier 2 capital. Moreover, in the course of a restructuring procedure Tier 1 investors may decide voluntarily to waive debt. Any other procedure, however, would encroach inadmissibly on investors’ property rights and irreparably damage the investor base for bank securities.

In the following section we will outline our views on the proposed mechanism for Option 3, explaining why we reject it, and in the final section we will address other critical issues in relation to the frequently asked questions in the Annex.

1) Comments on the Option 3 mechanism

Option 3 would broadly undermine the distinction between going-concern and gone-concern capital that was drawn in the Basel Committee’s consultative document “Strengthening the resilience of the banking sector” in December 2009 and would impose even tougher loss absorbency requirements, in particular with regard to Tier 2 instruments.

If provisions of this kind are incorporated into contractual terms as a matter of course, Tier 2 instruments would in practice dwindle in significance and, in the medium to long term, banks would no longer make use of them. Given the lack of participatory rights, investors are hardly likely to accept the same treatment as shareholders or other lenders of common equity core capital in the event of an impending solvency crisis, unless this less favourable position were to be compensated by banks through higher returns. Banks would consequently have to expect a marked increase in the cost of Tier 2 or hybrid capital and may even be confronted by a perceptible shortage of such capital in the market due to a lack of investor appetite. Presumably investors would expect a bigger risk premium than for share capital if the mandatory permanent write-off of the instrument is not offset by a compensation mechanism.

\(^1\) To prepare for this, the Commission held a high-ranking Roundtable on Debt Write Down as a Resolution Tool on 10 September 2010. A preliminary discussion document from the Commission was discussed by those present.
offering some benefit if the bank actually recovers (conversion to company stock allowed by the Committee or the prospect of subsequently reallocating value to the asset). As a result, issuers would also have little to gain commercially from negotiating non-common Tier 1 or Tier 2 capital instruments.

The Option 3 mechanism outlined provides that Tier 2 and hybrid Tier 1 instruments must be permanently written off – possibly in conjunction with a mechanism for converting the value of the former Tier 2 capital that has been written off into common shares or an equivalent (and hence into common equity core capital). This reduces the bank’s balance-sheet debt and, by the same token, boosts the bank’s common equity Tier 1 capital. We fail to understand the need for a permanent write-off. If the bank recovers its economic health and pays back the public support it has received, it must be possible for that value to be reallocated. If that is not the case, it is essential that the conversion mechanism described by the Basel Committee as merely optional is always agreed, otherwise investors who put up hybrid or Tier 2 capital would be at a disadvantage compared with shareholders who, if the economic situation improves, are able to share in the company’s success through rising share prices and the payment of dividends. Such a rule, however, would discriminate against banks which are not incorporated as joint stock companies – e.g. those in public or cooperative ownership – as they have no convertible equity. By contrast, an investor in a bank operating as a joint-stock company would under these circumstances obtain shares from conversion, and if the bank recovered those would certainly be able to appreciate new value. In this respect, the proposed mechanism would create distortions to competition, and for that reason it should be rejected.

Moreover, not even a joint-stock company is always able to hold the required amount of authorised equity to draw upon in the event of conversion. For example, a bank with a core Tier 1 ratio of 5% plus non-core Tier 1 and Tier 2 capital worth 7% RWA will probably have to hold authorised stock worth more than 100% of its stock issue in order to be able to compensate non-core Tier 1 and Tier 2 investors adequately if the need arises. In terms of company law, this volume of provision is questionable, and even if it were legally admissible it would be bound to encounter major shareholder resistance in regular times. However, the situation would even be problematic if the maximum requirement of authorised capital was available (N.B.: the German Act governing stock companies restricts the volume of authorised stock to 50%). If these authorisations are used up in full to cover Tier 1 or 2 notes, there would be no residual leeway to authorise a conventional capital increase. That is not an acceptable constraint.
In the proposal from the Basel Committee, the decision to make a public injection always depends on a decision by the “relevant authority”. The question here is what exactly is meant by a “public sector injection of capital or equivalent support” and who will function in such an instance as the “relevant authority”.

It is unclear how precisely to proceed if the “relevant authorities” decide differently in a context of banking groups with an international structure. There is an open issue as to the sequence in which capital components should be converted/written off in the event that the regulator supervising the parent company consolidating the group thinks the trigger event has occurred but the regulator supervising the (foreign) subsidiary does not.

2) Comments on questions in the Annex

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

As we stated at the beginning of this paper, the introduction of an appropriate framework for bank resolutions should be welcomed and driven forward. As we have argued above, this alternative can probably be implemented more rapidly than Option 3.

b. Would it be simpler to de-recognise Tier 2?

We essentially share the views of the Basel Committee published in the Annex in answer to this question. We do not, however, believe that subordinate capital (Tier 2) will be cheaper than core capital if Option 3 is applied in the proposed form. An investor would always have to proceed on the assumption that a bank might become distressed and that the relevant authority would be free to require a write-off without obvious or foreseeable indicators. This will inevitably inflate the cost of supplementary capital – even where the bank concerned is not actually running any excessive risks.
c. Will this not impose unnecessary costs on small banks?
Yes. Although the Basel Committee is initially only looking at international players, in our reading of Option 3 all banks, even small ones, will have to adapt the contractual terms for their capital instruments so that the desired mechanism in Option 3 – write-off or conversion of capital instruments – can always take effect. It is not until the second stage that a “relevant authority” will decide whether or not a bank is too big to fail and hence whether it will benefit from a public bail-out. Moreover, we estimate that this rule would be introduced in Europe for all banks, so that all banks would have to apply contractual terms of this nature. This will diminish the appeal of such capital instruments for small banks, too. At any event, banks can reckon with substantial administrative costs.

d. Would the proposal change the investor base?
Yes, because the new instruments include an equity option, whereas many investors (e.g. investment companies and insurers) are not allowed by their articles to acquire shares. It is unlikely that they will find it easy to avoid these articles in the manner the Committee describes, and so the proposed formula would pose an investment hurdle to certain groups of investors.

e. What if the holders of the capital instruments are not permitted to own shares in the bank?
See d above.

f. Would it be better to have an automatic trigger for conversion/write-off linked to some market variable or regulatory ratio?
The trigger event should be presented to investors in a transparent and objective way at the point of issue. One way to do that would be to link the trigger to minimum capital requirements. It is the uncertainties about the trigger that have currently led some ratings agencies to refrain from rating instruments of this kind. Usually, however, fixed-income investors only invest in rated fixed-income securities, and so they would not be available to put up Tier 2 capital if it is designed this way. If, on the other hand, only equity investors can be found for the new-style Tier 2 instruments, that is going to restrict the demand for equity. The trigger decision should be left as late as possible and should on no account be driven by a desire to avoid drawing on public resources. That would incur a risk of identifying the
bank’s trigger too early – at a point in time when it is still viable. This would critically disrupt the sequence for capital instruments and hence investor confidence.

Tackling the problems associated with maximum sensitivity in identifying the right trigger events is another reason for drawing on a legally substantiated resolution framework.

However, it should never be possible to make a write-off decision before a decision has been taken to provide a bank with public support entailing a pledge of resources. Otherwise we would witness knock-on effects in the form of a retreat of money from top-tier creditors, which would in turn call for even greater public resources. The prospect of state intervention, on the other hand, would certainly calm the market, thereby substantially increasing the odds that the bank will recover once subordinate creditors have been written-off.

g. How would the approach apply to capital issued out of subsidiaries, could this not lead to the break up of a group?
Here again, the resolution procedure would be the better approach, although we do understand the Committee’s arguments.

h. Would we not be transferring the problem of a failing institution to the insurance companies and pension fund sectors that hold the bank capital?
We agree with the comments by the BCBS.

i. Does conversion/write-off improve loss absorbency even though it does not bring in new money?
See f above; only if backed by a promise of public support. Otherwise it is more likely that there will be knock-on effects.

j. Would the proposal reinforce moral hazard in relation to senior debt?
We agree with the Committee’s comments, but it should also be clearly explained that this makes it all the more important to implement Option 1.