Measures aimed at enhancing the loss absorbency of regulatory capital at the point of non viability

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ABSTRACT

The Basel Committee's recent consultative document on the "Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non Viability" sets out a proposal aimed at "enhancing 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."

As well as demonstrating its support of the Basel Committee's statement that a public sector injection of capital should not protect investors from absorbing the loss that they would have incurred (had the public sector not chosen to rescue the bank), this paper also highlights identified measures which have been put forward as means of rescuing failing banks – without taxpayer financing. Furthermore, it highlights why the controlled winding down procedure also constitutes a means whereby losses could still be absorbed in the event that a bank is unable to support itself in the private market.

Key Words: capital; insolvency; financial crises; moral hazard; Basel III; Investor Compensation Schemes Directive; bail outs; equity; liquidity

Measures Aimed at Enhancing the Loss Absorbency of Regulatory Capital at the Point of Non Viability

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Introduction

Capital is very significant in its role since it serves to absorb risks and protect deposits. Given the imposition of an adequately stipulated minimum ratio, it could also facilitate the process of equalising competition between banks (rather than impeding their ability to compete).

The Basel Committee's recent consultative document on the "Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non Viability" sets out a proposal aimed at "enhancing 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."[2]

Of particular interest are the Committee's observations regarding the consequences of rescuing several distressed banks during the recent Financial Crisis, through the injection of funds (by the public sector) in the form of common equity and other forms of Tier One Capital. Two associated consequences are as follows:[3]

- Its effect of supporting not only depositors but also the investors in regulatory capital instruments – which consequently resulted in
- The inability of Tier Two capital instruments (mainly subordinated debt), and in some cases, non-common Tier One instruments, to absorb losses incurred by certain large internationally active banks that would have failed - had the public sector not provided support.

As a means of ensuring that instruments are accorded with the status of "regulatory capital" and also dealt with accordingly, a pre condition was stipulated by the Committee – such pre condition being that "such instruments are capable of bearing a loss."[4]

As well as the affirmation of its opinion 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 if the public sector had not chosen to rescue

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[2] See Basel Committee on Banking Supervision, Consultative Document "Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non Viability" August 2010 at page 1 (page 7 of 20) < www.bis.org/publ/bcbs174.htm.>

[3] See ibid

[4] Of particular interest is the third option which was provided by the Committee as a means of ensuring this outcome (of ensuring that such instruments are capable of bearing a loss). This option is namely, the requirement that "all regulatory capital instruments include a mechanism in their terms and conditions that would ensure that they would accept a loss at the point of non viability." See ibid.

the bank", the Basel Committee clearly indicated in the Consultative Document that all regulatory capital instruments must be capable of absorbing a loss at least in gone concern situations.[5] This requirement was prompted by the Basel Committee's observations from the recent Financial Crisis – which revealed that many regulatory capital instruments do not always absorb losses in gone concern situations. In this respect it remarked that:[6]

"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 case of Hypo Real Estate (HRE)[7] is considered within this respect, not because it is regarded as having not absorbed any losses (at all), but rather, because it is questionable whether the resulting burden imposed on taxpayers (arising from government funding), could have been mitigated to a greater extent. Even though rescue aid was granted by the Commission to Hypo Real Estate on the 2nd of October 2008 and further measures were also communicated by the German authorities on the 26th October 2009 (measures which included SOFFin guarantees of 8 and 10 billion Euros for HRE),[8] HRE was eventually nationalised.[9]

B. How Can the Desire to Facilitate Gone Concern Loss Absorbency of All Regulatory Capital Instruments (Including cases where there is public sector support) be Achieved?

"Conversion/Write offs"

Whereby debt instruments are transferred into "higher quality and common equity capital with better loss absorption characteristics – with the result that the institution's ability to withstand further losses is consolidated."[10]

- Debt regarded as bank capital should be converted to stock or written off in a crisis – hence compelling bond investors to bear some of the cost of future bail outs.[11]

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5 The Basel Committee added that "if gone concern were to be defined as insolvency and liquidation, then all regulatory capital instruments would be loss absorbent on a gone concern basis and such loss absorbency would be achieved through the subordination of the capital instruments – with the result that any repayment in liquidation would only be received if all depositors and higher ranked creditors are first repaid in full." It however defined „gone concern" to include „situations in which the public sector provides support to distressed banks that would otherwise have failed. ibid at page 3

6 ibid at page 3

7 See European Commission, "State Aid no NN 44/2008 – Germany Rescue aid for Hypo Real Estate" http://ec.europa.eu/competition/state_aid/register/ii/doc/NN-44-2008-WLWL-en-02.10.2008.pdf

8 See European Commission "European Commission State aid no N 694/2009 – Germany Emergency Guarantees for Hypo Real Estate" paragraph 3

9 "In January 2009, the German government had promulgated necessary measures aimed at facilitating the adoption of legislation which would enable it acquire a majority stake holding in Hypo."<http://www.reuters.com/article/idUSTRE5381WB20090409> "The squeeze out of minority shareholders – this being approved by a court in Munich in October 2009, paved the way for the German government's rescue fund SOFFin to get 100% of the real estate lender." See Reuters; "Hypo Real Estate is Nationalised with Squeeze Out" <http://www.reuters.com/article/idUSLD67573320091013>

10 See Basel Committee on Banking Supervision, Consultative Document "Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non Viability" August 2010 at page 13 (page 19 of 20) < http://www.bis.org/publ/bcbs174.pdf?noframes=1>

11 "Basel Committee Says Bank Bond Investors Should Help Fund Future Bailouts" <http://www.bloomberg.com/news/2010-08-19/basel-committee-says-bank-bond-investors-should-help-bear-cost-of-bailouts.html>

- All regulatory capital instruments sold by banks should be capable of absorbing losses if the company is unable to fund itself – before taxpayers' cash is plundered into rescuing a lender, so-called contingent capital should be converted into equity or written off.[12]

Controlled Winding Down Procedures

In the case which involved Bradford and Bingley, the UK authorities decided to pursue a wind down procedure whereby the retail deposit book was to be sold while an orderly wind down of the remainder of the business was to be undertaken for the purposes of maximising recoveries – as well as minimising the burden on tax payers.[13]

Reasons for undertaking the route of a controlled winding down process – as opposed to uncontrolled insolvency were also highlighted. An orderly winding down process would not only "maximise the value of the remaining assets and minimise the amount of necessary state aid", but would also facilitate the repayment of the working capital facility as well as statutory debt. Furthermore, the reasons for the choice of a controlled winding down process necessitated a consideration of the legislation in force when the decision to wind down Bradford and Bingley (and thereafter, Rumpco) was taken – and such reasons include:[14]

- An absence of a "strictly defined time-frame" for large and complex liquidations such as that of Bradford and Bingley (B & B).
- The fact that B & B would not have obtained the working capital facility which was required in order to pay Rumpco creditors – had B & B chosen the route of uncontrolled insolvency. An uncontrolled insolvency procedure would also have resulted in a liquidation shortfall with respect to debt owed to creditors.
- An uncontrolled insolvency procedure would have endangered the prospects of the recovery of full value of statutory debt.
- Rumpco's uncontrolled insolvency would have undermined financial stability – as well as market confidence.

C. Definition of Different Classes of Capital – should there be a re-definition of what constitutes regulatory capital – since it has been proposed that all regulatory instruments should be convertible/capable of absorbing losses?

Capital is considered to comprise of elements of Tier One, Two and Three capital. Tier One Capital comprises common equity – which has the following attributes: [15]

- It is considered to be the highest quality component of capital
- It is subordinated to all other elements of funding – absorbing losses as and when they occur, having full flexibility of dividend payments
- No maturity date
- It is the primary form of funding which helps to ensure that banks remain solvent.

[12] ibid

[13] See European Commission, "State Aid N194/2009 – United Kingdom : Liquidation Aid to Bradford and Bingley Plc" at paragraph 4 page 2

[14] ibid at paragraphs 13 and 14

[15] Basel Committee on Banking Supervision, Consultative Document "Strengthening the Resilience of the Banking Sector" December 2009 at page 14

The distinction between definitions of Tier One and Tier Two capital are highlighted by the Committee as corresponding to capital which absorbs losses on a going concern basis and capital which absorbs losses on a gone concern basis respectively.[16]

Proposed key changes, whilst aimed at "significantly improving the quality and consistency of the common equity of Tier One capital", as well as simplifying Tier Two Capital (to the extent that there would be only one set of entry criteria – and the removal of sub categories pertaining to Tier Two) also include the recommendation that Tier Three capital be abolished "to ensure that market risks are met with the same quality of capital as credit and operational risks."[17]

As a result, the proposed harmonised structure of capital will consist of Tier One Capital (going concern capital) with further components comprising common equity and additional going concern capital and; Tier Two Capital (gone concern capital).[18]

In proposing a new definition of capital, the Basel Committee on Banking Supervision, in its Consultative Document,[19] elaborated on "certain overarching objectives" which had contributed towards its formulation of the proposed new definition of capital and these are as follows:

- a) Tier One Capital must help a bank to remain a going concern
- b) Regulatory adjustments must be applied to the appropriate component of capital
- c) Regulatory capital must be simple and harmonised across jurisdictions
- d) The components of regulatory capital must be clearly disclosed

The proposed new definition of capital offers several advantages – one of which is namely, the facilitation of harmonisation – since the regulatory definition of capital varies according to the jurisdiction and its governing law.[20]

D. Problems and Benefits Identified with Basel Committee's Loss Absorbency Proposal

Some problems identified with the Basel Committee's proposal - that all regulatory instruments should be capable of absorbing losses include the following:

- the need for a liquid market (which is considered not to exist at present)
- A possible rise in the banks' cost of capital (since investors are likely to demand compensation for the increased risk being borne – for which they will not be repaid.[21]
- Lower levels of investment

[16] ibid
[17] ibid at page 14-16
[18] ibid at page 17
[19] Basel Committee on Banking Supervision, Consultative Document "Strengthening the Resilience of the Banking Sector" December 2009 at pages 14 and 15 <http://www.bis.org/publ/bcbs164.pdf>
[20] The regulatory definition of capital is considered to be "inevitably embedded in company law". See European Banking Federation, Comments on Consultative Documents issued by Basel Committee on Banking Supervision "Strengthening the Resilience of the Banking Sector" and "International Framework for Liquidity Risk Measurement, Standards and Monitoring" at page 13
[21] "Basel Committee Says Bank Bond Investors Should Help Fund Future Bailouts" <http://www.bloomberg.com/news/2010-08-19/basel-committee-says-bank-bond-investors-should-help-bear-cost-of-bailouts.html>

- Increased uncertainty and further elevated levels of instability as a result of lower levels of investment

Even though the above-mentioned issues have been raised, the Basel Committee is clearly justified in its affirmation 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 if the public sector had not chosen to rescue the bank."

Furthermore, most of these concerns are not entirely well-grounded since investment (in any case – and regardless of the recommendation that all regulatory capital instruments issued by banks are capable of absorbing losses on a going and gone concern basis) will always involve an element of risk. Banks should not be made to pay more money to investors for regulatory capital (if and when investors demand compensation for increased risk for which they will not be repaid) since investors get paid to take risks and should expect risks with investments. Perhaps some form of reward or loyalty payments could be tied in to the investments – such rewards being redeemed[22] by investors only in the event that the bank or firm operates on a gone concern basis. Other schemes which serve to ensure that minimum safeguards are place to compensate investors, to insure investor protection - as well as encourage small investors to invest in securities, include the Investor Compensation Schemes Directive (the ICD) [23] and Deposit Guarantee Schemes Directive.[24] The ICD (which has been replaced by the Markets in Financial Instruments Directive – MiFID), "provides for clients receiving investment services from investment firms (including credit institutions) to be compensated in specific circumstances where the firm is unable to return money or financial instruments that it holds on the client's behalf."[25]

It is acknowledged that the Committee's recommendations should signal to investors that higher risks are to be anticipated. Furthermore, bond holders (and not tax payers) should now expect to be the first resort (in terms of funding and new equity) where it is evident that an institution is likely to operate on a gone concern basis. This could result in slightly lower levels of investment – however, it could also produce the beneficial result of discouraging investment by those investors who take excessive risks – hence reducing moral hazard. A balance should be struck between introducing appropriate incentives (aimed at sustaining healthy levels of investment) which would encourage non reckless investors to invest and the need to discourage excessive levels of risk taking.

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[22] The European Banking Federation (EBF) made a proposal that instruments should not qualify (or be included) as Tier 2 capital if there would be incentives to redeem. European Banking Federation, Comments on consultative documents issued by Basel Committee on Banking Supervision "Strengthening the Resilience of the Banking Sector" and "International Framework for Liquidity Risk Measurement, Standards and Monitoring" at page 13

[23] The Directive 97/9/EC on Investor Compensation Schemes, known as the Investment Compensation Scheme Directive (the ICD), was adopted in 1997 as a supplement for the Investment Services Directive (Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (OJ L 141, 11.6.1993, p. 27–46).

[24] Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes [amended by Directive 2005/1/EC of the European Parliament and of the Council of 9 March 2005 and Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay (Text with EEA relevance)]
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31994L0019:EN:HTML

[25] See Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 97/9/EC of the European Parliament and of the Council on investor compensation schemes at page 2 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0371:FIN:EN:PDF

Based on the Basel Committee's efforts to improve the disclosure requirements of the components of regulatory capital, greater transparency should be facilitated – such transparency contributing to less uncertainty and assisting investors in deciding whether or not to invest in certain products. Bank depositors have greater need of protection since more rules (range of conduct rules)[26] exist within the investment sector - which serve the purpose of assisting investors in arriving at their investment decisions. In so far as the Basel Committee is able to achieve efforts aimed at mitigating substantial elements of uncertainty which may exist – with respect to the implementation of new regulations, such efforts should eliminate the fears attributed to consequences of uncertainty – namely, greater volatility in the bank bond market.

Benefits of the Basel Committee's Proposals

- Discouraging excessive risk taking (since investors will not be encouraged to buy securities under the assumption that they will avoid losses in the event of a bank failure)
- It would reduce the need for government bailouts owing to the requirement that contingent capital be converted (to equity or written off) to fund rescues rather than taxpayers solely bearing the cost. Hence bond investors of a bank will serve as the first resort during the impending collapse of a bank.

E. Measures Identified by the AFME as Means of Rescuing Failing Banks Without Taxpayer Financing.

In its paper "The Systemic Safety Net: Pulling Failing Firms Back From the Edge", the Association for Financial Markets in Europe (AFME) shed some light on two mechanisms which are considered to be instrumental in the achievement of the goal of managing a failing financial institution – as well as the re capitalisation of such an institution (without the need for capital support from governments and tax payers).[27] These mechanisms are:[28]

- 1) The Bail In Mechanism : Whose implementation commences when a firm reaches a pre-defined trigger – which would re-capitalise a firm as a going concern (through the conversion of selected levels of unsecured debt to common equity). Since no shareholder or creditor consultation is considered to be necessary, a swift implementation of its operation is expected.

- 2) Contingent Capital: Whose implementation has been undertaken historically by the insurance sector and which serves as a provision for one-time losses. It is issued in the

[26] As well as serving as an "additional layer of protection in collaboration with conduct of business rules, prudential regulation and operational safeguards, the Investor Compensation Schemes Directive (ICD) is also aimed at "protecting investors against the risk of losses in the event of an investment firm's inability to repay money or return assets held on their behalf." See DG Internal Market and Services, EVALUATION OF THE INVESTMENT COMPENSATION SCHEME DIRECTIVE DG INTERNAL MARKET AND SERVICES EXECUTIVE REPORT AND RECOMMENDATIONS
At page 2
http://ec.europa.eu/dgs/internal_market/docs/evaluation/inv-comp-schem-directive_en.pdf
[27] Association for Financial Markets in Europe, "AFME Outlines Ways To Rescue Failing Banks Without Tax Payer Financing" http://www.afme.eu/AFME/Home/sifi%20pr.pdf at page 1 of 2
[28] ibid

form of notes which are convertible into equity as soon as a pre-defined trigger is attained by the issuer. Since it requires no regulatory involvement, transparency is enhanced – such transparency serving as a potential means in helping to prevent localised problems from triggering into a full blown systemic crisis."

One difference between both mechanisms can be attributed to the frequency of their applicability. Whilst contingent capital serves as a provision for one-time losses which are unexpected, the bail in mechanism operates according to an expected pre-determined threshold level.
According to the AFME, either of these options would serve as a better alternative than liquidation.[29]

F. Basel Committee's Measures Aimed At Improving the Quality of Tier One Capital

Category of Tier 1	Calculation	Notes
Common equity ("core Tier 1")	Common equity – Goodwill (deduction) = Tangible common equity – Other deductions = Common equity net of deductions	• Predominant form must be common shares plus retained earnings and other comprehensive income • No debt-like instruments included in core Tier1 • No "financial innovation" permitted • Net of deductions (goodwill, deferred tax assets, minority interest, investments in own shares, etc) • Deductions are internationally harmonised
Additional going-concern capital[1]	+ Preference shares Preferred stock + Other non-dated, loss-absorbing instruments (only limited debt-like features permitted)	• Instruments must meet strict entry criteria (eg subordinated, no maturity date, fully discretionary non-cumulative dividends, no incentive to redeem) • Only limited debt-like features permitted (preferred dividends) • Grandfathering of capital instruments under consideration (including government rescue package instruments) • Elimination of the use of innovative hybrid debt instruments
	= Tier 1 capital (going-concern capital)[1]	• Enhanced disclosure of all elements of Tier 1 capital, including all regulatory adjustments, main features, explanation of ratios
	Contingent convertible bonds (contingent capital)	• Under review: some debt in banks' capital structure converts to equity when a predefined threshold is reached

Source: "Improving the Quality of Tier One Capital"[30]

[29] Furthermore, the AFME adds that with each option, the bank's shareholders would bear the loss through devaluation or dilution of their equity and that (more critically), neither option requires capital support from tax payers or a pre capitalised fund for providing liquidity. See ibid.
[30] ibid

Conclusion

According to Laeven and Majnoni,[31] regulatory capital, "should cope with the occurrence of unexpected losses – that is, losses that are large but infrequent and further, loan loss reserves should, instead ‚cope with expected losses." In reconciling the different views held about bank capital requirements, they propose a partitioning of regulatory capital which is based not only on terms relating to priority (as is the case for Tier One and Tier Two Capital), but also (and foremost) on risk management considerations.[32] The management of "Too Big to Fail Firms" should be sent appropriate signals – signals which would highlight the fact that the importance of such firms (to systemic stability) does not provide justification for the management of such firms to act recklessly. Intensive restructuring, to the extent that the entire management of such a firm is replaced (with new management) serves as an example of such a warning. This would also facilitate the reduction of moral hazard and excessive levels of risk taking.

Distinguishing between Expected and Unexpected Losses: Regulatory Capital and Unexpected Losses v Loan Loss Reserves and Expected Losses

Should Tier One Capital alone cover potential losses – particularly in view of the Basel Committee's recent recommendation which is aimed at ensuring that all regulatory instruments absorb losses? Which component should (have) or be endowed with greater capacity to absorb expected or unexpected losses?[33]

With respect to the current debate on loss loan provisioning, the European Banking Federation (EBF), the EBF is supportive of the provisioning based on Expected Loss model and recommended a provisioning model based on the EL concept, which "captures the economic reality of the lending activities of financial institutions in line with the six principles of the Bank for International Settlements" in order to achieve sound Expected Loss provisioning approach.[34]

Two principal reasons have been put forward by the European Banking Federation to justify their proposal of a sufficient level of non-predominant Tier One when limits to the capital components are determined.[35] These are attributed to "the quality of non-core instruments

[31] See L Laeven and G Majnoni, „Loan Loss Provisioning and Economic Slowdowns: Too Much, Too Late? at page 6

[32] ibid

[33] The preference for total regulatory capital – owing to its effectiveness in capturing potential losses, was highlighted by the Federcasse – in reference to the proposal of a consideration of only Tier One capital to cover buffers. See Federazione Italiana delle Banche di Credito Cooperativo Casse Rurali ed Artigiane,(Federcasse) Comments on consultative documents issued by Basel Committee on Banking Supervision "Strengthening the Resilience of the Banking Sector" and "International Framework for Liquidity Risk Measurement, Standards and Monitoring"
http://www.bis.org/publ/bcbs165/ifoccb.pdf at page 10

[34] European Banking Federation, Comments on consultative documents issued by Basel Committee on Banking Supervision "Strengthening the Resilience of the Banking Sector" and "International Framework for Liquidity Risk Measurement, Standards and Monitoring" at page 6
http://www.finansraadet.dk/media/208544/ebf_hoeringssvar_international_framework_for_liquidity_risk_measurement_standards_and_monitoring_150410.pdf

[35] European Banking Federation, Comments on consultative documents issued by Basel Committee on Banking Supervision "Strengthening the Resilience of the Banking Sector" and "International Framework for Liquidity Risk Measurement, Standards and Monitoring" at page 13
http://www.finansraadet.dk/media/208544/ebf_hoeringssvar_international_framework_for_liquidity_risk_measu

which will increase significantly compared to today's instruments; and the fact that institutions will need to increase their global own funds level to comply with the new rules. "[36]

Should the minimum capital ratio of 8% be revised?

For reasons associated with the desire to facilitate competition between banks, an increase in the present capital ratio is not favoured.

Tier Two capital should be able to cover losses absorbed at the point of non viability – however, restrictions should be imposed on such potential – in contrast to the case with Tier One capital. There should be less restrictions on the classes of debt like instruments which can be included under Tier One capital.

Furthermore, those shares which are to be redeemed (as incentives) in the event of the firm operating as a gone concern (and which should also absorb losses – hence resulting in a reduction of their values when and if they are redeemed) should be included as Tier One capital. As illustrated, Basel III reforms reflect efforts being made within this field – particularly with respect to contingent convertible bonds (which are currently being reviewed).

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[36] Other benefits attributed to the non-core Tier 1 instruments include its large investor base and the very useful currency diversification. For this reason, a request was put (by the European Banking Federation) to the Committee to set Core Tier 1 at a reasonable level - close to 51%.;ibid

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