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News Bulletin

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Super-Absorbent Bank Regulatory Capital

The Basel Committee on Banking Supervision ("BCBS") has refined its views on the features capital instruments must possess in order to be acceptable as regulatory capital. On 19 August 2010, BCBS published a consultative document[1] containing a proposal to require, as a pre-condition of regulatory capital treatment, that the contractual terms of capital instruments issued by banks provide for write-off or conversion to common equity, at the discretion of the relevant regulatory authority, in the event that the bank issuer is unable to support itself in the private market (the "Gone-Concern Proposal").

Background

BCBS had previously published two consultative documents (referred to as the Basel III framework)[2] relating, *inter alia*, to the definition of capital, the treatment of counterparty credit risk, the introduction of a leverage ratio and the imposition of global liquidity standards.

In the first of these consultative documents entitled "Strengthening the resilience of the banking sector," BCBS highlighted its ongoing review of the role of contingent capital instruments involving mandatory write-off or conversion features, both:

- as a criterion for Tier 1 and/or Tier 2 capital to ensure loss absorbency (which has led to the Gone-Concern Proposal); and
- more generally in relation to minimum regulatory capital and buffers.[3]

At the time, BCBS stated that it would discuss specific proposals in its July 2010 meeting.

BCBS has now stated its view that all bank regulatory capital instruments must be capable of absorbing loss (at least) in "gone-concern situations." By gone-concern situations, BCBS is referring not only to insolvency or liquidation situations (in which circumstances it notes that all bank regulatory capital instruments qualify as

[1] BCBS Consultative Document: A proposal to ensure the loss absorbency of regulatory capital at the point of non-viability (19 August 2010), http://www.bis.org/publ/bcbs174.pdf?noframes=1 (comments deadline: 1 October 2010).

[2] BCBS Consultative Documents (17 December 2009): (1) Strengthening the resilience of the banking sector (17 December 2009), http://www.bis.org/publ/bcbs164.pdf?noframes=1; and (2) International framework for liquidity risk measurement, standards and monitoring, http://www.bis.org/publ/bcbs165.pdf?noframes=1.

[3] *See* Morrison & Foerster client alert: More, More, More: A Summary of the Basel Proposals (2 February 2010), http://www.mofo.com/files/Publication/2f280bc1-1b9a-4d98-929f-0a4554236d0f/Presentation/PublicationAttachment/7cf62184-8f7b-48c4-a4f8-1de08055cfe4/SummaryoftheBaselProposals02022010.pdf. *See also* Morrison & Foerster client alert: A Little Bit Less and a Bit Longer: Update on Basel Capital and Liquidity Reforms (6 August 2010), http://www.mofo.com//files//Uploads/Images/100806BaselCapital.pdf.

"loss-absorbent") but also the situations where the relevant bank fails without public sector support. In this regard, BCBS believes that any government injection of capital to rescue a failing bank should not be applied to protect the holders of regulatory capital instruments.

BCBS outlines the proposed mechanism for enhancing the entry criteria of regulatory capital, primarily by requiring the inclusion, in all regulatory capital instruments, of write-off or conversion provisions which can be triggered by regulators at the "point of non-viability." The point of non-viability refers to the contingency that a bank becomes "unable to support itself in the private market" such that it needs rescuing by the public sector, rather than in the narrow sense of insolvency or liquidation.

BCBS had considered three different options which could help ensure that, as a pre-condition of being treated as regulatory capital, an instrument (in particular a Tier 2 instrument) is capable of bearing loss at the point of non-viability.

Option 1: Developing national and international bank resolution frameworks that enable losses to be allocated to all capital instruments issued by internationally active banks that have reached the point of non-viability.

Option 2: Identifying systemically important banks and prohibiting them from including Tier 2 instruments in their regulatory capital.

Option 3: Mandating that all regulatory capital instruments include a mechanism in their terms and conditions that ensures they will take a loss at the point of non-viability.

BCBS ultimately chose to propose Option 3. Option 1 was regarded as unrealistic in the short term, due to the need to achieve convergence of national insolvency laws and bank resolution regimes. Option 2 would entail the practical difficulty of trying to identify systemically important banks, which itself gives rise to possible moral hazard issues and, therefore, would probably mean prohibiting all banks from including Tier 2 instruments in their regulatory capital, to the detriment of smaller, non-systemically important banks.

Minimum Requirements under the Gone-Concern Proposal

BCBS has adopted the "minimum necessary" approach in its proposal, laying down only the minimum international requirements, pursuant to which each country is allowed to implement the proposal in a manner which avoids conflicts with its own national laws (or other legitimate constraints).

Type of Instruments Covered

All non-common Tier 1 and Tier 2 instruments issued by banks must have provisions in their terms and conditions that require them to be written-off upon the occurrence of the "Trigger Event" described below.

Issue of Common Stock upon Trigger Event

Any compensation paid to the instrument holders as a result of the write-off must be paid (i) immediately and (ii) in the form of common stock (or its equivalent in the case of non-joint stock companies). In order that the issuing bank is capable of compliance with its stock issuance obligations, it must maintain all prior authorisations necessary under applicable national company laws and its articles of association (e.g., authorised share capital) for the immediate issuance of the specified number of shares, should the Trigger Event occur.

The Gone-Concern Proposal does not impose a single method of calculating the number of shares to be issued upon a conversion following a Trigger Event. Each country is free to impose such a method, or to establish caps or minimums on the number of shares to be issued, as deemed fit in its own national context.

Trigger Event

The Trigger Event is the earlier of:

- the decision to make a public sector injection of capital (or equivalent support), without which the bank would have become non-viable, as determined by the relevant authority; and
- a decision that a write-off/conversion, without which the bank would become non-viable, is necessary, as determined by the relevant authority.

Thus, the occurrence of the Trigger Event will always be in the discretion of the relevant regulatory authority.

Any issuance of new shares upon the Trigger Event must be timed to precede any public sector injection of capital, to prevent a dilution of the public sector capital.

Treatment of Banking Groups

The relevant jurisdiction for determining the Trigger Event is that in which the capital is given recognition for regulatory purposes. Likewise, the write-down/conversion must be capable of being triggered by the regulatory authority in the jurisdiction(s) in which it is given credit as regulatory capital. Where an issuing bank is part of a wider banking group and wants to include the instruments in both its solo capital and the consolidated capital, both the jurisdictions of the issuing bank and the banking group must be capable of triggering conversion/write-down.

In particular, their terms and conditions must specify an additional Trigger Event, which is the earlier of:

- the decision to make a public sector injection of capital, or equivalent support, in the jurisdiction of the consolidated supervisor, without which the firm receiving the support would have become non-viable, as determined by the relevant authority in that jurisdiction; and
- a decision that a write-off/conversion, without which the firm would become non-viable, is necessary, as determined by the relevant authority in the issuer's jurisdiction.

In such case, any common shares paid as compensation to the instrument holders can be those of either the issuing bank or the parent company of the consolidated group. This feature has been incorporated in order to allow banking groups or national jurisdictions to avoid unwanted changes to a banking group's ownership structure, by creating new shareholders upon conversion of the instruments.

On the other hand, if the banking group only wants the instruments to be included in the regulatory capital of the issuing bank, and not the wider banking group, write-off/conversion will be triggered by the Trigger Event occurring in the issuing bank's jurisdiction alone.

Potential Impact on Incentives

Common Stockholders

Under the Gone-Concern Proposal, BCBS suggests that the conversion rate could be viewed as a spectrum whereby, at one end, zero shares are issued to the instrument holders upon a write-off following a Trigger Event, whilst at the other end of the spectrum a high number of shares are issued to those holders:

- *Zero shares (i.e., write-off):* Investors in write-off instruments would charge the bank a higher coupon rate relative to an instrument that converts into common equity. Therefore, if a bank issues write-off instruments, common stockholders will suffer the consequence of increased risk-taking as the bank must pay higher coupon rates on its write-off instruments.

- *High number of shares (i.e., conversion to common equity):* Investors in a conversion instrument that will receive a large number of common shares upon write-off following a Trigger Event will be compensated (potentially in full) for the write-off of their original instrument. Although the investor would probably charge a lower coupon rate relative to the write-off instrument (as they will receive at least some compensation, in the form of shares), common stockholders will suffer the dilution of their common equity in this case.

A write-off could be viewed as a transfer of wealth from the instrument holders to the common stockholders (as it increases the common stockholders' claim to the bank's net assets), and BCBS notes, in passing, that this potentially creates an incentive for common stockholders to try and persuade a regulator to declare a Trigger Event, although BCBS accepts that this may be unlikely, as it effectively would involve the bank being certified as "non-viable."

Investors in Capital Instruments

The Gone-Concern Proposal will help to ensure that non-common Tier 1 and Tier 2 instruments of a systemically important bank are capable of absorbing a loss when, or immediately after, the issuing bank becomes non-viable. BCBS notes that this will make non-common capital instruments more expensive at banks that are, or are perceived to be, subject to an implicit public sector guarantee.

BCBS hopes that its proposed increased downside risk for investors in such instruments will motivate those investors to monitor the risks taken by the issuing bank, with consequent increases in the coupon rate demanded by investors from banks perceived to be trading on more risk, thereby exerting an added market discipline on banks.

Next Steps

BCBS has requested feedback by 1 October 2010 from market participants, including investors in bank capital instruments, on all aspects of the proposal, including any legal or operational obstacles to their implementation. In addition, BCBS has asked industry practitioners to work with regulatory authorities in developing possible drafting for the terms and conditions of the regulatory capital instruments which would comply with the requirements of the Gone-Concern Proposal, whilst respecting relevant national constraints.

For more on Basel III, please see our prior alerts and presentations at http://www.mofo.com/resources/regulatory-reform/.

For more on contingent capital instruments, please see A Requiem for Hybrids?; MoFo Tax Talk, Volume 3, Issue 1; International Briefings: Contingent Capital Instruments; and Is it a Bird? A Plane? Exploring Contingent Capital.

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