October 1, 2010

Comment on the Basel Committee on Banking Supervision's Consultative Document *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability*

Japanese Bankers Association

We, the Japanese Bankers Association, would like to express our gratitude for this opportunity to comment on the Consultative Document *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability* released on August 19, 2010 by the Basel Committee on Banking Supervision (hereafter "Consultative Document").

We hope that our comments below will further assist the Basel Committee in its efforts to finalize the rules.

I. General Points

We understand the following concepts of regulatory capital proposed by the Basel Committee: "All regulatory capital instruments must be capable of absorbing a loss at least in gone-concern situations" and "Furthermore, [the Basel Committee] believes 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 had the public sector not chosen to rescue the bank." However, the impact of the introduction of these new requirements is unforeseeable at this time particularly on investor behavior, market efficiency, and banks' ability to raise capital. Therefore, mainly from the perspectives of banks' stable funding of capital and fostering sound capital markets, we sincerely hope that the following points will be taken into account in further discussions.

<u>*Requirement for Regulation*</u>

We are strongly concerned that issues such as level of required capital and transition periods are being discussed prematurely based on a tacit assumption, i.e. banks will be able to issue sufficient amount of capital instruments fulfilling the proposed requirements (hereafter "contingent capital") in the future.

Introduction of contingent capital will dramatically change the features of existing hybrid regulatory capital instruments, such as subordinate debts and preferred securities,

and there are almost no available markets for contingent capital right now. Therefore, it is uncertain how much contingent capital can be procured under the new requirements. From a conservative standpoint, there is a possibility that non-common equity Tier 1 and Tier 2 capital will both be hard to be funded under the new requirements for the time being. In that case, banks may even have to satisfy most of the total capital requirement (z%) by common stocks and retained earnings, resulted in maintaining their core Tier 1 ratio, Tier 1 ratio and total capital ratio at nearly the same actual levels.

Therefore, it is necessary not only to capture the potential amount of contingent capital to be required by the entire banking industry through the Quantitative Impact Study (QIS), but also to assess carefully, through dialogue with the markets, which capital markets will be able to accommodate the new requirements and to what extent the capital-funding needs of banks can be procured. We urge that new requirements be determined in an appropriate and feasible manner so that demand from investors will match the potential supply of contingent capital.

Nurturing the Market and Sufficient Test Period and Transitional Introduction

According to the Consultative Document, instruments that can be included in non-common equity Tier 1 and Tier 2 regulatory capital must have clauses regarding conversion to common stocks or write-off.

Under current regulations, there are no such requirements so that there are few records of issuances of similar capital instruments in the past. Considering the outstanding balance of Tier 2 instruments amounts to more than 10 trillion yen (approximately 120 billion dollars) for major Japanese banks alone, we have many unknowns regarding the sufficiency of potential market for non-common equity Tier 1 and Tier 2 instruments that satisfy the new requirements to cover and replace existing ones, or whether the market for these instruments will function effectively as a source of stable regulatory capital funding for banks. From life insurance companies and other major investors in Japanese non-common equity Tier 1 and Tier 2 instruments, we have received many comments that instruments with conversion to common stocks or write-off features would not be eligible for their investments. As such, it is clear that there will be an impact on existing regulatory capital investors. A capital instrument with a clause of conversion to common stocks or write-off, may require a higher return than common stocks, depending on the requirements, and may therefore not function as a rational tool for capital-raising. Therefore, from the perspective of banks' stable capital funding, introduction of the new requirements should be determined after giving due consideration[1] to the needs and viewpoints of investors who are the providers of

[1] Just as the Basel Committee requests comments on the Consultative Document, we believe that

regulatory capital.

If this process is circumvented, enormous needs for capital-raising by banks will overwhelm the limited capacity of investors in the relevant markets. This may lead to decline the market efficiency, cause a lack of fairness,[2] and in turn negatively affect the real economy by spreading higher cost of capital-funding to non-bank corporate sectors.

Therefore, when introducing contingent capital, it is critical that legal and other systems have to be developed appropriately so as to enable banks to raise sufficient amount of capital from markets in a stable manner. Investor preferences and market effectiveness have to be examined from perspective of investors and market participants. All of these will require sufficient *testing period*.

Either in refinancing of existing Tier 2 instruments, which we assume will be at substantial amounts each year on a global basis, or in simply issuing new Tier 2 instruments, it should be allowed for banks to issue capital instruments on the basis of the consultative document released last December for a certain period of time, with some requirements revised appropriately[3], in order to facilitate funding without causing confusion in capital markets. Full consideration should be given to phased-in arrangement with a sufficiently long *transition period*. With respect to the additional requirements for conversion to common stocks or write-off proposed in the Consultative Document, we believe that, in light of the unfamiliarity of these new requirements, appropriate observation of investor risk tolerances and degree of market efficiency is necessary. In order to have some flexibility to revise, for example, the level of minimum required capital after introduction of the rules due to potential lack of demand for contingent capital, or to increase the portion of contingent capital in the regulatory framework due to a gradual increase in demand in contrast, or to review impractical, unnecessary conditions of contingent capital, sufficient *testing period* will be required to ensure such flexibility. In this process, there are likely to be differences in the degree of market development of each jurisdiction, the timing of implementation should therefore

---

opinions should be proactively solicited from investors, securities companies, and other market participants regarding the ability of the markets to absorb instruments that meet the requirements of the new rules.

[2] We are concerned about the possibility that a level playing field may not be ensured, depending on the depth of each country's capital markets. In other words, if, for example, Bank A's needs for funding contingent capital cannot be absorbed in the capital market of its home country (Country A), it will have to acquire the capital in the capital market of another country (Country B). Since a home country bias will arise between Bank B in country B (home country) and Bank A in country A, the procurement costs of Bank A will become higher. As a result, the fear may arise that fairness in competitive conditions cannot be ensured due to the implementation of new capital regulation. Even if Bank A decided to raise capital through common equity offering in Country A, its capital costs will be higher than Bank B, because cost of common equity capital is thought to be higher than cost of contingent capital in general. In either case, fairness would not be ensured.

[3] See the public comments for the consultative document published in last December submitted to the Basel Committee by the Japan Bankers Association on April 15.

be at the discretion of jurisdictional authorities.

Clearly, the private sector has to make ongoing efforts to expand the markets for these new capital instruments until the date of full implementation.

Grandfathering

Most existing capital instruments do not satisfy the *minimum requirements* proposed in the Consultative Document, and we believe that a sufficient grandfathering period will be necessary in order to facilitate the replacement of the existing capital instruments. As discussed earlier, if a sufficient period is not ensured, large volumes of refinancing of capital instruments will be simultaneously generated, causing confusion at the markets, resulting in excessive spreads due to imbalance of supply and demand. Excessive spreads may be created through investors' concern for a specific institution about incapability of raising sufficient amount of required capital.

We believe that the grandfathering rule, for which the Consultative Document does not contain any statements, should cover all the instruments issued prior to the introduction of contingent capital requirements, according to the grandfathering principles set forth in the press release of September 12. Outstanding capital instruments issued under the current rules and new capital instruments issued on the basis of the consultative document released last December, with some conditions revised appropriately, should be recognized in the same capital categories as currently defined until maturity (or until the first call date) for term instruments. Instruments without specific maturity should also be grandfathered for a considerable period of time after introduction of the new rules (or until the first call date).

If capital instruments will be issued during the testing period on the basis of the consultative document released last December, with some conditions revised appropriately but without write-off features, they should also be subject to the grandfathering. By allowing some flexibility in recognizing regulatory capital through these measures, global regulators should facilitate stable capital-funding of banks without causing unnecessary confusion at the markets.

From the perspective of practical funding operations, the treatment of capital instruments is unclear if it will be issued during the period between the date of adoption of the proposal and the date of finalization of detailed rules and regulations by jurisdictional authorities. There are, therefore, some uncertainties for banks in considering their future capital management plans. In light of this, and as already stated above, we would urge that there be sufficient grandfathering and transition periods which enable banks to raise capital stably even for the above mentioned period. And we

request that the Committee give full consideration and publish clarifications on this matter at the earliest possible time.

We also note that, if the Committee would set a “cut-off date” of the grandfathering before the markets for contingent capital will be fully developed, it may have an adverse impact on refinancing of existing capital instruments. Therefore, we would like the Committee to give full consideration on this issue.

Capital Hierarchy

One important point we should pay attention in introducing contingent capital is to maintain hierarchy of capital instruments. When a financial institution faces financial difficulties, the priority for loss absorption begins with common stock, which is going concern capital, and then moves on to 100% loss absorption (100% capital reduction) by investors in non-common equity Tier 1 (preferred stocks, preferred securities), and thereafter, loss absorption by investors in Tier 2 capital. This order should be strictly observed and maintained.

Corporate law, bankruptcy law and other domestic Japanese laws stipulate priority/subordinate relationships in economic benefits and modalities for voting rights in terms of corporate control based on these capital hierarchies, and by its nature, contingent capital may have an impact on these priorities stipulated in domestic law.

If, as advocated in the proposal, “a permanent write-off” becomes a necessary condition of contingent capital and any write-up mechanism is ruled out, there would be cases in which common stocks would have some residual value even after Tier 2 capital would have been impaired at the time of the injection of public funds. In such cases, the price of common stock may decline at first, but future upside remains. Then the capital hierarchy will collapse, and the collapse of this framework will significantly reduce investors' appetite for Tier 2 instruments. Mechanisms will therefore be required to ensure that the order of priority is maintained in the capital hierarchy.

As a example of approaches to maintaining the hierarchy, we believe that “write-up” and “partial write-off,” described later, would be effective. Alternatively, the discrepancy in capital hierarchy could also be resolved by limiting trigger events of “a permanent write-off” to cases in which holders of common stock are requested capital reductions. Or, rather than limiting the requirement to conversion to common stock or write-off, the same purposes could be achieved by enhancing subordination clauses imposed on Tier 2 instruments so that Tier 2 instruments are subordinate to public funds injected after a trigger event, resulting in deferment of interest payments and extensions of redemptions. In such situations, after the injection of public funds, these capital instruments would only recover their right to claim interest and dividends and their right

to residual assets after repayment of public funds in full. Therefore, should a financial institution fail after the injection of public funds, these capital instruments would fully serve the purposes of loss absorbency.

II. Specific Points

Section 1: Introduction (p. 1 - p. 3)

The proposal in the Consultative Document calls for designing instruments that have both debt and equity features. In Japan, for example, the Japanese Companies Act, Financial Instruments and Exchange Act, timely disclosure rules and other regulations distinguish between debt instruments with common equity conversion features and the other debt instruments ("traditional debt instruments"); each category has different issuing procedures and regulatory systems. New instruments designed according to the proposal would impose new burdens on the back office processing and systems of securities companies and other payment and settlement institutions. This would in turn lead to an increase in legal restrictions, which can be expected to create further practical barriers—for example, the lack of agility for Tier 2 capital funding and the inability to issue instruments to existing investors under current procedures. We would therefore urge the Committee to take account of the opinions of and impacts on a wide range of related parties when it makes the decision to introduce rules. Prior to any such decision, the issuing procedures and rules in individual jurisdictions should be fully studied, rules should be introduced to allow issuing under the same procedures as traditional debt instruments, and steps should be taken to ensure consistency with jurisdictions' corporate laws and other ordinances. For example, rather than including common equity conversion features and write down features in instruments' terms and conditions, we believe there could be rooms for allowing the same issuing procedures as traditional debt instruments have after these features are stipulated in each jurisdiction's banking rules, such as the Banking Act and Deposit Insurance Act in Japan.

We believe that there must be sufficient flexibility to allow the design of instruments that achieve the intended effects in the context of jurisdictions' specific, unique legal and tax systems. Therefore, to provide for flexibility in structuring and capital-raising, we believe that issuers of capital instruments should not be limited to the bank (and subsidiary banks), but rather there should be explicit permission for issuing by non-banking subsidiaries, including Special Purpose Vehicles (SPVs). If an issuer of regulatory capital instruments is only limited to a bank itself, banks in some jurisdictions may be at a competitive disadvantage in designing instruments that satisfy the requirements of regulatory capital due to the differences in jurisdictions' legal and tax systems, as mentioned above.

Section 3: Proposal and an explanation of the mechanism (p. 4 – p. 8)

Proposed minimum requirement (p. 4)

The proposal presents minimum conditions to be adhered to at the international level and gives jurisdictions latitude to implement these requirements in ways that do not contravene domestic laws and other constraints. We agree with this approach.

Scope and post trigger instrument (p. 4 – p. 5)

The proposal stipulates that "permanent write-off is necessary." However, if the intentions of the draft for consultation are: 1) to prevent investors holding other capital instruments from having higher priority in claims than public funds; and 2) to enable from a regulatory standpoint the absorption of losses by capital instruments in the event that a bank is unable to support itself in the private market, then there would be no inconsistency with the intention as long as steps are taken to contractually ensure the priority of public funds over regulatory capital raised in the private market and satisfying loss absorbency from a legal and accounting[4] perspective in the event that one of the triggers in the proposal is breached. There is therefore no need to completely reject the potential for write-up with the same order of priority as public funds have, or for write-up after the repayment of public funds. This would be justified because there is the possibility of upside to common stockholders due to higher share prices or dividends after the repayment of public funds.

If, therefore, a trigger event is encountered leading to a write-off, following which the injected public funds are repaid in full and the institution has sufficient capital that no further injections of public funds will be required subject to regulatory approval, it should be allowed a write-up within, for example, the scope of distributable earnings.

Restricting post-conversion instruments to common stock only will require major Japanese banks alone to increase in advance in the total number of authorized common shares, equivalent to more than 10 trillion yen (approximately 120 billion dollars) of the outstanding subordinated debt. This may not be realistic from a practical standpoint, depending upon the method used to determine conversion rates. There is a risk that the market will see the potential dilution when a sound bank makes a significant expansion in its issuing authorization in order to prepare for common stock conversion. Similarly, when there is an outstanding balance of Tier 2 instruments that are convertible to common stock, there will always be concerns in the market about the potential dilution,

[4] From an accounting perspective, recognizing a write down of liabilities in conjunction with a write-off may involve estimating the probability of future write-up for the liability and the provisioning of reserves against contingent losses. A certain capital restoration effect is also expected. Legally, it is possible to structure the contract so that claims on contingent liabilities can only be lodged after repayment in full of public funds, which will provide for sufficient loss absorbency during the phase from injection of public funds to either bankruptcy or repayment in full.

which may serve as a factor preventing share prices from increasing.

One approach to allaying concerns about dilution would be to allow a *partial write downs* that would decrease the amount of common stock to be issued through the conversion and also would alleviate concerns about potential dilution.

Taking it a step further, there may also be cases in which an institution can maintain its viability with a specific amount of write-off of regulatory capital rather than an injection of public funds. In such cases, there is no need to require *100%* write-offs of capital. It is sufficient to write-off the amount required to maintain viability without the injection of public funds (in other words, *partial* write-offs). We therefore believe that the write-off rate should not be uniformly *100%*, and that the rules should allow for *partial* write-offs.

As described above, allowing *write-up* and *partial write-off* would also contribute to the maintenance of the capital hierarchy.

We would also note that the level playing field may not be maintained in the case of write-off (or write-up) due to differences in jurisdictions' accounting and tax systems, and that measures will be needed to address this.

We also think there is room to allow instruments that would bring greater flexibility and diversity to funding by, for example, immediately returning 10% of principal to holders at the time of write-off in exchange for only including 90% in capital.

As described under alternatives to common stock conversion and write-off features in the section on *capital hierarchy*, it is also worth strengthening subordination features on capital instruments in order to provide greater flexibility and diversity in funding instruments.

In addition, the requirements imposed in the draft for consultation would strengthen the positioning as gone concern capital, and in light of this, we believe that the stipulations regarding straight-line amortization are unnecessary from the perspective of maintaining the correspondence between inclusion in regulatory capital and loss-absorption capacity. If, for example, straight-line amortization were performed, the amortized portion of regulatory capital would not be counted towards regulatory capital and therefore the amortized portion would not need to be subject to write-off.

Similarly, the requirement that the issuer not be able to redeem instruments until at least five (5) years have elapsed is inconsistent with positioning as gone concern capital and should therefore be deleted or at least relaxed.

We would note the risk, depending upon conversion rates, of unintended changes in shareholder structure when contingent capital is converted to common stock. The form in which common equity conversion features are introduced may also undermine the functioning of legal systems, for example the large holdings reports and takeover bid (TOB) regulations of equity markets. We believe that it may be necessary to consider formulating uniform rules among all jurisdictions in light of the absolute necessity of mitigating potential business risks on issuers and ensuring the same levels of transparency in the bond market as in the equity market.

<u>*Trigger events (p. 5)*</u>

As discussed in the Consultative Document released last December, it is necessary for jurisdictions to set highly objective and transparent trigger points in advance in light of their financial systems and other circumstances in order to ensure transparency for the markets. We understand the necessity of authorities to determine whether or not to invoke trigger events, but the invocation of trigger events according to regulatory discretion for which the rationale is not immediately apparent will likely make appropriate risk evaluation, or pricing or determining ratings impossible. This will reduce investor demand and potentially impede the issuing of capital instruments and the sound development of capital markets.

When trigger events are up to regulatory discretion, a bank, depending upon the timing of the trigger, may potentially be deemed by the authorities *non-viable* before it has reached insolvency. The rationale and processes by which authorities make write-off decisions should be delineated as clearly as possible in advance and should be rigorously adhered in order to protect the asset rights of investors as well as enabling the investors to appropriately valuate the risks of capital instruments. In particular, relevant laws and ordinances should clearly define *non-viable* as a rationale for write-offs so that investors understand in advance the basis of decision-making and are able to objectively anticipate this. Furthermore, triggers should be determined in terms of the de facto bankruptcy of individual financial institutions and should not be set in ways that are unrelated to the creditworthiness of the individual financial institutions, for example, when public funds are injected across the board as a preventative measure to preserve the integrity of the financial system. We believe that cases such as these should be explicitly excluded.

There is also the potential for inconsistencies with the capital hierarchy if authorities determine a write-off of subordinated debt without injecting public funds and also without reduction of common stock, since only subordinated credits would bear the risk. This would significantly reduce the willingness of investors to invest in capital

instruments. We believe steps are needed to address these inconsistencies, for example, by limiting the trigger events at the discretion of authorities to cases in which capital reductions of common stockholders can be required.

The envisioned process leading to the trigger decision would be a finding by the authorities that the institution is unable to continue because its capital has been impaired by the emergence of some form of risk phenomenon in the course of normal operations and the situation will not improve even with a Pillar 2 regulatory review and early remedial measures. It can be assumed that there will be some form of reaction from the market during the course of this process and that this will accelerate the deterioration of the situation. Steps therefore need to be taken to address the systemic risk inherent in the process leading to the trigger.

Group treatment (p. 5)

As already discussed in our comments in Section 1: Introduction, there should be explicit permission for issuing by non-banking subsidiaries, including SPVs, rather than limiting issues of capital instruments to the bank itself (and subsidiary banks) in order to ensure appropriate dynamism in capital funding and flexibility in structures.

Explanation of the elements of the proposal (p. 5 –p. 8)

Though not directly addressed in this Consultative Document, the consultative document released last December discussed the appropriate handling of Tier 1 capital which have tax deductible coupons (Paragraph 76). We believe that coupons can be tax deductible because this would increase the incentives to use contingent capital and allow greater flexibility in the design of instruments to suit a wider range of investors' needs. We seek clarification on this point for non-common equity Tier 1.

Annex (p. 10)

Would the proposal change the investor base? (p. 11)

We have received the following opinions on contingent capital from life insurance companies and other major Japanese investors in traditional Tier 1 and Tier 2 instruments.

- At the very least, common stockholders should also bear losses at the time of write-off, and it should not be considered unless the principal priority/subordinate relationship with common stockholders is clarified.
- Too much is left up to the discretion of authorities. Investment is predicated on the elimination of arbitrariness.

- Principal write-off are not envisioned in Tier 2 instruments and they cannot be treated as traditional debt instruments.
- Instruments with common equity conversion features will be categorized as equity, which will make investment other than strategic investment difficult.

The majority of investors in Tier 1 and Tier 2 instruments are either life insurance companies like those commenting above, pension and bond funds managed by investment trusts and investment advisors, or other debt investors. These debt investors (particularly in Japan) will treat contingent capital with common equity conversion features as equity and likely be unable to invest in it. While there is some expectation that debt investors will to a certain extent accept contingent capital with write-off features because there is no need to change the investment category from bond to equity, the rules themselves are unclear at this time and it is impossible to anticipate how they will be applied. We therefore believe that careful observations will be needed to determine whether these instruments are actually accepted and to what extent markets can be created. At the current time, only hedge funds and retail investors will be able to invest under the new requirements. For equity investors to invest in contingent capital, they must be given call options that they can exercise at their discretion. Absent this, the investor base will not expand.

The depth of the investor bases will presumably be different between bond and equity, but in order to attract both categories of investor, the rules should allow for mechanisms that give investors the option of either *conversion to common stock* or *write-off* rather than specifying only one of them in the event of a trigger.

Investors consider the injection of public funds to be largely at the discretion of authorities and therefore want greater objectivity and transparency in trigger events and clarity in rules. Failure to provide these assurances will significantly increase the hurdles to investment decisions. We would therefore look for more objective decision-making criteria (clear articulation of the decision-making standards for public funds injections, etc.) in the design and promulgation of national rules.

The broader the scope for regulatory discretion in triggering principal write-off and conversion to common stock, the more difficult it is for ratings agencies to determine appropriate ratings. Without ratings, investment decisions become much more difficult. This will result in the failure of an adequate Tier 2 market to develop and, potentially, the inability of banks to easily raise Tier 2 capital from the markets. Therefore, processes and mechanisms must be introduced for the assignment of ratings.