

October 1, 2010

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002
Basel, Switzerland

Re: Consultative Document: *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability*

Ladies and Gentlemen:

The American Bankers Association¹ (ABA) welcomes the opportunity to comment on the consultative document published by the Basel Committee on Banking Supervision (Committee or BCBS), *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability*.² We understand the view that contingent capital and convertible capital instruments can play an important role in ensuring that banks are capable of absorbing losses and we welcome the Committee's interest in alternative instruments in a bank's capital structure. We agree that the Committee's proposal is a superior alternative to de-recognition of tier 2 instruments; in fact, the proposal reflects the important loss-absorption and capital buffer role of these instruments.

We have the following concerns with, and suggestions for, the proposal that has been published:

- There is a need for further study and analysis of contingent and convertible capital instruments
- The proposal would change fundamentally the risk-reward profiles of bank debt and equity investors, ultimately raising concerns about the marketability of these instruments
- The proposal would apply too broadly to all non-common tier 1 and tier 2 instruments
- The proposal would increase the cost of capital for banks
- The issuance of contingent or convertible capital instruments should be voluntary
- Contingent or convertible capital instruments should qualify as part of the capital conservation buffer required under Basel III
- The terms and conditions of contingent or convertible capital instruments should not be set by regulators but, rather, negotiated by banks and their investors

¹ The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's \$13 trillion banking industry and its two million employees.

² www.bis.org/publ/bcbs174.pdf.

- Any rules regarding contingent or convertible capital instruments should be accompanied by appropriate grandfathering and phase-in periods

There is a need for further study and analysis of contingent and convertible capital instruments. As the Committee is aware, contingent and convertible capital instruments are among a range of tools under consideration to mitigate systemic risk. Capital surcharges, “bail-in” debt requirements, and proposals for resolving large bank and financial firm failures are also under consideration in the Committee and the Financial Stability Board. Before adopting any scheme for contingent capital, the Committee should consider the relative merits of the full range of systemic risk proposals under consideration, and the impact of each such proposal on the banking industry and the broader financial system. Moreover, any such scheme should take into consideration the December 2009 capital and liquidity proposals and national legislative and regulatory developments. Only by conducting a comprehensive impact study will regulators and the industry be able to develop a coordinated and comprehensive package of prudential measures that add to the resilience of the banking industry and the broader financial system without impairing the ability of the industry to perform its critical intermediation functions.

The proposal would change fundamentally the risk-reward profiles of bank debt and equity investors, ultimately raising concerns about the marketability of these instruments. Contingent capital instruments carry the upside potential of debt instruments, which is limited to the contractual coupon plus return of principal, and the downside of equity instruments, which is a total loss of the investment. Moreover, under the proposal, convertibility would be determined by regulatory action rather than as the result of pre-determined, market-based triggers. These characteristics, in our view, would make contingent capital indistinguishable from common equity.

This limited upside, unlimited downside, and the lack of objective triggers create significant concerns about the marketability of these instruments and the ability of rating agencies to issue credit ratings. Certain classes of institutional investors are precluded from investing in equity instruments, including instruments convertible into equity. Institutional investors are major participants in the market for bank capital instruments and provide substantial depth and liquidity to that market. The inability of institutional investors to participate fully in this market raises critical concerns about the marketability of these instruments, particularly in periods of market uncertainty or elevated volatility.

In addition, institutional investors generally are limited in their ability to invest in unrated securities. We also understand that the rating agencies may not be willing to rate these securities, given their uncertain and subjective triggers based on a *regulatory determination* that a write-off or public injection of funds is necessary. The lack of an institutional investor market for contingent capital instruments would constrain greatly the marketability of these securities, raising serious liquidity issues, particularly in times of industry or market stress. Additional study should be conducted with market participants to determine the market for, and likely pricing of, contingent or convertible capital instruments.

The proposal would apply too broadly to all non-common tier 1 and tier 2 instruments.

The proposal envisions that **all** non-common tier 1 and tier 2 instruments in a bank’s capital structure would have a clause in their terms and conditions that require them to be written off or converted to common stockholders’ equity on the occurrence of a trigger event. This requirement would have a profound impact on the markets that could constrain the ability of banks to raise capital, negatively impacting safety and soundness as well as the health of the broader financial system.

In considering a bank’s capital needs, regulators should evaluate what would meet the bank’s need for additional capital in a severe but plausible stress scenario. Requiring banks to have capital buffers beyond this level would create inefficiencies in banks’ capital structures and would increase the overall cost of capital and, thus, increase the cost and/or availability of credit to the broader economy.

Many banks already issue subordinated debt, which plays a role similar to that of contingent capital with respect to loss absorption. In the United States, subordinated debt and other non-common elements of tier 1 and tier 2 capital provide protection to insured depositors and, thus, are important and cost-effective components of a bank’s capital structure. These instruments should be allowed to continue to play their useful role in banks’ capital structures, without changes that could limit the marketability of these instruments.

The proposal would increase the cost of capital for banks. Requiring the convertibility or write-off of all non-common instruments also would have a deleterious effect on the ability of banks to raise common equity. The cost of equity capital would increase due to concerns about dilution upon a trigger event, rising dramatically the closer a bank approached to a triggering event. Moreover, certain investors may be incented to short the common stock of the issuer during a stress event, raising the likelihood that a trigger condition would be met and perpetuating a downward spiral in the share price of the issuer. All of this would tend to increase bank risk rather than diminish it, particularly in periods of bank stress.

The issuance of contingent or convertible capital instruments should be voluntary. The proposal to require banks to issue contingent or convertible capital instruments would hinder unduly the flexibility of banks to create a capital structure that best meets the needs of the bank and its investors. For some banks, the issuance of contingent or convertible capital instruments could be a good option for ensuring that adequate buffers over the minimum requirements are available to meet unforeseen needs. Other banks may not be able to, or may find it inefficient to, issue contingent or convertible instruments for a variety of reasons – including, for instance, restrictions under their chartering instruments, tax issues related to the deductibility of payments on the instruments, lack of market access, or insufficient investor interest. These banks should not be harmed by a perception that they are not as well capitalized as others simply because they need to or choose to meet their capital needs through other acceptable channels.

Contingent or convertible capital instruments should qualify as part of the capital conservation buffer required under Basel III. As discussed above, contingent or convertible capital instruments should be one option that a bank could use to meet the need to maintain a capital buffer over and above minimum capital requirements. Contingent or convertible capital

instruments potentially are very valuable buffers because as they are designed to promote market discipline through risk-based pricing. Triggers that can be negotiated between banks and their investors can be designed to respond to investor concerns about a particular business model or type of bank – for example, the triggers that might apply to instruments issued by a retail bank could be different from triggers that would apply to instruments issued by a bank with significant trading activities.

That said, banks should have the latitude to meet buffer requirements through the use of a variety of vehicles, depending upon the cost-effectiveness and efficiency of different options. Contingent capital instruments could be one, but not the only, method for meeting capital buffer needs and requirements. If contingent and convertible capital instruments are not considered to be appropriate instruments for meeting the capital conservation buffer, the need for both requirements should be reviewed carefully, as should the calibration of the buffer. It appears to us duplicative to require both a capital conservation buffer of 2.5 percent of risk-weighted assets plus a requirement for contingent or convertible capital instruments.

The terms and conditions of contingent or convertible capital instruments should not be set by regulators but, rather, negotiated by banks and their investors. An important advantage of contingent or convertible capital instruments is the flexibility afforded to craft terms and conditions, including triggers, to best serve the interests of banks and their investors, as well as the regulatory interest of risk mitigation, without the use of public funds. Contingent capital instruments should be based on terms and conditions, including triggering events, negotiated by banks and their investors. To do otherwise would be to require banks to issue securities for which no viable market exists at reasonable prices, thereby forcing banks to offer extraordinary returns to compensate investors for extraordinary risk. This would cause a damaging hit to banks' profitability and, therefore, to their ability to attract other forms of capital.

The terms and conditions of contingent and convertible instruments should permit carefully designed partial or temporary write-downs within reasonable bounds. Temporary write-downs could be reversed if the bank's condition improves or in cases in which the trigger is a "false positive" that does not reflect accurately the health of the bank. Allowing for the reversal of write-downs would help to prevent investor flight at the first signs of distress and, thus, avoid the so-called "death spiral" that can lead to premature regulatory-induced demise of the institution.

In any event, terms and conditions should not be adopted in a one-size-fits-all manner. A one-size-fits-all approach to terms and conditions would be inappropriate for instruments that could be crafted in many different ways to meet the specific needs of a bank and the concerns of its investors regarding potential sources of risk. Flexibility of terms and conditions can maximize the potential for recovery as opposed to resolution, thereby minimizing the costs to the broader economy.

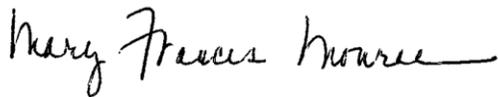
Regulatory imposition of the terms and conditions of these instruments would frustrate this flexibility as well as the ability of the market to evolve and optimize the use of these instruments over time and with experience. A regulatory trigger would be very subjective, allowing for a high degree of latitude by supervisory authorities without reference to specified criteria. Experience teaches that under political pressure regulators could be just as prone to forebear as

they would be to exercise such a trigger. Regulatory triggers may also preclude the ability of a bank to “cure” a trigger event, a common feature of other capital instruments.

Terms and conditions of contingent or convertible instruments should be readily determinable and objective so that investors can determine the risk of convertibility of a particular instrument. Regulators have recently voiced their willingness to allow market forces to determine whether a bank should fail and to allow those banks to fail regardless of size or systemic importance. Regulatory triggers would frustrate the proper role of market forces upon the non-viability of a firm.

Any rules regarding contingent or convertible capital instruments should be accompanied by appropriate grandfathering and phase-in periods. Recognizing the need for a measured approach to new capital and other prudential measures, we strongly encourage the Committee to grandfather existing non-common tier 1 and tier 2 measures and accommodate an orderly and gradual phase-in of any rules regarding contingent or convertible capital instruments. Appropriate grandfathering and phase-in periods would be consistent with the approach taken in the broader Basel III scheme and would allow banks to integrate these rules into their capital planning processes in an orderly manner.

Respectfully submitted,

A handwritten signature in cursive script that reads "Mary Frances Monroe". The signature is written in black ink and is positioned above the typed name.

Mary Frances Monroe
Vice President
Office of Regulatory Policy