

DG Internal Market and Services
Directorate H – Financial Institutions,
Unit H1 – Banking and Financial conglomerates
European Commission
SPA2, 1049 Brussels

3 March 2011

Dear Sirs,

Response submission from the International Capital Market Association (ICMA)

Re: European Commission Consultation Paper – Technical details of a possible European crisis management framework

Introduction:

The ICMA¹ is a pan-European self regulatory organisation and an influential voice for the global capital market. It has a membership of 400 firms and represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges and other venues, central banks, law firms and other professional advisers. The ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years.

The ICMA notes that this Commission consultation includes a wide range of potential measures intended to ensure that authorities across the EU have the powers and tools to restructure or resolve (the process to allow for the managed failure of a financial institution) all types of financial institution in crisis, without taxpayers ultimately bearing the burden. Whilst many of these important proposals are of significant interest, this response nevertheless focuses on just one specific aspect – namely the consultation's Annex 1: "Debt write down as an additional resolution tool" (i.e. bail-ins).

This response has been compiled in light of a range of inputs provided by ICMA's member firms, including representations made from both Issuer and Investor perspectives. As such it presents a synthesised view informed by both ends of the value chain – i.e. those firms that issue the senior unsecured debt potentially impacted by the contemplated bail-in regime; and those firms that invest in such debt instruments. The ICMA consider that this provides a well informed, broadly based view of the proposals and, consequently, respectfully requests that the Commission give careful consideration to the points that this response raises.

¹ For more information regarding ICMA please go to <https://www.icmagroup.org/home.aspx>

Commentary:

This response comprises two segments. Firstly it lays out some overall thoughts regarding the concept of a bail-in regime applicable to senior unsecured creditors. Moving on from this, it then sequentially addresses each of the specific questions posed in Annex A of this consultation.

A. Overall remarks

The ICMA welcomes the opportunity to contribute to the Commission's examination of the topic of senior unsecured debt bail-in, as articulated through the text and questions laid out in Annex A of this consultation paper. Through its publication of this Annex A the Commission is taking an important step forward to properly frame and inform a public debate on an important topic, which although much discussed in financial market circles over the past year has thus far lacked an adequate common frame of reference. The ICMA recognise the Commission's objectives and the ambitious goal it seeks to reach through the potential development of a senior unsecured debt bail-in regime.

Whilst being supportive of the Commission's endeavours, the ICMA perceives that there are nevertheless some significant overriding challenges which will need to be overcome in the final design of any such senior unsecured debt bail-in regime. Concretely, the ICMA considers that:

1. Whilst investors appreciate the capital risks of investing further down the bank capital structure, they invest in senior bank debt principally to match their liability structure; not to add risk. If bail-in extends to senior unsecured bank debt it will either:
 - Restrict investment criteria; and/or
 - Make other asset classes more attractive on a relative value basis; and/or
 - Justify a significant premium over current senior unsecured levels.
2. Under pressure to find other attractive sources of funds banks will face increased competition for retail deposits and make increased use of various forms of secured funding and/or securitisation. This will encumber (typically higher quality) assets, to the detriment of other creditors – including depositors. Such increased competition for retail deposits is likely to drive up rates for depositors (so decreasing bank interest margins), but will also induce increased deposit shifting (i.e. funding becomes less stable).
3. The risk of runs is likely to increase, as senior unsecured creditors are incentivised to ensure that they exit their debt investment ahead of any triggering of a senior unsecured bail-in.

These effects are incongruous with the Basel proposed NSFR (Net Stable Funding Ratio) and LCR (Liquidity Coverage Ratio). They will also lead to higher bank lending costs; and/or reduced bank lending. This is particularly pertinent as this point in the cycle, with the price and availability of bank funding (especially for smaller/weaker entities) already significantly pressurised by events.

For these reasons, the ICMA consider that it would be best to restrict explicit loss absorption features to capital instruments and not to extend them to senior unsecured debt. The ICMA believe that it is important to consider this viewpoint in context of a number of other very significant changes, which have already been agreed or are already well under way. In particular there are several important measures which will dramatically increase both the quality and the quantity of capital being held against banking sector risks, in consequence of which the impact of any future crisis will be much reduced in comparison to that experienced over the last few years. At the same time other important measures will occasion a marked increase in the stability of the financial system, thereby concurrently decreasing the risk of future crises. The ICMA consider that this reduction in both the probability and the severity of future crises affords the public authorities the opportunity to take stock of the aggregate impact achieved and to calibrate incremental steps in regulatory reform accordingly. Complete phasing in of these other changes should precede any new senior unsecured debt bail-in regime.

B. Responses to specific questions

In case there is to be a bail-in provision related to senior unsecured debt, the ICMA is keen to play a constructive role in debating the applicable detailed considerations. Accordingly the ICMA proposes the following further comments and responses that it believes could be valuably taken into account.

The overall senior unsecured debt bail-in concept should be developed based on consideration of the outcome that might reasonably be expected in case there was sufficient time to negotiate a debt work out, allowing that the entity be sustained as a going concern. In evaluating this scenario, it should be assumed that the alternative is a disorderly failure leading to liquidation – regardless of the fact that the entity is question is likely to be considered to be too significant (for whatever specific reason) to fail. In other words the intention is to mimic the normal process that would be applicable in a private sector corporate insolvency restructuring, where creditors negotiate amongst themselves regarding the distribution of loss. This general concept is followed in formulating the answers to the consultation questions that follow:

62a. What classes of debt (if any) would need to be excluded from a statutory power to write down senior debt?

The Consultation paper quite correctly identifies the need to exclude swap, repo and derivatives counterparties (including claims that are covered by master netting agreements – even if uncollateralised) and other trade creditors; short-term debt (defined by a specified maximum maturity); retail and wholesale deposits and secured debt (including covered bonds). The exclusion in respect of secured debt should relate to the amount which is secured.

62b. Is it desirable to undermine the principle that creditors of the same ranking should be treated similarly? Should a discretionary power allow authorities to discriminate within classes of debt?

The Consultation paper quite correctly identifies that, as a matter of principle, the design and exercise of a debt write down power should preserve as far as possible the ranking of claims on insolvency. In particular, equity and all other capital instruments should be fully wiped out before any senior unsecured debt bail-in. This specific point is of fundamental significance to the acceptability of any senior unsecured debt bail-in regime, as it assures the full potential utilisation of the capital structure and correctly respects the fundamental distinction between “capital” (in all its forms) and senior debt.

Any discretion to discriminate within a class of debt should proceed from an identification of the rights which parties would hold in the negotiation of a debt restructuring, including whether they are subject to a debt bail-in regime or not. Any discrimination should then reflect the hypothetical negotiated outcome of a debt restructuring, reasonably arrived at in light of such rights; and it is hence acceptable that debt subject to a bail-in regime be treated differently than otherwise equivalent debt.

62c. What are the consequences of the fact that this approach may result in the ranking of creditors in the context of resolution being different to that in normal insolvency? Is further provision needed to address this?

It is precisely the fact that the outcome of a normal insolvency may be different (i.e. worse) which explains why it is that different stakeholders will be prepared to reach reasonable agreement in a negotiated restructuring. It is maybe helpful to consider that it is not really the ranking which a bail-in regime would change, but rather the quantum of the claim – which is reduced by the bailed-in amount. In other words, the bail-in regime represents one factor leading to effective structural subordination, as distinct from any form of legal subordination.

62d. *What measures would be appropriate to reduce debt restructuring and regulatory arbitrage? For example, would it be necessary to require a minimum amount of debt remains in scope at all times?*

It should not be necessary to require that an absolute minimum amount of debt remains in scope at all times, but there may be a case for developing a form of encumbrance ratio – designed to limit how much excluded senior debt may be permitted in relation to the amount of debt that remains in scope. Rating and market pressures have always provided an element of constraint to the encumbrance of too large a portion of the balance sheet and will continue to do so, but the reality is that the distinction between debt covered by a bail-in regime and that which is exempt will increase the pressure to maximise the use of exempt forms of funding – which may dictate the need for regulatory authorities to articulate their tolerance for encumbrance.

63a. *What factors should authorities take into account when determining the correct amount of 'bail-in debt' that should be issued acknowledging the need to ensure that institutions are 'resolvable' while avoiding single market distortions?*

In this case, periodic capital stress tests offer a logical tool for identifying how much bail-in debt should be issued. These tests need to be robust, with the chosen confidence level being suitably increased in order to size the amount to hold in addition to the “normal” required capital buffers (this should not however involve targeting zero failure – i.e. 100% confidence).

63b. *Would a market for large amounts of such debt exist at a cost which is lower than equity?*

There are various arguments for and against the adoption of the targeted approach. One important consideration in its favour is that it allows investors to express their investment preferences more precisely. Those investors unwilling to buy senior unsecured debt that is subject to a bail-in regime will still provide a source of funds, rather than being precluded from investing in banks; whilst those willing to price the incremental risk of the regime will be able to charge for such instruments accordingly. By virtue of allowing investors to explicitly appreciate, and be compensated for, the bail-in risk associated with prospective investment decisions, this approach also appears to provide a fairer transition to a new regime than simply imposing bail-in on existing investors.

Though subject to a conceptual upper limit, the size of the market will be a function of price. Price will inevitably reflect the strength of the entity in question, with those least in need of such an incremental layer of potential capital support able to raise the largest/cheapest amounts. For any entity where there is real concern that the bail-in feature could be triggered price will escalate rapidly and will soon exceed that of further equity. Raising and maintaining required minimum amounts may only prove to be possible in case an entity already has sufficient capital that the bail-in debt is arguably not needed – which may demand incremental equity raising and/or de-risking.

63c. *As an alternative to a statutory requirement to issue certain instruments with specified terms, might institutions be permitted to insert a write down term in any debt instrument they deem appropriate to meet the fixed requirement for 'bail in' debt? Would there be any drawbacks to such an approach?*

This alternative seems iniquitous; since it threatens to arbitrarily and retrospectively impact the rights of the holders of whichever debt instruments are “deemed appropriate”.

64a. *Would the trigger be sufficiently clear and predictable (i.e. will instruments be rateable and will markets be able to price them) if linked to the failure of an institution?*

The answer to this question is necessarily ambiguous as it depends on precisely how “failure of an institution” is defined. This is not as obvious as it might be, given the reality that the bail-in tool can only prove of use in case activated before an actual ‘failure’ has finally occurred.

The ideal triggers would be transparent and objectively measurable, but the inclusion of some discretionary element in the operation of the bail-in appears unavoidable. This inevitably increases uncertainty, thus reducing demand and/or increasing pricing. Nevertheless, there is one crucial building block upon which a solid foundation for a senior unsecured debt bail-in regime can be established. As already noted in response to question 62(b) above, equity and all other capital instruments should be fully wiped out before any senior unsecured debt bail-in. The bail-in trigger can thus be thought of as being the full satisfaction of this pre-condition. This builds upon the embedded notion that a senior unsecured bail-in regime should be a “gone concern” resolution tool; and is not just another layer of “going concern” capital. This approach avoids many, potentially complex, valuation, accounting and other concerns, by simply focussing on the future state outcome – in other words post bail-in all the former capital providers of the entity in question will have no remaining stake derived from their capacity as such.

64b. Are market participants likely to have an appetite for such instruments? Why or why not? If you consider that the pool of likely investors would be small, are there any adjustments which could be made to make such instruments more attractive without undermining the objectives of the tool?

It is likely that the aggregate investment pool for such instruments will prove to be significantly constrained (see also the answer to 63(b) above). This will be associated with falls in ratings (as “systemic support” is derecognised by credit rating agencies); increases in pricing; and increased differentiation across the issuer credit spectrum. It is expected that these factors will outweigh any improved bondholder sentiment relating to increases in bank capital (pursuant to agreed revisions to requirements). There is no doubt that transition will be difficult to manage, so that it is important to respect concerns related to the timing of implementation of any bail-in regime. Failure to do so is likely to significantly disrupt funding access, particularly for any but the strongest of credits.

Without necessarily undermining the objectives of the bail-in tool, there are two conceptual approaches which may be considered to mitigate investor concerns over the introduction of bail-in. The first is a provision allowing for subsequent restoration of written down amounts, through payments out of retained earnings – with priority over any payments to other classes of capital provider. The second is to compensate the written down amounts through an allocation of common equity. In either case what is under consideration is the allocation of rights as between the affected debt holders and other providers of new (shareholder) capital, pre-existing capital providers having been fully wiped out. The deployment of a well designed mitigation mechanism should be considered as a pre-requisite for the establishment of any senior unsecured bail-in regime.

64c. What are the most likely classes of investor: e.g. other banks or investment firms, insurers, pension funds, hedge fund and other high yield investors, retail? Should certain types of investor be restricted from holding such instruments?

Each class of investor may conceptually participate, though the different classes will have different levels of appetite – which will vary over time for each class dependant on investment alternatives and the economic situation. Normal considerations should dictate the imposition of any restrictions, including limiting contagion through cross holdings; appropriateness; and, in case of an equity conversion feature, bank ownership constraints.

65. *Under what circumstances would additional compensation mechanisms be needed and what form might they take?*

As noted in the consultation paper and in the answer to questions 62(b) & (c) above, there ought not to be a need for additional compensation. In case there is, this should take one of the two forms discussed in answer to question 64(b) above.

66. *Should a regime of the kind discussed in this Annex allow flexibility in where within the group 'bail in debt' issue or held? What are the relative pros and cons of such an approach and what mechanisms would there be for ensuring all resolution authorities have viable resolution tools?*

As this is contemplated as an EU regime, there ought in principle to be the flexibility to issue at the EU holding company level within a group, or at individual entity levels beneath this. Intra-group supervision and regulatory requirements should be reviewed to ensure their coherence with whatever bail-in arrangements are established. This would be consistent with the single market.

67. *Is there a case for giving some creditors of a newly bailed in institution 'super senior' status? Should such a status be discretionary or a rule? What sorts of claim should be included and what mechanisms for transition back to a normal state should be considered?*

On the face of it the existing practice of agreeing priority status for certain IMF advances works quite effectively. It may then be reasonable to conclude that this same notion could be extended to certain other situations where new money is being provided to effect resolution. Cases of priority status should nevertheless be limited and it should be made clear to which extent this is contemplated; whilst retaining some flexibility through staying with a discretionary approach to application.

68. *Is it necessary to design a 'bail-in' mechanism for non-joint stock companies? How might this be achieved without unduly benefitting the members at the expense of creditors?*

If any requirement is imposed only on a discrete population of systemically important financial institutions there should be few non-joint stock companies in scope. If there are non-joint stock companies that supervisory authorities determine to need 'bail-in' debt there would be a need to design such a mechanism. One possible solution could be to require a conversion to joint stock company status – with the normal mechanism for bail-in then being followed. If this is not feasible it may be possible to use a write down mechanism, akin to that recently deployed by Rabobank.

Concluding remarks:

The ICMA appreciate the valuable contribution made by the European Commission's examination of the issues articulated in this consultation paper and would like to thank the European Commission for its careful consideration of the points made in this response. The ICMA remains at your disposal to discuss any of the above points.

Yours faithfully,



David Hiscock
Senior Director - Market Practice and Regulatory Policy