

**BAIL-IN WORKING GROUP
OF THE ICMA
ASSET MANAGEMENT & INVESTORS COUNCIL**



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CC Pär Torstensson

31 July 2015

Dear Mr Constâncio and Ms Lautenschläger

The ICMA¹ is a pan-European self regulatory organisation and an influential voice for the global capital market. It has a membership of over 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 Bail-In Working Group (BIWG) of ICMA has compiled this discussion paper, the purpose of which is to set out views on the operation of the bail-in mechanism. The views represent a range of inputs provided by the BIWG, which in turns reports to the Asset Management and Investors Council (AMIC) of ICMA². As such, it represents a well informed and considered view of the bail-in proposals from the buy-side perspective.

General:

Regulators, government officials, central bankers and investors maintain the same goal: to reinforce the safety, soundness and ultimately, the stability of the financial system. The BIWG generally concurs, in varying degrees, with many of the comments that have flowed through the market regarding the proposed TLAC term-sheet and issues regarding bail-in and ultimately bank resolution. But the BIWG stresses the need to create conditions that allow investors to assess the range of potential risks - a crucial part of the investment decision making process. **The BIWG is concerned that extra layers of regulatory complexity may not only make it more difficult for banks to raise**

¹ www.icmagroup.org

² <http://www.icmagroup.org/About-ICMA/icma-councils-and-committees/Asset-Management-and-Investors-Council-AMIC/>

capital in the first place, but also ultimately negatively impact investor demand and investor behaviour, and thereby render bank capital uninvestable.

Complexity of triggers:

The main focus of concern is the development of regulatory measures to which investors, especially in the credit world, will now be subjected. More specifically, regulators have set a number of triggers, including: Pillar 1, Pillar 2, Minimum Requirement for Eligible Liabilities (MREL), Total Loss Absorbing Capacity (TLAC), Maximum Distributable Amount (MDA), risk-weighted basis, leverage basis, stressed basis/unstressed basis, and most crucially, Point of Non Viability (PONV). The location of these triggers along a now more complex, revised capital structure is not entirely clear and may indeed be varied through time. Moreover, many of these triggers are subject to significant degrees of regulatory discretion. The absence of a track record of new-style interventions leaves investors with almost no insight into the risks associated with such discretion. Consequently, it is impossible to reasonably price such contingencies.

Transparency:

The more complexity in the underlying framework of the capital structure, the greater will be the challenges around transparency and predictability for both balance sheet and resolution regime.

Under new and more intrusive supervision, regulators are likely to be privy to more detailed information. As such, the BIWG is keen to avoid a situation whereby credit investors are not only underwriting the risk of management failures, but are essentially underwriting the risk of regulatory failure which arises due to regulatory complexity, and a lack of available information by which to price risk. Investors are arguably compensated for the former through the credit premium. (However given the loose monetary policies deployed at present by many central banks, it is far from clear that markets are correctly pricing a variety of risks including both credit risk and liquidity risk). It is however unlikely that investors are being adequately compensated for the latter as there is currently no reliable means by which to price this risk.

Asset quality/legacy bad loans:

While primarily responding to questions regarding the liability structure, many asset quality issues arising from the financial crisis remain, to a large degree, unresolved - in particular, the high stock of bad loans remaining on the books of many of the euro area banks. The concern here is that investors may be called upon to fund these bad loans years after the onset of the financial crisis and as part of the bail in/resolution of a bank. Arguably this is the case with the resolution of Heta in Austria. In dozens of cases, particularly across the euro area, these bad loans exceed the tangible common equity of many banks and are at historically high levels to the GDP of individual countries and the Euro 19 collectively. While growth in the banking system via the credit markets is a common goal, there is a need to dramatically reduce over time the legacy bad loans that remain. Present levels of pre-provision profitability show that this may take years to even out.

Market and individual bank estimates of loss-absorbing capital required (under the present TLAC Term Sheet) exceed upwards of €1.0 trillion. This roughly equals the ECB reported stock of NPE (Non Performing Exposure) under the "simplified definition" of the EBA following the latest Europe-wide AQR/Stress tests. To address the liability mix without addressing the issue of the other risks of the

balance sheet would be a missed opportunity, and credit investors will be less willing to fund new capital and TLAC instruments if the perception is that these funds will be deployed to clean up legacy problems. In other operating environments - such as the US market - a unified regulatory disclosure is substantially more detailed.

Quality of underlying risk – equity - capital:

The quality of the underlying risk capital – i.e. the equity buffer that comes in before bail-in debt – also needs to be assessed before trying to price capital instruments, which today adds an additional level of complexity for investors.

Preserving confidence:

Banks remain viable entities as long as they are perceived to be solvent. Therefore it is crucial to preserve depositor and investor confidence through the journey to increased levels of required regulatory capital. While a period of stability in the rule-setting process would be welcomed, consideration of the following issues, which could be implemented by way of streamlining and simplifying the regulatory treatment of banks, could help to encourage this confidence:

I. Enhanced Transparency:

Enhanced transparency is at the core of investment decision making. Greater visibility, for example on **asset encumbrance** and **Pillar 2 requirements**, is necessary. Mindful of the technical challenge it may pose, the development of a unified, detailed and publicly available chart of accounts and financial reporting for the euro area financial system is crucial (whilst respecting the need for confidentiality in certain instances), for reasons set out further below. In this regard, the BIWG is fully supportive of the detailed work of the Enhanced Disclosure Task Force (EDTF) of the FSB.

A significant number of euro area bank assets do not fall under the remit of direct regulation of the ECB. In addition, many banks are not listed, and hence are not subject to the additional market discipline and scrutiny of the capital markets. Fixed income investors may be indifferent as to ownership structure and size of balance sheet, but consider that consistent disclosure of data is vital. A unified, detailed and publicly available chart of accounts and financial reporting (especially on asset quality) is a medium-term goal that could be achieved in parallel to the new capital requirements and resolution regimes.

In particular, given the concerns raised above regarding underwriting regulatory failure, authorities should be encouraged to establish the maximum possible degree of parity between what the banks disclose to the market and what they disclose to the regulators, as to which a unified, detailed and publicly disclosed chart of accounts and financial reporting for banks in the euro area would help. Given the intended shift from a bail-out regime (with costs largely borne primarily by the public sector - ultimately, taxpayers) to a bail-in regime (with costs born primarily by private-sector investors), a fundamental shift in the mind-set of the authorities regarding disclosure is required.

Investors are likely to be at a considerable information disadvantage versus the regulators in resolution planning, and should receive significantly better *ex-ante* disclosure as to the manner in which a resolution would likely unfold at any given institution. This should go beyond the mere

disclosure as to which entities in a group are resolution entities and is perhaps of particular importance in groups which deploy a Hold Co/Op Co structure and/or are intending to operate a “multiple point of entry” structure.

Even with significantly enhanced transparency, it remains unclear that the rights of creditors will be adequately protected under the new regime given the levels of discretion accorded to both bank management and regulators especially with regard to Additional Tier 1 instruments. In this particular regard, the “No Creditor Worse Off” protection is of no value. Members of the BIWG would welcome further debate and disclosure around this topic.

II. Enhanced Simplicity:

The future development and success of the market for TLAC and regulatory capital instruments will be best served by a high degree of standardisation/ homogeneity. The rules of the game therefore need to be clearer.

There is in Europe a significant challenge regarding the manner in which subordination of TLAC-eligible instruments is achieved. For example: Hold Co/Op Co structure (United Kingdom); Statutory Subordination (German Proposal); and Contractual Subordination (discussions around “Tier-3” TLAC instruments). Whilst these potential solutions address national idiosyncrasies, a common framework would be simpler, and therefore, preferable.

Equally, as noted above, the multiplicity of trigger points for the imposition of losses on TLAC/regulatory capital instruments is a concern. In this regard, it is important for investors to be able to determine which the effective triggers are given any reasonably foreseeable scenario, rather than whether losses are imposed via coupon restrictions or losses to principal via write-down or equity conversion.

III. Enhanced Predictability:

The BIWG recognises that the resolution regime is still in the development/transition stage. However, with many of the pieces of the jigsaw now in place, an extended period of stability in the rule-setting process would be welcomed. Where possible, any further changes should avoid retroactive application, especially regarding such fundamental issues as the creditor hierarchy/relative subordination.

The BIWG understands the need for limited flexibility in order to vary capital requirements throughout economic cycles. Nonetheless, further fundamental shifts in the quantum of capital required would be very damaging especially given the long-term nature of the proposed TLAC instruments. This is particularly the case were it to impact the proximity of bail-in.

The BIWG supports and recognises the value of the stress testing regimes that have been introduced in the main jurisdictions. Ultimately, these should enhance discipline within the banking sector and lower the risk to regulators and investors alike. However, concerns remain that the outcome of stress-testing both in terms of the capital outturns and the regulatory response to “failure” may lack

a degree of predictability. This is especially the case depending upon the stresses applied in the actual exercises.

The advent of resolution regimes puts all interested parties - regulators, government officials, central bankers and investors into uncharted waters. It may take many years before a pattern of resolutions emerges, and not every resolution may be the same. Nonetheless, the BIWG would encourage the authorities to establish, at the earliest opportunity, a consistent approach that can then be clearly and transparently articulated to the market.

Conclusion:

The BIWG looks forward to engaging the ECB and other regulatory bodies in a constructive and open dialogue to achieve the ultimate goal of fortifying the safety, soundness and, ultimately, the long-term stability of the financial system.

Yours sincerely

A handwritten signature in dark ink, appearing to read 'Robert Parker', with a long horizontal stroke extending from the end of the name.

Robert Parker
Chair of the ICMA Asset Management and Investors Council