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Basel III: minimum requirements to ensure the loss absorbency of regulatory capital at the point of non-viability

On 13 January 2011 the Basel Committee published the minimum requirements for regulatory capital to ensure loss absorbency at the point of non-viability. Together with the criteria set out in "Basel III: A global regulatory framework for more resilient banks and banking systems" published in December 2010, we now have greater clarity as to the shape of bank capital in future years. However, questions still remain.

The requirements in a nutshell

The terms and conditions of all non-common Tier 1 and Tier 2 instruments must have a provision that requires such instruments, at the option of the relevant authority, to either be written off or converted into common equity upon the occurrence of a specified trigger event.

However, this is not required if (a) the governing jurisdiction of the bank has in place laws that (i) require such Tier 1 and Tier 2 instruments to be written off upon such event, or (ii) otherwise require such instruments to fully absorb losses before tax payers are exposed to loss, (b) a peer group review confirms that the jurisdiction so conforms and (c) it is disclosed by the relevant regulator and by the issuing bank, in issuance documents going forward, that such instruments are subject to such loss.

The trigger event will be the earlier of (a) a decision that a write-off, without which the firm would become non-viable, is necessary and (b) the decision to make a public sector injection of capital, without which in either case the financial institution would become non-viable, as determined by the relevant authority.

Instruments issued after 1 January 2013 must meet these requirements. Instruments issued before 1 January 2013 which do not meet these requirements will be phased out from 1 January 2013.

What are the key issues?

The proposal will lead to a significant change in the way Tier 1 and Tier 2 instruments will need to look in the future and raises a number of other significant issues.

- *Implementation* – The current UK Banking Act does not provide specific powers to write down Tier 1 and Tier 2 instruments, unlike the interim legislation recently adopted in Ireland. It is possible that the UK or other countries will extend their resolution regimes, for example, to reflect the outcome of the European Commission's recent consultation on crisis management, which contemplates so-called "bail-in" powers for both senior and subordinated debt, or the ongoing work of the Financial Stability Board on resolution powers. However, the tide appears to be running in favour of only applying any such powers prospectively (i.e. to newly issued debt), because of concerns about their impact on the rights of existing creditors.

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The new Basel criteria also require specific disclosure relating to any relevant legislative measures in issuance documentation, which also appears to indicate that the legislative route to compliance with the new criteria applies prospectively to new issues, even if there might be ways to use existing resolution powers to impose losses on existing debt holders before taxpayers are exposed to loss. This suggests that banks may not readily be able to rely on legislation to ensure that existing capital instruments comply with the new Basel III requirements.

- *Transitional relief* – From 1 January 2013, any non-Basel III compliant instruments will receive reduced recognition for regulatory capital purposes. The initial mark-down is 10% of outstanding nominal, which will taper thereafter by 10% each subsequent year.

  The December 2010 paper had indicated that these transitional arrangements were only available for instruments issued before 12 September 2010, but the latest release extends this to instruments issued after that date and before 1 January 2013 but only if they meet all the requirements set out in the December 2010 paper.

- *Refinancing opportunities*? – Therefore, it seems likely that banks will wish to refinance some or all of their existing Tier 1 and Tier 2 capital before or as soon as possible after 2013 (to the extent that further capital can be sourced on terms which do not exceed the cost of the existing capital which is effectively increased by the initial and subsequent mark downs). The terms of the existing capital will determine whether the issuers have call rights as a result of the gradual phasing out of regulatory capital benefits. The negotiations around these refinancings will be interesting as the investors from whom consent and/or buy-backs will be sought will be the same to a large extent to those that are needed to subscribe the further capital required by the Basel III capital rules. In particular, there will be acute interest in the acceptability to investors of instruments with trigger events of the kind contemplated by the latest release (as opposed to triggers set by reference to defined capital ratios as contemplated by the few contingent capital issues to date) and whether issuers and investors prefer conversion or write down structures to meet the criteria (the release does not discuss the possibility of terms allowing the future write up of written down debt).

- *Corporate authorisations* – If a bank elects to use equity conversion to meet the non-viability requirements, it will need to maintain at all times any necessary corporate authorisations required to enable it immediately to issue the required number of shares to satisfy the conversion required on the happening of a trigger event. In jurisdictions where this is a relevant consideration, pre-emption rights will have to have been dis-applied and the need for corporate authorisations (or restrictions on issuing shares below par value) may mean that it is necessary in some jurisdictions to fix or cap the number of shares that will be issued on conversion. This may limit any eventual dilution of equity shareholders, although the specified trigger events are likely to involve significant further dilution (or even elimination) of their positions in any event. This would however limit the ability to compensate subordinated debtholders for their loss in cases where the equity has some value following the trigger event and may have an impact on pricing. Similarly, while the bank may need to undertake to seek a listing for the shares issued on conversion, it seems unlikely that conversion can be conditional on this (and it is likely to be difficult to produce any necessary disclosure document for listing at the time of a trigger event).

- *Tax* – The impact of conversion or write down features on the tax deductibility of interest costs will need to be considered. It will also be necessary to consider whether a tax charge would arise for the bank on the occurrence of a trigger event, in particular in relation to write-down structures, and whether this possibility could have an impact on the regulatory capital treatment. Since tax laws across jurisdictions are not uniform, it is likely that the new proposals will give rise to competitive advantages and disadvantages between issuers based in different countries.

- *Group issues* – The proposal raises a number of issues in group structures. However, it specifically allows the implementation of conversion structures where the debt issued by a subsidiary bank converts into shares in a listed parent company. In addition, where a subsidiary bank issuer is part of a wider group with a different consolidated supervisor from its own regulator and wishes to include the debt as regulatory capital in the consolidated returns, the debt will have to be subject to a double trigger, so that either the direct or the consolidated supervisor can force conversion or write down if required.

Nevertheless, despite the questions which remain, the finalisation of the criteria fires a starting gun on the race by banks to meet the Basel III requirements for more, higher quality capital.