EC discussion paper on the debt write-down tool

Resolution legislation is a critical piece of the banking regulation overhaul. It deserves a careful design. In that regard, the Commission ‘s discussion paper on the debt write-down tool or “bail-in” is a significant contribution to the debate in so far it clarifies many concepts that were still in the making. We are pleased to participate to these efforts towards a workable regulation and you will find below our reactions to the questions rightly raised by the paper. Meanwhile we also believe that some fundamental comments have to be made. The regulation must have consistent objectives while the financial markets need certainty and clarity.

Consistent objectives

The core capital requirements have been multiplied by around 4 to 5 times. We subsequently feel that the new requested amount of equity can easily absorb the losses of the magnitude we have observed in the last crisis. A going concern resolution should normally only be based on the subordinated debt conversion. The need to enlarge the bail-in scope should therefore request a convincing and documented justification considering the very significant impact of such a decision on the economy. Conversely a gone concern resolution would require a full debt write down similar to the one applicable in a bankruptcy proceedings. Bail-in is an original feature only when associated with a restricted scope.

Besides, the maturity transformation constraints set by the regulatory reforms call for an increase of the banks’ medium term indebtedness while the market has little appetite to provide such financial resources as bank risk, associated to sovereign risk, is not attracting investors, to say the least. In that context it is essential that the proposed framework provides sufficient clarity so investors know in advance what risk is attached to each layer of the liability side of EU Banks.

Need of certainty and clarity

Market participants that are under growing regulatory scrutiny and also short of medium term resources are looking for predictable outcome for their investments. They may accept properly priced equity like instruments for limited amount or unquestionable senior debts. Anything in between, particularly if the scope of the bail-inable debt is reduced by the exemption of the clients’ deposits, operating and secured claims and uneasy to forecast, would not be palatable for them because of the high uncertainty of the possible write down amount.

Conclusion

In total, should there be a bail-in feature in the coming European legislation on resolution, its scope should be pre-determined, i.e. a collection of instruments identified at their issuance as bail-inable at resolution. We acknowledge that this stance requires supervision bodies to set an amount of contingent capital, subordinated debts included, considered to be high enough to keep as a going concern an institution which is being restructured. We suggested that the additional Tier 1 and Tier 2 debt amount should suffice. Should there be evidence that a higher amount is needed, it could not presumably represent more than an extreme loss that would have wiped out the core equity. This extra layer of contingent capital, if any, should be established on a consolidated basis as part of the Pillar 2 assessment process, taking into account the business model and risk profile of the institution.

This supplementary loss absorption buffer should be construed as a substitution to the SIFIs' capital surcharge since it addresses the same concern. It should be kept within a very reasonable range in order not to make cost of doing business unbearable and eventually accelerate the starting deleveraging process. This could be a very untimely blow to the weakening European economy.

BNP Paribas position in regard to the Commission services discussion paper on the debt write-down tool /Bail-in

1. Do you consider that the point of entry into resolution should be the same as the one for the rest of the resolution tools? Do you consider that it should be a point close to insolvency?

Yes, the point of entry into resolution should be the same for all resolution tools, and should also be identical to the point of conversion of remaining loss absorbing instruments qualifying for Tier 1 and Tier 2.

It should be made clear in a) of the second paragraph that the breach of minimum capital requirements should not be a formal trigger of entry into resolution. A bank may be temporarily in breach of such minima, particularly as these minima may be placed at a very high level, and such a breach is not necessarily an indication of impending insolvency. We would urge the Commission to delete this sub-paragraph a).

2. Do you consider that a credible framework for the resolution of banks should include both the open bank and the closed bank bail-in?

We feel that this distinction between open and closed bank is misleading, as it refers to two very different situations in which debt, or some parts of debt, may be converted into equity. It seems to us that the term of 'bail-in' is being used to describe both situations, which is generating confusion in market reactions, and generating uncertainty over the future status of senior bank debt. Clarification of this uncertainty is clearly essential in order to ensure stable resources for the banking industry.

The 'open bank' situation, in our understanding, refers to a situation in which a bank enters resolution, but has the potential to emerge rapidly from resolution (after the week-end) provided that it can be rapidly recapitalised. The bank may then need to restructure and re-organise its activities, including possible sales of subsidiaries or business lines, but it is fundamentally the same institution. For this institution to have a credible funding capacity going forward, it is important that its senior debt holders have not suffered losses. To this end, the debt converted to equity should be debt that was from origination clearly identified as being subject to this risk. The most pragmatic solution would be for this debt to take the form of Tier 1 or Tier 2 instruments, or of contractually bail-inable, write-downable or convertible debt. The common feature of these varying forms of debt is that they would have been known from origination to contain the risk of being converted to equity, and would have been priced accordingly by investors.

The 'closed bank' situation, in the understanding of BNP Paribas, refers to a situation in which losses are so great that the bank has no ability to emerge rapidly from resolution, and should therefore enter into a process of orderly liquidation. Parts of the bank may be run off or closed, parts may be sold on to third parties, and parts may be re-introduced to the private sector via one or more bridge bank or good bank splits. The difference with the previous situation is that what emerges or survives is absolutely not the same institution. This is the banking equivalent of bankruptcy, and were the company to be a normal corporate entity, standard insolvency rules would apply. Given the special characteristics of banks, the forced conversion of senior debt to equity, or simply its write-down, subject in all instances to the 'No Creditor Worse Off than in Liquidation' (NCWOL) principle, would be a highly useful tool to facilitate an orderly liquidation during which critical economic functions could be maintained for the necessary period of time. In this instance, the scope of debts written down should be as wide as possible, subject to justified exceptions decided by the resolution authorities (which could include net derivatives positions). Write down or conversion to equity of senior debt, subject to NCWOL, would be a form of application of normal insolvency rules to the particular instance of banks.

All senior debt, subject to the exceptions decided by resolution authorities, would naturally bear losses in this ‘closed bank’ situation, reflecting the insolvency risk inherent in any form of lending, and which would normally be considerably lower than those generated in a disorderly bank liquidation.

BNP Paribas believes that by drawing a clear distinction between the bail-in of specifically identified instruments in an ‘open bank’ scenario, and the write-down of senior debt in a ‘closed bank’ scenario, the future status of senior debt would be significantly clarified.

3a. Do you agree with the suggested list of excluded liabilities?

In an ‘open bank’ situation as construed by BNP Paribas, no list of excluded liabilities will be needed, as the debts subject to bail-in will be clearly identified ex ante.

In a ‘closed bank’ situation, BNP Paribas would favour a wide application scope for debt write-down. This means a progressive implementation of the insolvency waterfall rules in the way most appropriate to the bank being resolved. This would certainly mean that the DGS should be called upon as proposed, in order to avoid losses on these claims.

3b. Do you consider that liabilities with an original maturity shorter than a certain period should be excluded from bail-in? Should this period be 1 month, 3months, or another period?

In the ‘open bank’ situation as we construe it, these liabilities will not be affected

In the ‘closed bank’ situation, these liabilities should eventually be written down..

3c. Do you consider that derivatives should be included in the scope of bail-in? If not, what would be the reason that would justify granting them a preferential treatment?

This question would not arise in an ‘open bank’ situation as construed by BNP Paribas.
In ‘closed bank’ scenarios, our response would be as for 3 b, unless the resolution authorities determined otherwise.

3d. Do you consider that DGS should be included in the scope of bail-in (i.e. DGS suffers losses instead of covered depositors pari passu with unsecured liabilities)?

See 3.a, in the case of the ‘closed bank’ situation.

3e. Do you consider that secured liabilities should be included in the scope of bail-in when the value of the security is lower than that of the liability? Under what conditions do you consider they could be totally excluded without granting them an unjustified preferential treatment?

In our vision of the ‘open bank’ scenario, this question would not arise.

As for 3 b. In a ‘closed bank’ situation the unsecured portion of the liability should be eventually written down. Any exclusion from write down simply by virtue of the liability being secured, whatever the quality of the security, would be open to abuse.

3f. How would it be possible to avoid that financial instruments are designed with the purpose of being excluded from the scope of bail in able liabilities (i.e. bonds with embed options?

In an ‘open bank’ situation as construed by BNP Paribas, no ambiguity as to bail-inability can exist.

In a ‘closed bank’ situation, the use of wide scope write-down should negate the potential for instruments being designed to avoid write-down.

4a. Which of the two options do you consider more appropriate in order to mitigate any systemic impact of the use of the tool and minimise the impact in funding costs?

In our interpretation of an ‘open bank’ situation, bail-in debt is clearly identified ex-ante.
In a ‘closed-bank’ situation, Option 1 should be applied. There would be no grounds to consider Option 2, as the bank would be in orderly liquidation in a ‘gone concern’ perspective.

4b. If you do consider the sequential model to be suitable Do you consider that derivatives that are cleared through a CCP should be treated differently from other derivatives in a bail-in?

See 4 .A , our interpretation of the two differing situations removes the need to make this distinction.

5a. Which do you consider is the best way to fix a minimum amount of bail-inable liabilities – option 1 or 2a), 2b)? If you consider option 1 preferable how could possible fragmentation of the internal market and unlevel competitive conditions within the Internal Market be avoided? How would clarity and predictability be ensured under option 1?

In order to prepare for a ‘closed bank’ situation as we understand it, in which the DGS would be called upon, the fixing of a minimum amount of liabilities available for write-down is not a relevant concept, as all liabilities are potentially available for write-down, subject to possible exemptions in the hands of the resolution authorities.

To prepare an ‘open bank’ bail-in, a target amount of specifically identified bail-inable debt could be fixed between the bank and its supervisor under Pillar 2. Theoretically, this amount should not exceed the minimum Core Tier 1 level that has been calibrated to absorb extreme losses (4.5% of RWA). We insist upon the fact that this amount must be fixed in a reasonable manner, taking into account the risk profile of the institution, and particularly the existence of a G-SIFI surcharge that meets the same objective. In addition, attention must be paid to the ability of the banking system globally to raise such contingent capital in a narrow market.

Predictability and clarity are, in the view of BNP Paribas, achieved by public knowledge of the amount of specifically bail-inable debt issued by banks. The holders of bail-inable debt will be aware of the bail-in risk associated with their investment, and senior debt investors will be aware of the cushion of bail-inable debt available to protect their investment.

5b. What do you think is the optimal minimum level of bail-inable liabilities + capital (e.g. 10% of total liabilities excluding own funds) to prepare for future potential crisis?

In terms of principle, BNP Paribas finds it hard to believe that the European Commission could question the relevance of the RWA framework which is the basis of its regulation for capital requirements. Shifting to a gross liability base is totally inconsistent and would create multiple issues particularly for banks with very significant depositor bases and low-risk asset portfolios. Moreover, we understand that bail-inable debt is intended to regenerate an adequate level of equity after absorbing extreme losses and we would like to underline the fact that all these notions are derived from risk based measures.

As stated in 5a above, BNP Paribas believes that it is of the utmost importance to understand that the market for contingent capital is quite narrow. BNP Paribas has been able in the past to raise €20 to 30 billion of senior debt per year, and estimates its capacity to raise junior debt (additional Tier 1 and Tier 2) at €2 to 3 billion per year. On the assumption that junior debt can be issued for an average term of 10 years, this implies the capacity to generate a maximum stock of € 25 billion, which represents around 4% of BNP Paribas Risk Weighted Assets of just over € 600 billion. This corresponds to the target level of additional Tier 1 (1.5%) and Tier 2 (2%) capital instruments, plus a narrow margin of 0.5% of RWA.

Coming at the problem from another angle, we believe it may be possible for BNP Paribas to issue, in addition to maintaining its current additional Tier 1 and Tier 2 levels (3.5%), around €1 billion per year of contractually bail-inable debt, for maturities of up to 7 years. This would represent an increase in junior debt outstanding of around 33% and would provide, after 7 years of continuous issuance, a stock of bail-inable debt of up to €7 billion, or about 1% of RWA. This demonstrates that there are clearly market constraints and a timing issue that have to be taken into account.

Starting from the BNP Paribas 9% fully loaded Basel 3 Common Equity Tier 1 ratio, which will be reached at the end of 2012, and assuming a hypothetical and sudden loss of €30 billion (4.5% of RWA), the application of the 'open bank' bail-in tool as construed by BNP Paribas would lead us to bail in junior debt equivalent to 4.5% of RWA (1.5% of additional Tier 1, 2% of Tier 2, 1% of contractual bail-in debt), leaving the bank with a core Tier 1 solvency ratio of 9% once again (as € 30 billion is equivalent to 4.5% of RWA).

This post bail-in level of 9% core Tier 1 solvency ratio would have been achieved without any haircut, write-down or forced conversion of senior debt-holders. The bank could then be given a few years to reconstitute the additional Tier 1, Tier 2 and bail-in debt

This level of hypothetical loss of € 30 billion is of the same order of magnitude of the record loss ever suffered by an EU bank (RBS 2008), during the recent financial crises. BNP Paribas did not suffer any full year loss at all.

Were it to be considered, which we believe to be reasonable, that this type of hypothetical loss situation would justify consuming the conservation buffer and opening up a period of time in which to reconstitute it, an even higher level of hypothetical loss could be absorbed without affecting senior debt holders.

5c. Would a minimum amount of bail-inable liabilities + regulatory capital have an excessive negative effect on certain types of banking businesses present in Europe (retail vs. investment banking)? Would it be necessary to establish an exclusion from the minimum rule for certain banks or no rule at all (e.g. small banks, overwhelmingly deposit financed, mortgage banks)?

Unreasonable minimum levels of bail-inable liabilities would have a detrimental effect on all types of banking business, and in particular in the European economy where disintermediation is low.

This, however, cannot justify the fixing of differentiated levels of bail-inable debt between so-called 'large' and 'small' banks, as in each individual banking market, all compete on equal terms in their specific markets. As suggested above, supervisors should be able to take into account the true risk profile of each institution to set the appropriate level of additional junior debt.

5d. Do you consider that the requirement to hold a minimum amount of bail-in-able liabilities should be set both at holding and subsidiary level? Do you consider that resolution authorities should be allowed to apply the requirement exclusively at holding level if that is agreed by all the competent resolution authorities in the context of the resolution plans?

While the FSB resolution approach is focused at the consolidated level, a point of view that we fully support, we are somehow surprised that the commission proposal is institution based. Worst, it even excludes support from the parent company from the scope of the bail-inable debt which appear to BNP Paribas to be self-defeating. In reality, a parent company loan to its subsidiary is the best expression of its support and keeping it outside the bail-inable scope could lead to the dilution of the shareholding company, which will not be in a position to rescue its subsidiary. This specific exclusion is a direct blow to the existence of European banking groups. Therefore we consider that the requirement to issue a certain amount of bail-inable debt should be mostly at consolidated level, in the highest level entity of the group. We are conscious that this necessarily implies that international agreement be reached on the burden sharing between host and home authorities in order to settle the case of foreign subsidiaries that are not "in bonis" and the fate of which is jeopardized by the resolution of the holding company

There are banking groups which are organised on an 'archipelago' basis, but the same reasoning should be applied, with resolution strategies being formed at the highest point of entry in each of the independently resolvable sub-groups that make up the group.

6. Do you agree that there should not be an absolute obligation to cancel existing shares? Would it be enough in certain cases to establish a sufficiently penalising rate of conversion?

BNP Paribas believes that when bail-in is implemented it should be carried out at the latest stock exchange value. This has the following advantages

It is consistent with securities law,
It has the same financial impact on the company as cancellation
It will lead to strong dilution of existing shareholders
It will mean that the lion's share of subsequent recovery will accrue to the bailed-in creditors

7. Do you consider that a business reorganisation plan should be presented soon (e.g. 1 month) after the application of the bail-in tool? Should this only apply in the case of an open bank bail-in or also for a closed bank bail-in?

Yes. We consider that a business reorganisation plan should be implemented soon after the application of bail-in or write down, in both open and closed bank situations.

8. Do you consider that including a contractual recognition of the debt write down would facilitate the enforcement of the debt write down powers with respect to instruments issued under the law of a third country?

This would effectively seem to be an essential condition if the European Community introduced bail-in regulations applying to senior debt. If there were to be differences in practice between different jurisdictions, this would encourage investors to push banks for issuance in jurisdictions in which bail-in rights were not recognised. Banks would thus find themselves constrained to issue up to the regulatory minimum amount in an EC jurisdiction, in order to gain recognition of this debt as bail-inable, but would then be incentivised either

1) to issue outside the EC any senior debt over the regulatory minimum
2) to issue greater amounts of secured debt

This constitutes in our view an additional merit of our proposal for ex-ante identification of bail-inable junior debt.

9a. According to your views, what would be the likely impact of the debt write down tool? What measures (if necessary) could be envisaged to mitigate such impact?

BNP Paribas considers that if bail-in regulations are introduced in the form suggested, the cost of senior debt will be significantly increased. Whilst current senior debt pricing may well already include a reduced value placed on any implicit public guarantee, we do not believe that senior debt investors are currently fully pricing the possibility that they may be bailed in before other pari-passu ranking debt, and are not pricing any notion of sequential bail-in. Moreover, investors' current reluctance to invest senior bank debt is also resulting in rarefaction of this resource. We believe that this phenomenon would be amplified by the bail-in and write-down mechanisms proposed by the Commission.

In the opinion of BNP Paribas, two major constraints must be considered. The first is the risk appetite of investors for junior debt, which our experience tells us is limited. Investments in such equity-like instruments often do not meet investment criteria contained in asset management mandates. The second is the risk of non-availability of medium term resources. The medium term funding market is faced with growing demand from sovereign issuers and corporate issuers that banks can no longer finance under Basel 3. In the context of this competition between issuers, financial institutions that are required to secure more medium term funding in order to reduce maturity transformation would not be able to achieve this target and would be forced to further reduce their loans. EU growth would thus be further penalised.

BNP Paribas believes that our suggested distinction between 'open bank' bail-in of defined instruments, and a wide scope 'closed bank' write-down, would re-establish clarity over the ranking of senior debt. Senior debt investors would be aware that no implicit public guarantee was available, but would know that they only faced losses in the event of the bank taking catastrophic losses that would make 'open bank' bail-in an impossible proposition. This re-clarification of the status of senior debt may contribute to reversing the contraction of the market for senior bank debt, and give bank debt a better chance of competing in the medium term debt market.

9b. Do you consider that the bail-in tool provisions should only become applicable after a certain date in the future? What do you think that date should be?

BNP Paribas considers that the date of application of any new rules is of secondary importance compared to the market perception of the importance of any future regulation.

If regulators announce publicly that they believe banks should significantly and further reinforce their loss-absorption capacity through bail-in debt regulations, the markets will justifiably expect these targets to be reached as soon as possible. The announcement of a future target date does not invalidate the regulatory statement that this reinforcement is needed. If banks are unable to reach the targets rapidly through issuance, they will be forced into deleveraging.

This is precisely the same phenomenon that arose upon the acceleration of Basel 3 capital requirements.

9c. Do you consider that it would be desirable to exclude debt issued before a certain date from the scope of bail-in (grandfathering)?

See 9.b.

9d. Do you consider that there is a need to foresee a transitional period/progressive phase-in for the building of the minimum requirement of "bail-in-able" liabilities? What do you think it should be and over how many years?

See 9 b.

<u>Conclusion</u>

We believe that as soon as future regulations on crisis management are finalised, the impact on the market of bail-in requirements will be immediate, and proportionate to the extent of additional junior liabilities required. In such a context, we would encourage the Commission to consider as highly probable the scenario described by the recent IMF paper forecasting a € 2 trillion decrease in bank’s balance sheets. Although the IMF expects most of this reduction to come from sales of securities and non-core assets, it still sees credit supply declining by 1.7%. It should also be noted that securities and banks’ non-core assets do also finance the economy.