Japan Securities Dealers Association

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Mr. Nout Wellink
Chairman
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Mr. Wellink,

The Japan Securities Dealers Association (JSDA)[1] welcomes the opportunity to comment on the consultative *proposal to ensure the loss absorbency of regulatory capital at the point of non-viability* and appreciates the work done so far in the Basel Committee on Banking Supervision (BCBS).
The JSDA shares and supports the BCBS's view that regulatory capital instruments must be capable of absorbing a loss and should be subordinate to capital injected by public sector.
This said, the proposal includes a number of factors that have serious impacts on capital markets. As a major stakeholder in capital markets, the JSDA considers it our duty to provide comments and/or counterproposals on this issue consulted. We hope our inputs will be helpful in your committee's further deliberations.

1. Factors affecting capital markets' basic features and principles

The proposal attaches great importance to all original regulatory capital instruments being subordinate to any capital injected by the public sector. Consequently, the seniority/subordination among the original regulatory capital instruments may change under the proposal. However, we are inclined to think that the senior-subordinate structure between debt and capital must be clear and be preserved in order to ensure proper expected return and price formation of securities in accordance with risk taken. With this in mind, we are concerned about the following points in the proposal.

1) Seniority/subordination inversion between debt and capital

Under the proposal, preferred stock and subordinated debt that should be intrinsically

[1] Japan Securities Dealers Association (JSDA) is a hybrid association functioning both as a self-regulatory organization (SRO) and as a trade association in the Japanese securities market. Its legal status is that of an organization established under the Financial Instruments and Exchange Act. Under the law, the JSDA has been granted authority by the Prime Minister. The JSDA's more than 500 members consist of securities firms and other financial institutions operating securities businesses in Japan.

senior to common equity are expected to absorb losses prior to the remaining common equity in some cases. For instance, subordinated debt (Tier 2 capital) with a clause to be fully written-off without conversion into common shares on the occurrence of the trigger event will be reduced to zero ahead of common equity (Tier 1 capital), which means that Tier 2 capital absorbs the loss preceding common equity.

In this regard, we are confronted with the question whether subordinated debt, which is to be fully written-off prior to common equity and demonstrates higher loss absorbency, should be classified into Tier 1, not Tier 2. Considering that the BCBS attaches great importance to the level of loss absorbency when judging quality of capital, we cannot help but be skeptical about placing such subordinated debt into Tier 2.

2) Relationship between debt and equity holders

With a view to preventing moral hazard, consideration is required to restrain virtual wealth transfer caused by changes in risks incurred by debt and equity holders on the occurrence of an event that triggers write-off/conversion of contingent capital instruments. As discussed in the consultation document, clarification of seniority/subordination among common equity, preferred equity and subordinated debt would be essential to evaluate risks after write-off/conversion to common equity. It would be necessary to incorporate in advance the planned shares of loss-bearing into the terms and conditions of contract and reconcile conflicts among capital instrument holders.

3) Concerns associated with double gearing

For example, in Japan, not only pensions and hedge funds but also banks have a high amount of investment in contingent capital instruments. Accordingly, in the case that contingent capital instruments possessed by financial institutions are converted to common equity, the financial system as a whole may face higher risks. Particularly, since such common equity is subject to the double gearing provision under Basel III, the capital adequacy ratio of financial institutions holding contingent capital instruments may decline when conversion occurs. Looking at a worse case scenario, a trigger event that occurred for the contingent capital of one financial institution may cause a decline in the capital adequacy ratio of another financial institution that holds the contingent capital instrument and cause a trigger event in that financial institution, inviting a downward spiral in the overall financial system. Thus, avoiding such spillover effects will also be a critical issue.

2. Counter proposal for modified approach--- Process for ensuring loss absorbency of regulatory capital maintaining the seniority/subordination.

We would like to raise the following idea to complement the BCBS's proposal and make it possible to ensure "the loss absorbency of regulatory capital at the point of non-viability" in a more effective and transparent way. Among other advantages, our recommended process can maintain the seniority/subordination among capital instruments as well as within regulatory capital, which seems to be usually assumed by market players. Under this process, capital instruments can be priced based on the seniority/subordination, or in other words, on risks that each instrument should intrinsically bear. Therefore, no substantial change is anticipated in the investor base.

When a financial institution falls into a non-viable state, it may not be clear whether the problem is lack of capital (solvency) or liquidity unless a rigid asset assessment is conducted. This said, it is impractical to conduct a time-consuming rigid asset assessment under the circumstance where a systemically important institution (SII) gives rise to serious mistrust in its asset component and a liquidity crisis is about to break out. However, in order to maintain the seniority/subordination among capital instruments ensuring the loss absorbency of regulatory capital, it seems to be worth thinking of a process that enables rigid asset assessment to judge the appropriateness of public sector injection of capital.

When an SII faces concern about a serious liquidity shortage, government authorities should first declare their readiness to provide the SII with liquidity without limitation and inject public funds as necessary. At the same time, the authorities should announce that the amount and instruments for the public sector injection of funds would be determined after a rigid asset assessment.

After this announcement, the government authorities embark on the asset assessment preferably with third parties. If the SII is identified as having negative equity, common equity is fully reduced to start with. Next, it is judged whether preferred shares can absorb the residual loss. And, if necessary, preferred shares are also fully written-off. Then, it is determined whether subordinated debts can fully absorb the remaining loss. Should there be no remaining assets, the subordinated debts are fully written-off as a matter of course. If there still remain net assets for subordinated debts, the subordinated debt can be converted to common shares. If some of subordinated debt holders cannot own common shares, the amount equivalent to their share of remaining assets is paid to them in cash.

In the cases where negative equity is not identified, preferred shares are first converted to common shares depending on the residual net assets and shortfall in the required capital. If there remains a shortfall in the required capital, subordinated debts are converted to common shares. Investors who cannot own common shares, are compensated with cash. Only in the case that there still remains a shortfall in the required capital are public sector funds injected in the form of common shares taking into account the required capital shortfall identified in the rigid asset assessment.

In the process described above, regardless of whether or not negative equity is identified, the existing regulatory capital absorbs the loss to the greatest possible extent before injection of public sector funds. The residual amount of existing regulatory capital is converted to common shares or redeemed. Therefore, no existing regulatory capital remains senior to the capital instruments injected by the public sector. In this process, provisions on trigger events for conversion/write-off (or redemption) are to be incorporated into the instruments including preferred shares and subordinated debts.

By stabilizing the SII's liquidity situation and ensuring its viability for the meanwhile under the commitment of full support from public sector, government authorities gain time to implement the rigid asset assessment. If the credibility of such a process became well established, it would stabilize the SII's liquidity situation for the time being even if injection of public sector funds was not implemented. When the announcement of public sector support does not improve the confidence of market participants, the authorities can inject public funds in the form of subordinated debt with a conversion to common shares feature.

In this process, a trigger event could be defined as "the announcement by relevant authorities to provide the SII with public support with the aim of maintaining the stability of the financial system", which is simpler than that described by the BCBS proposal.

Our recommended process cannot secure ex ante transparency but, through the (ex post) rigid asset assessment, makes it possible to share the loss within regulatory capital in a transparent way based on the seniority/subordination of capital instruments and inject public sector funds corresponding to the needs. We believe that this approach would be able to ensure ex post transparency in examining the appropriateness of the relevant authorities' decision-making.

It should be noted that our recommended process cannot cope with the issues emerging from double gearing. Other measures are required to handle these issues.

Furthermore, taking Japan as an example, a special resolution at a shareholders meeting[2] is required to reduce common shares (Article 447 of Corporation Act). To accommodate such time-consuming legal procedures, some legislative arrangement may be needed to be made in each jurisdiction.

In closing, we appreciate the collaborative and comprehensive consultative approach the BCBS is taking with market stakeholders. We believe such an approach is essential for the development of efficient and effective global regulatory standards for financial and capital markets. We hope you find our comments useful in your deliberations. If you have any questions, please do not hesitate to contact us.

Yours sincerely,

Tetsuo Mae

Tetsuo Mae
Chairman

[2] Having a quorum of majority of shareholders' voting rights, a resolution needs to be made by more than two thirds of voting rights of attending shareholders.