Insight Investment's response to the EBA Consultation Paper on Draft Regulatory Technical Standards in Own Funds – Part one

Insight welcomes changes to the bank regulatory environment and is pleased to have the opportunity to provide comments to the EBA on its consultative document. By way of background, Insight manages just over £170bn of largely fixed income assets, which includes a significant proportion of corporate bonds. Our clients are predominantly UK and European institutional pension funds and we manage their portfolios on an 'active' basis.

While we believe it is in the interests of our clients and of the banking sector for a hybrid capital market to continue to exist, we expect our participation in this market going forward to be less than our historical involvement. The instruments will, most likely, not be investment grade rated therefore effectively removing the targeted buyer base. Having reviewed how existing instruments have behaved over the last few years, some of our clients have decided to explicitly exclude them from their fixed income guidelines.

We believe our clients' appetite for hybrid instruments will be diminished further if the additional tier 1 instruments are not structured in such a way that respects seniority of the asset class to equity investors. In addition the coupon required by the market on such an instrument would likely make them uneconomic for the bank to issue. As requested in the article please find below Insight's response to some of the questions posed in the paper.

Q12. Are the provisions on the procedures and timing surrounding a trigger event and the nature of the writedown sufficiently clear? Are there issues which need to be elaborated further?

In response to article 20 point 1, we believe that any trigger event must be based upon a measurable, transparent and consistent methodology. Any ambiguity around how the trigger might work in practice will make such securities extremely difficult to value with any accuracy. Furthermore, the trigger must also be linked to a capital event and it would be unacceptable for a write-off in these circumstances based on a regulatory decision.

Secondly relating to article 20 point 2, a permanent and potentially full write-off scenario upon the occurrence of the stated trigger event effectively means that holders of hybrid instruments are subordinated to equity shareholders, begging the question why they should accept anything less than equity-like returns. The argument that if a bank issues a 'write-off instrument', its common shareholders will suffer the consequence of increased risk-taking through higher coupon rates on hybrid securities is not a compelling one in our view. In summary, in a bank which has equity investors, a permanent writedown does not provide the correct incentives for management and due to effective subordination to equity investors, it is likely not a structure we could recommend to clients.

There are two alternatives to this structure, the first being a conversion to equity. The conversion price would have to be at a significant discount to the prevailing share price at the trigger point therefore diluting existing shareholders substantially. This would provide the correct incentive to shareholders whilst at the same time not preventing other investors from injecting capital post trigger point. This theoretically does not subordinate investors as the share price should recover as the bank recovers. Unfortunately in practice, it does present issues as many mandates do not permit equity to be held and it would have to be sold in a short timeframe, limiting the number of clients which could theoretically buy these securities. In addition to this there is a risk that if a bank with these securities in its capital structure were to get into trouble, it could create something of a "death spiral" as the share price plummets if investors began to fear this were the case.

The second option is a temporary writedown structure which Insight believes to be the most investable option. This meets the requirement for loss absorption, but does not subordinate tier 1 investors to equity investors, as there remains an option to participate in the upside as the bank recovers.

Q13. How would you assess the impact of the provisions to be applied to temporary write-downs and write-ups?

For additional tier 1 to work at all there needs to be a material amount of the securities in issue to actually provide enough capital to either leave the bank with strong capital ratios, or more time to find additional investors to recapitalise the bank before it hits the point of non-viability. The write-down/write-up structure has many advantages to any other structure. Firstly it fulfils the loss absorption criteria, secondly with the correct language it can respect seniority, and thirdly the structure is more familiar to investors as many already hold securities which have these provisions (for example the silent participations in Germany).

In direct response to article 20, point 3 the methodology for write-down and write-up should be made as simple and as transparent as possible.

- The write-down should be a on a pro rata basis amongst similar additional tier 1 instruments with the same trigger point. The magnitude should be the greater of replenishing the capital ratio back to a previously specified level or zero, if this is not possible.
- Regarding coupons which are addressed in article 20, number 3 point a. It is acceptable for coupons to be cancelled whilst the security is partially written down but in order that tier 1 investors are not subordinated to equity investors, dividend payments must also be suspended. If this is not the case there is no incentive for management to try and raise capital via other sources if they are nearing the trigger point.
- With regards to the example write-up/write-down process in the appendix and article 20, number 3, point c): It is completely unacceptable to Insight that whilst the tier 1 remains written down and not paying coupons that equity investors can theoretically receive dividends. If there is no incentive to write the security back up again, an unscrupulous management team could take that option despite the bank being in a strong position. Until the security is written back up there must be a ban on dividends to equity investors so that tier 1 investors are not subordinated to them. There should also be no ban on the acceleration of a write-up as this could restrict management from raising additional capital in this market. In addition the formula for writing the instrument back-up is flawed in our view as it is far too slow and unfairly penalises tier 1 investors. A quicker, more transparent and more equitable process would be to put a floor on the amount of profits which should be used to write-up (for example 50% when the capital ratio is at x%), but not place a maximum amount on this when it is above y%.
- With regards to article 20, number 3, point d: We are in agreement with this point. The possibility of different trigger points, for example a bank with tier1 triggers at 5.125% and 7% could complicate this. It seems logical that a 5.125% trigger should be seen as more senior than a tier 1 with a trigger at 7% and therefore there should be written up ahead of the 7% trigger.

In summary, we believe hybrid capital still has a role to play in bank capital structures, but on no account should holders be subordinated to equity investors. We believe our clients will have far greater appetite for hybrid capital if these securities have clearly defined and measurable trigger thresholds, a temporary writedown structure, as well as clear provisions for the write-up respecting the seniority of tier 1 to equity and greater uniformity of structure.

Yours Faithfully,

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For and on behalf of Insight Investment Management (Global) Limited