ISEEE MEETING

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THE BANKS' SUBORDINATED DEBT PROBLEM IN CONNECTION WITH BASEL II AND BASEL III

Prof. dr. Draško Veselinovič

Gea College

Slovenia

drasko.veselinovic@gea-college.si

Different (financial) Risks

According to **Galai** (1999) we can sort them like: diversifiable, idiosyncratic, credit, market, economic, accounting, financial, business and other risks.

Different (financial) Risks, again

According to Veselinovič (1998) there are the following **financial risks** that companies can be exposed to: currency, interest rate, credit, market (exposure), inflation, liquidity, (re)callable, country, other. A **country risk** involves political, economic, social, sovereign, transfer and other.

CAPM

CAPM teaches us about diversifiable and non-diversifiable risks.

The first are nonsystematic and the second one systematic.

They are measured according to their **beta**.

Risk Management Process

According to Galai (1999) **risk management process** takes approximately the following route: environmental factors (including competition and innovations; added by Veselinovič) drive the nature of different products and companies, firms have to decide which risks to **avoid**, which to **transfer** and which to **manage**. The last but not the least the company has to establish a substantial risk management process.

Other Risks

Since I focus on economic and financial risks some other important ones are in my classifications in the category other: top business security, theft of innovations, the most important employees, IT area, etc. In banking we have a category for all these and we call it **operational risks**. They can be measured by registering all negative happenings in the company from the areas mentioned.

Basel II

Consequently, the banks need more capital higher operational and all other even more important (credit, counterparty, market, interest rate, currency, etc.) risks. This is the essence of capital accord Basel II.

More risks = more capital a bank needs.

Hedging

For hedging we use many different **financial instruments** including standardized and those which can be tailor made and many innovations. We can do **asset/liabilities** structures matching, we can use different **guaranties**, we can **insure**, we can **diversify**. And finally, there are always some **other ways** and/or combinations. More efficient hedging - less additional capital needed.

Volatility

In some longer period: E/USD currency rate movements between 0,8 and 1,5; FED interest rate movements between almost 0% and 20%, ECB interest rate between 0,75% and 4,75% (in the last 13 years only), German Bundesbank interest rates movements before introduction of euro were volatiling between 1% and 9%, etc.

Basel II

Tier 1

The crucial and key element of any banks capital is **equity capital** and disclosed **reserves**.

Tier 2

Undisclosed reserves

Ordinary shares and noncumulative perpetual preffered stock

Revaluation reserves

General provisions/general loan-loss reserves

Hybrid debt capital instruments

Subordinated term debt

Basel II

Tier 3

At the **discretion** of national authorities, banks may employ a third tier of capital ("Tier 3"), consisting of short-term subordinated debt for the purpose of covering market risks.

Limitations

In brief; valid for credit and counterparty risk, limitation of 250% of banks Tier 1 part supporting market risks, Tier 2 and Tier 3 together not exceeding 100% of Tier 1.

Deductions from capital

Goodwill and increase in equity resulting from securitisation exposure are to be deducted from Tier 1. Especially important issues are deductions resulting from investments in **subsidiaries** engaged in banking and financial activities which are not consolidated in national systems (authoritiy discretion).

Basel III

1. Issued and paid-in capital.
2. Subordinated to depositors, general creditors and subordinated debt of the bank.
3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors.
4. Perpetual with no maturity date and no step-ups or other incentives to redeem.
5. May be callable at the initiative of the issuer but only after a minimum of five years and even in that case under certain extremely strict requirements.
6. Any repayment of principal (through repurchase or redemption) must be with prior supervisory approval and banks should not assume or create market expectations that supervisory approval will be given.
7. Favorable dividends out-payments discretions for the banks.

Basel III

8. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organisation's credit standing.

9. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.

10. Instruments classified as liabilities for accounting purposes must have principal loss absorption through either conversion to common shares at an objective pre-specified trigger point or a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point.

Basel III

11. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.

12. The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.

13. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (but through a special purpose vehicle), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital.

The Essence of Basel III

Basel III (if adopted as proposed) will force banks to have much more quality capital (tier 1) in their capital structure compared to nowadays or to the times before the crisis.

Summary 1

H1: There are many risks out there for everyone. In financial industry the risks are very well defined and precisely 'sliced' in order to better see them, follow them and especially control them. Nevertheless, all these instruments and regulation didn‘t prevent us to fall into deepest crisis ever. Therefore, the companies dealing with the financial institutions suffer, investors suffer.

Summary 2

H2: It seems that Basel II underestimated many risks that banks were disposed to in the bad times. It seems that tier 2 (and not even to mention tier 3 where applicable) definitely played too important role in the total banks capital in spite of the fact that many (especially in the U.S.) wanted tier 2 and especially subordinated instruments within it to play even more important role.

Summary 3

H3: The private owners of tier 2 and even some debt tier 1 instruments were hit the most by the (banking) crisis; the official debt got more seniorised (the so called subordination problem).

Summary 4

H4: It seems that Basel III (when or if adopted as proposed) will force banks to have more capital of the best quality than necessary; therefore, the banks might understimate the evaluations of their risks in the future in a bookkeeping way – not in the real life, consequently they will be more conservative than in the past.

Summary 5

H5: As we saw in early 2009 when the markets got very nervous about the solvency and/or liquidity (of banks) the subordinated debts' market can be hit very hard and subject to selling at any price. The current Eurozone crisis has the potential to cause a very similar situation and the question of whether to buy bank subordinated debt entirely depends on how the Eurozone crisis evolves.

Summary 6

The subordination problem caused tremendous problems in debt markets and consequently in equities'markets,as well. Since banks need more capital and subordinated one does not sell the pressure to collect Tier 1 (ordinary and preference shares) is much higher.

Subordinated debt did not prove to be an early (enough) warning signal (as supposed in theory) for regulators and markets.

Consequently, we will see either more governments intervening to help bail out banks or more banks collapsing. Again,far from good for the markets. Therefore, additional mistrust being build in the markets.