DETAIL RESPONSE TO CEBS DRAFT PROPOSAL FOR A COMMON DEFINITION OF TIER 1 HYBRIDS

21 February 2008

1 Introduction

This note sets out in detail the concerns of Prudential plc with two features of the proposed draft technical advice from CEBS for a common definition of Tier 1 hybrids – mandatory principal write-down or equity conversion and requirements to allow Alternative Coupon Settlement Mechanism (ACSM).

Given the number of involved parties in each jurisdiction, including issuers and holders of hybrid instruments, regulators and tax authorities, we think that the stated objectives may be achieved most effectively through principle-based regulation which can be implemented taking into account the distinct regulatory, tax and legal framework in each jurisdiction.

2 Principal Write-Down/ Equity Conversion

We understand that the aim of requiring principal write-down of hybrid capital instruments and/or conversion into equity is to improve the loss absorption of such instruments and to remove a perceived obstacle to re-capitalisation of institutions in distress.

2.1 Improvement of Ability to absorb Losses

We think that the purpose of the ability to absorb losses is two-fold: (i) to preserve the issuer as a going concern and (ii) to provide a "cushion" for senior creditors in insolvency. This is achieved through a combination of perpetual tenor, deep subordination, solvency conditions and the ability to defer payments.

On a going-concern basis, we do not think that either a principal write-down or a mandatory conversion into ordinary shares at certain trigger points (whatever they are) would improve the protection of senior creditors, including depositors (and policyholders, for insurers). In the UK, the existing regulatory requirements already ensure that Tier 1 hybrid instruments support the solvency of the issuer in the same manner as preference shares by focusing on the desired outcomes:

- the existence of the instrument itself must not be relevant for determining whether the issuer is or is likely to become insolvent;
- the directors of the issuer must not be obliged to take into account the existence of the instrument for the purposes of trading while insolvent; and
- holders of Tier 1 hybrid instruments or third parties must not be able to petition for the winding up of the issuer on the grounds that the issuer may be or become unable to meet its obligations under the hybrid instrument.

The FSA also requires issuers to provide an independent legal opinion that explains how the instrument meets the FSA requirements.

In liquidation, the deep subordination of hybrid Tier 1 instruments (to the level of preference shares) provides a “cushion” for more senior creditors such as depositors and policy holders.

Currently, hybrid Tier 1 instruments are classified as “innovative tier 1” in the UK. Whereas principal write-down and/or conversion into ordinary shares would re-arrange the components of an issuer’s tier 1 capital by moving such instruments (or parts thereof) from innovative into core tier 1, it is difficult to see how this would, in practice, improve either the issuer’s position as a going concern or the senior creditors’ position in liquidation.

2.2 Removal of Obstacle to Re-Capitalisation

It is not clear to us how the proposed requirements, particularly the requirement for principal write-down, would improve an issuer’s chances of re-capitalisation. For the write-down to create a benefit, the issuer would have to be able to redeem the instrument at the written-down (reduced) amount. However, this would cause a cash outflow in a distress situation, depleting the cash resources of the issuer; this may be unpalatable for the issuer’s regulator and may not be permitted. In addition, it is likely that a recapitalisation will include an element of hybrid capital. It is unlikely that a distressed issuer in need of re-capitalisation will be able to issue hybrid instruments on terms which are comparable to the terms of its existing hybrids.

One should also bear in mind that hybrid capital instruments contain dividend stoppers to prevent payments to the holders of more junior forms of capital. We anticipate that such dividend stoppers would apply whilst the principal of a hybrid instrument was written down; this would not be palatable to anyone considering a re-capitalisation of the issuer.

A conversion into ordinary shares would make a hybrid instrument more equity-like. However, a conversion in a distress situation would create new shareholders with voting rights and interests which may well be incompatible with those of anyone seeking to re-capitalise the issuer.

2.3 Negative Consequences

(i) *Tax Position of the Issuer:*

In the UK, automatic principal write-down and /or equity conversion raise serious questions regarding the “results dependent” nature of a hybrid instrument. If an instrument was so classified, periodic payments would not be allowable expenses for tax purposes. In addition, a principal write-down provision might have an impact on the issuer’s tax grouping.

(ii) *Dilution:*

Equity conversion in a distress situation could cause massive dilution which would be a major concern for issuers.

(iii) *Transfer and Stamp Duty:*

These may become applicable on transfer and conversion.

(iv) *Corporate Law:*

Complications could be caused by changing liquidation preferences, with regard to corporate authorisations etc.

(v) *Position of the Holder:*

Depending on the jurisdiction of the holder, the incorporation of principal write-down and/or equity conversion features with defined triggers may lead to a re-classification of the hybrid instrument with consequences for the tax treatment of payments, regulatory capital requirements etc.

In addition to the possibility of increased costs of holding hybrid instruments due to tax or regulatory implications, both principal write-down and equity conversion would abolish a basic principle of hybrid Tier 1 capital: for the holder, it is the risk equivalent of perpetual preference shares and ranks senior to ordinary shares both on an on-going basis and in liquidation.

The investor base for hybrid instruments is not the same as that for ordinary shares. Implementation of the proposed requirements will reduce the attractiveness of hybrid instruments for this investor base. The likely result is an increase in cost and a reduction in availability, without benefits for senior creditors which would outweigh these disadvantages.

(vi) *Forced Indirect Issuance*

A requirement for principal write-down and/or equity conversion would force issuers in the UK and jurisdictions with similar tax regimes to issue hybrid Tier 1 indirectly. Indirect issuance significantly increases legal and operational risks and increases the cost and complexity of an issue. (NB: Under current UK rules, indirect issuance is not possible for insurers.)

Prudential plc suggestion: adopt an <u>outcomes-based</u> approach as suggested in 1.1 to ensure that hybrid instruments have the appropriate ability to absorb losses, and delete the requirement for automatic/ mandatory principal write-down.

3 Requirements for allowing ACSM

The draft advice states that ACSMs are “acceptable solely if they are put in place for tax reasons and in cases where the issuer has full discretion over the payment of coupons or dividends at all times”, but only “if (i) they are made out of already authorized and unissued shares, (ii) subscribed by the hybrid holders and (iii) exercised immediately to avoid the accumulation of debt.”

The benefits of these restrictions are not clear to us, and we are concerned about the limitations on the use of ACSMs and the manner in which they restrict issuers’ financial flexibility.

Even if ACSMs are not required to strengthen the tax analysis of a hybrid instrument, they improve the financial flexibility of the issuer if structured properly: they preserve the cash resources of the issuer and provide loss absorption, whilst improving the holders’ chances of eventually receiving the payment which is settled through the ACSM. Incidentally, it is usually unhelpful for any tax analysis if a transaction includes elements solely for tax reasons.

We understand the requirement for sufficient authorised unissued shares, but not the requirement for the hybrid holders to receive them. As outlined above, the hybrid capital investor base is not the same as that for equities, and hybrid investors may be unwilling or unable to receive ordinary shares in lieu of cash. This requirement could seriously impact the attractiveness of hybrid instruments for investors, without actually benefiting the issuer. Whether the issuer has to deliver shares of a specified value to hybrid holders or whether it sells shares and delivers the proceeds to hybrid holders has exactly the same financial effect.

We also do not understand why the shares for the ACSM would have to be issued/sold immediately. As outlined in Section 1.1, mechanisms exist to ensure that hybrid instruments do not create liabilities which affect the going-concern position of the issuer. Therefore, the accumulation of deferred payments is not a problem in our view.

An immediate sale may be undesirable in distress situations, and we consider it more helpful if deferred payments can be deferred into perpetuity if necessary. For the settlement of current coupons through an ACSM, most hybrids with this feature already incorporate suitable mechanisms.

Prudential plc suggests the deletion of the following proposed requirements: (i) ACSM only allowed for tax purposes, (ii) the hybrid holders have to receive the shares issued under the ACSM and (iii) shares for ACSM have to be subscribed immediately. An undesirable build-up of liabilities can be prevented by a principles-based approach which ensures that deferred payments do not create liabilities which affect the going-concern position of the issuer.