INTESA SANPAOLO

INTESA SANPAOLO COMMENTS
ON THE CEBS DRAFT PROPOSAL FOR A COMMON EU DEFINITION OF TIER 1 HYBRIDS

Intesa Sanpaolo welcomes the opportunity to comment on the Committee of European Banking Supervisors' (CEBS) Draft Proposal for a common EU definition of Tier 1 hybrids (the "Proposal") dated 7th December 2007. We welcome in particular CEBS recommendation to standardise capacity limitations and grandfather outstanding Hybrid Instruments. However we believe that the document has a number of substantial deficiencies that should be discussed and resolved before the implementation into EU legislation.

We believe that the proposed rules need to be amended in order to:

- avoid discrepancies with local legal environments with reference to bankruptcy law, company law and tax law
- avoid any competitive distortion which could disadvantage the European industry

Intesa Sanpaolo comments on the Proposal are summarized below.

1) PERMANENCE

CEBS Proposal

[...permanence is a key feature for a hybrid instrument to be eligible as Tier 1 capital as it provides the bank with the greatest flexibility and ensures that capital is available in stress situations.] (pg 13 par. 78)

1) *Hybrid instruments are considered as permanent if they are contractually undated.*

2) *Hybrids may be callable (i) only at the initiative of the issuer, (ii) subject to prior supervisory approval and (iii) under the condition that they will be replaced with capital of the same or better quality unless the supervisor determines that the bank has capital that is more than adequate for its risks.*

[omissis]

7) *Early redemption triggered by an event such as a change in regulatory recognition of hybrids or a change in the tax treatment of these instruments, subject to prior consent of the supervisory authority, is not considered to be an incentive to redeem.*

Intesa Sanpaolo Comments

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1) When discussing the treatment of hybrids it is generally agreed that the main guidance should be "substance over the form". We believe point 1 should be amended as follows: "Hybrid instruments are considered as permanent if (i) they are contractually undated or (ii) they don't include any provision to be early redeemed before the dissolution, winding up, liquidation or bankruptcy of the company. Both in case of (i) and (ii) above, cash early repayment (if any) is allowed only subject to regulatory authorisation". Without materially change the substance of the instruments, such alternative wording is aimed to avoid any discrepancy with local legal frameworks under which undated instrument are not regulated. In addition, by the adoption of such proposed wording, <u>substantially permanen</u>t instruments (such as "Mandatory Convertibles") will be qualified as "hybrids instrument" even though <u>formally dated,</u>

2/7) In accordance with Basel II guidelines, the early redemption of the instruments should not be subject to the issuance of new instruments. In case the issuer is required to integrate its capital adequacy profile after the redemption of a hybrid, the regulators should refer to any possible capital instrument not only to a new hybrid issue.

2) LOSS ABSORPTION

CEBS Proposal

1) *The Proposal states that the instruments must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids are senior only to ordinary share capital.*

[omissis]

3) *In the case that the Tier 1 ratio falls below 2%, the instrument must be able to absorb losses either by ensuring that:*

   I. *The principal of the instrument can be partially or fully written down in order to enable the institution to absorb losses. The principal of the instrument can be reinstated only out of future profits and pari passu with the shareholders; or*

   II. *The instruments can be converted into ordinary shares*

[omissis]

7) *If the bank wants to redeem the instrument whilst the principal is written down, it can only redeem it at the written down amount. Redemption at par will not be possible until the principal is completely written up.*

Intesa Sanpaolo Comment

As a general comment we believe that it would be helpful to provide a definition of loss; a common understanding of "loss" should be achieved before questioning about loss absorption and related issues.
"Loss" can mean operating loss, i.e. the deficit recorded on the profit and loss account, but also balance sheet loss. The Proposal seems to suggest that CEBS considers as loss the breach of certain capital ratio thresholds. Taking into consideration the above, we suggest the following amendments:

1) The instrument must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids are senior only to the share capital represented by the sum of (i) ordinary shares, (ii) any other category of shares such as saving shares as provided by the governing law effective in the Country of incorporation of the Company. Payment of dividends provided by saving shares treatment is directly linked to the earnings of the Company. Therefore, as far as seniority of hybrids instruments is concerned, saving shares should be considered at the same level of seniority of ordinary shares.

3/7) The repayment of principal at its *nominal amount*, after a write down (if any) through distribution of profits should be allowed. The reimbursement of the instruments at a written down value would imply strong distortion with the market price of the instruments. In fact, in case of losses of the Issuer, hybrid holders would be exposed to deterioration in terms of market value and the write down mechanism would not provide any additional protection to the investors. For example market value and written down value may differ significantly.

Furthermore, in every Member State, the treatment of hybrids is driven by specific legal frameworks with diverging rules in the area of bankruptcy laws, company laws and tax laws. Achieving tax deductibility is particularly critical to issuers. The total or partial write-down of the principal amount of the instruments is not consistent with the definition of "debt instrument" as provided by Italian and others Member State laws and therefore tax deductibility would not be achieved in all Member States. Considering all the above, the Proposal should be amended in order to avoid any write down mechanism, or, alternatively, it would have to be reworded as follows:

"In the case that the Tier 1 ratio falls below 2%, the instrument must be able to absorb losses either by ensuring that:

(i) the obligations of the Issuer to make payments relating to the principal amount of the instruments will be suspended to the extent necessary to enable the Issuer to continue to carry on its activities in accordance with applicable regulatory requirements. Such obligations will be reinstated, as if they had not been suspended, in the event of winding up, dissolution, liquidation or bankruptcy, or in case of early redemption or finally to the extent that the stress situation is no longer continuing; or

(ii) the principal of the instrument can be partially or fully written down in order to enable the Issuer to absorb losses. The principal of the instrument can be reinstated only out of future profits and pari passu with shareholders; or

(iii) the instrument can be converted into ordinary shares

3) FLEXIBILITY

CEBS Proposal

1) If the institution is in breach of the minimum capital requirement (or another level defined by the supervisor), then it must waive payments.

In addition, supervisors can require institution to waive payments at their discretion based on the financial situation of the institution.

Dividend pushers are acceptable but must be waived when one of the supervisory events mentioned above occurs between the date the coupon is pushed and the date it is to be paid. Under those circumstances, payment of the coupons will be forfeited and no longer be due and payable by the issuer.

Intesa Sanpaolo Comment

1) In order to ensure the seniority of hybrid holders with respect to the shareholders, this section should be reworded. The Issuer shall suspend payments of interest if both of the following events occur:

I. the Issuer is in breach of the minimum capital requirements (or another level defined by the supervisor); and
II. the Issuer has not paid dividends

We believe that the payment of dividends should be suspended in case the Tier 1 ratio falls below 2%. Moreover it could be helpful to have more clarity on the time window defined for the acceptance of dividend pushers.

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4) LIMITS TO INCLUSION INTO TIER 1

CEBS Proposal

1) *Overall limit: ordinary shares and disclosed reserves / retained earnings represent at least and at all times 70% of the required Tier 1 capital. When an institution operates above the required Tier 1 capital, ordinary shares and disclosed reserves / retained earnings represent at least and at all times 50% of the total Tier 1 after deductions.*

2) *Some CEBS members want the same 70% limit to prevail in all cases as in their view this would be more in line with the stated aim of improving the average quality of capital.*

3) *Limit for instruments with incentive to redeem and instruments with ACSM: 15% of Tier 1 after deductions (this limit is included in the overall limit to hybrids)*

Intesa Sanpaolo Comment

The most important comment we have is in relation to the saving shares treatment. Saving shares should not be considered hybrids instruments. Therefore the new limits related to hybrids instruments should take into account only hybrids instruments, excluding any other category of shares such as saving shares.

The proposed system creates a "cliff effect": although banks usually operate at higher capital ratios than those imposed by the regulators, a part of their outstanding hybrids would no longer be eligible as Tier 1 in case their Tier 1 ratio decreases. Moreover, when a bank operates in a stress situation (below the minimum capital), the funding in the hybrids market would be prevented.

We believe that it is of crucial importance that a common set of limits are agreed throughout all Countries in order to establish a level-playing field across Europe.

Therefore we suggest that:

1) tier 1 should be simply split into Core Tier 1 and "Hybrids". In this case the two categories would become complementary and the limits should be applied to them;

2) harmonization within EU should be achieved regarding the exact composition of Core Tier 1;

3) we believe that a "one off" limit should be set at 50% in all European Countries so to avoid a competitive disadvantage vis a vis Banks outside the EU. Regulators may continue to set limits on individual institutions in case of capital adequacy stress.

Furthermore, CEBS proposes to broaden the range of instruments to which the limit would apply. It proposes, more particularly, to also include principal stock settlement and instruments with ACSM features into the 15 % limit.
We believe that it would not be appropriate to go beyond the Sydney Press Release: the 15% limit should apply to true innovative instruments only, i.e. with a principal incentive to redeem which gives the instrument a dated nature. In particular we believe that ACSM should not be considered as an incentive to redeem, but as an instrument to access investors particularly sensitive to the payment of coupons.

5) GRANDFATHERING

CEBS Proposal

1) *Instruments with an incentive to redeem: instruments remain eligible until the first call date.*

2) *The eligibility of all other instruments (including hybrids with incentive to redeem which are not callable and those which are callable but have not been redeemed) will be gradually reduced over a period of 30 years (see below).*

3) *Any redemption should be made at the initiative of the issuer and subject to prior supervisory approval.*

Years after new requirements entered into force	*Limit for inclusion of grandfathering instruments into Tier 1*
10 years	*20%*
20 years	*10%*
30 years	*0%*

Intesa Sanpaolo Comment

1) The Proposal introduces discrimination between hybrid instruments with incentives to redeem and other hybrid instruments. We believe that such distinction is not relevant and appropriate from a grandfathering perspective. In addition once the step-up has occurred, if the instrument is not redeemed, it will turn into an instrument without incentive to redeem.

This letter represents our view in relation to certain technical matters only and does not include any legal, tax or any other form of advice. We strongly appreciate the opportunity to provide comments on your proposal in relation to a harmonized definition of Hybrid Instruments.

We would be more than happy to discuss our comments at your convenience.

Best regards

Intesa Sanpaolo S.p.A. Milan, 22 February 2008