Dresdner Kleinwort

Dresdner Bank AG
London Branch
PO Box 52715
30 Gresham Street
London EC2P 2XY

Telephone +44 (0)20 7623 8000
Telex General 885540 DRES BK G
www.dresdnerkleinwort.com

Mrs Kerstin af Jochnick
Chairman
Committee of European Banking Supervisors
Tower 42
25 Old Broad Street
London EC2N 1HQ
United Kingdom

13 February 2008

Dear Mrs Jochnick,

Comments on Consultation Paper No. 17 "Draft proposal for a common EU definition of Tier 1 hybrids"

Dresdner Kleinwort ("DKIB") congratulates the Committee of European Banking Supervisors ("CEBS") on the publication of Consultation Paper Nr. 17 "Draft proposal for a common EU definition of Tier 1 hybrids" ("CP 17").

This Consultation Paper represents a significant milestone towards the goal of establishing a common standard in EU regulations with respect to hybrid Tier 1 capital and creating a 'level-playing field' between banks from different EU jurisdictions.

We welcome the opportunity to comment on CP 17 and have summarised our remarks and observations below:

1. Allowable Instruments

As outlined by CEBS at the public hearing on 22 Nov. 2007, one of the key principles governing the drafting of the proposed Tier 1 rules is the one of 'substance over form'.

Our understanding is that the proposed rules will be binding for all Tier 1 instruments, regardless of their legal form (e.g. subordinated debt or preference share). However, we also understand that under the CEBS proposal individual regulatory bodies will continue to have the discretion to require that, in addition to meeting the European requirements, only certain types of legally defined instruments can qualify as Tier 1 capital.

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A number of regulators throughout the EU currently allow only legally-defined instruments to qualify as hybrid Tier 1 capital (e.g. *Silent Participations* in Germany for solo Tier 1; directly-issued preference shares in the UK for non-innovative Tier 1). This results in a lack of consistency across Europe as, for example, in some countries non-innovative Tier 1 is tax deductible and in others it is not.

We suggest that the CEBS proposal should require national supervisory authorities to accept subordinated debt instruments as hybrid Tier 1 capital *provided* that such instruments fulfil the requirements for Tier 1 capital at an EU level. In other words, there should be no super-equivalence at a local level.

2. Limits

A central issue in the proposal is that with respect to the definition of limits. The proposal, as currently drafted, requires that, for example, the 15% limit for instruments "with an incentive to redeem" must be met "at all times". This is a change from that set out in the original 'Sydney Press Release' which explicitly referred to the limit as being the relevant amount at time of issuance. A similar issue emerges with respect to the 70% equity requirement for the minimum required Tier 1 capital that must also be met at "all times". The issue that arises here is that there is a double impact in that if equity reduces then the hybrid Tier 1 may no longer fully qualify despite the fact that it is fully paid-in capital. There would therefore be a 'double whammy' effect on Tier 1 capital in times of stress which, in our view, should be avoided by amending the proposal. The feedback we have received from clients is that this is a particularly unhelpful change given the volatility of reported shareholders' equity under IFRS and the possibility for further significant accounting standard changes as IFRS rules continue to evolve.

3. SPV vs. Direct issuance

We note the CEBS observation that there be no 'credit enhancement' of a hybrid issue by the issuer, via a guarantee or in any other way, where this leads to increased seniority of the ranking of the hybrid Tier 1 instrument. We accept this point but we would appreciate clarification from CEBS that subordinated guarantees of SPV-issued hybrid securities, where the subordinated guarantee offers no 'enhancement' over a directly issued hybrid Tier 1, are permitted.

In addition, we understand that CEBS sees it of little relevance whether or not the hybrid Tier 1 instrument is directly-issued or issued via a financing vehicle. Currently, in the capital regulations of Member States there is a difference between 'solo' and 'group/consolidated' capital with indirectly-issued hybrid issues qualifying as consolidated capital only. We would appreciate clarification as to whether a change in the regulations is anticipated in this area.

4. Early Call Provisions

In CP 17 CEBS proposes that redemption prior to the first regular call date which is triggered by either (i) a change in the tax treatment of the hybrid instruments or (ii) a change in their regulatory recognition, and which is subject to regulatory approval, should be permitted.

We see a potential issue here in that the text of the CEBS proposal may be interpreted too narrowly and therefore early redemption could be limited to only circumstances (i) and (ii). This would be problematic as, in our view, issuing banks should be granted flexibility to manage their capital base for any set of adverse circumstances, in every case, subject to regulatory approval. We therefore suggest that early call provisions should be allowed *provided* these are subject to prior regulatory approval. Examples include changes in IFRS classification, rating agency treatment, etc. There is no need for CEBS to be prescriptive with respect to such events.

5. Perpetual vs. Dated Maturity for Hybrid Tier 1

The proposal also states that for hybrid Tier 1 instruments to fulfil the requirement to be "permanent", it must be contractually undated. In contrast to this, the FSA in the UK has proposed in its Discussion Paper 07/6 to consider allowing dated Tier 1 instruments with a "lock-in" clause, which basically would only allow the hybrid to be repaid if its redemption would not result in a breach of capital adequacy.

We acknowledge that a perpetual maturity has been established as the standard maturity for hybrid Tier 1 instruments in Europe for nearly a decade. However, we believe that CEBS should take this opportunity to consider alternatives, particularly if such alternatives would bear advantages for all interested parties (issuers, investors and regulators). This is particularly relevant in the context of the on-going Basle review of Own Funds and, more specifically, a possible harmonisation between Europe and the US, where in the latter, dated Tier 1 capital is the norm.

6. Principal Write-Down / Conversion

The CEBS proposal states that in the event that the Tier 1 ratio of an issuing bank falls below 2%, then the instrument must absorb losses either through (i) a write-down of the principal amount of the hybrid instrument (the "principal write-down"), which can later be written up again out of future net profits and *pari passu* with common equity or (ii) through a permanent conversion of the instrument into ordinary shares.

With respect to the conversion feature, the primary concern is that many fixed income investors are prohibited by investment restrictions from holding equity securities. The proposal therefore could limit the investor base for hybrid Tier 1 issues. In addition, from the issuing bank's perspective there may be authorisation, governance and corporate law considerations in approving the issuance of debt instruments that may in the future convert into equity.

A write down feature would also be viewed very negatively by traditional hybrid Tier 1 investors as this is a fixed income investor base with no 'upside' exposure. Whilst 'write down' features exist currently in a number of European countries they are less 'harsh' than that proposed in CP17.

The CEBS proposal allows for the redemption of the instrument at below par (if written down at that point). This proposal would create tax problems in many European countries and it is therefore likely that the documentation of such hybrids would not allow for redemption when written down.

Further, when written down the proposal is that no interest would accrue on the hybrid. Whilst this is the case currently in a few European countries for legally-defined Tier 1 instruments (that are defined in law as tax deductible), in many European countries such cancellation of interest would lead to a loss of tax deductibility on direct issues of such instruments. We therefore suggest that CEBS propose that any interest accruing during such periods survive into liquidation, albeit in a subordinated form (perhaps *pari passu* with equity).

The suggested write-up mechanics give rise to one major issue in particular – this is that the write up of hybrid instruments *pari passu* with common equity invalidates the fundamental principle of seniority of hybrid Tier 1 over common equity. Any breach of this principle is likely to be perceived negatively by hybrid Tier 1 investors, and thus result in a shrinking of the available investor pool.

To summarise on the proposals for loss absorption, DKIB views the CEBS proposals for hybrid Tier 1 as going beyond the concept of a fixed income debt instrument. Specific 'headroom' limits are imposed on hybrids because of the fact that they are not as 'equity-like' as equity but the CEBS proposals moves hybrid Tier 1 too far towards equity (in some cases beyond) and, in our view, such a move could endanger the availability of a well-established Tier 1 capital fixed income investor base for European banks.

7. ACSM applicable only to optional interest deferral

The proposal with respect to Alternative Coupon Satisfaction Mechanisms ("ACSM") suggests its usage solely for "tax reasons and in cases where the issuer has full discretion" over interest payments on a Tier 1 hybrid. This implies that ACSM is not permitted for other situations where coupons may be mandatorily deferred (lack of distributable profits, regulatory intervention, capital adequacy), and in such cases coupons would be cancelled.

The tax deductibility of interest payment on an instrument is determined in several EU jurisdictions by reference to whether the tax authorities see an instrument as effectively cumulative (i.e. coupons are settled either via ACSM or are due in liquidation). Limiting ACSM application only to optional interest deferral would undermine the tax deductibility of directly-issued hybrid Tier 1 instruments. It may still be possible for issuers to achieve tax deductibility, but this would require complex indirect issuance structures, something that is inefficient for all parties concerned.

8. ACSM – Shares to be allotted to the hybrid holders

We also note the proposal that ACSM should only be subscribed to by the hybrid investors themselves. Hybrid Tier 1 investors are typically fixed-income investors who often cannot invest in any equity because of e.g. their statutes and / or investment restrictions. Therefore the proposal is likely not to be feasible in a practical context. In our view CEBS should amend this proposal to allow the issuer to market shares to new third party investors. We see no reason why this is unsatisfactory from a regulatory perspective.

9. ACSM – Execution only at the Time of Interest Deferral

The final condition in respect of ACSM is that it must be executed immediately at the point in time of interest deferral. Any interest not settled in this manner is cancelled.

However, at the point in time of interest deferral the share price is likely to be low and it would therefore be pragmatic for the issuer to have a reasonable time period in which to utilise the ACSM mechanism. Setting a specific time period, and in particular a very short one, is contrary to the flexibility required by banks at a time of financial distress. Further, as already highlighted, having a cancellation of interest raises again issues with respect to tax deductibility in many countries.

10. Suspension of Dividend Pushers upon Mandatory Deferral of interest

The proposal also states that whilst dividend pushers are an acceptable feature of hybrid Tier 1 instruments, they must be waived upon the occurrence of a "supervisory event" (interest payments on hybrid instruments must be waived upon a breach of regulatory capital ratios or upon a supervisory intervention).

The issue which arises in this context is that, if following the occurrence of a "supervisory event" dividends are declared/paid or there is any other transfer of economic benefits to common equity shareholders, via, for example, share buy-backs (and the regulator cannot prevent this), then the fundamental principle of seniority of hybrid Tier 1 investors over common equity shareholders is invalidated. We suggest that CEBS consider revising this proposal, perhaps to require that any interest settled at such a time be settled only via ACSM.

11. European versus Local regulations

We see the CEBS proposals as a significant move forward in achieving consistency of regulations across the EU Member States. However, we have some concerns that this uniformity may be diluted at a national level. For example, with respect to the issuer's ability to call or indeed replace a hybrid Tier 1 issue, national supervisors would retain total discretion. Similarly, with respect to interest deferral, national supervisors would have the right to set (higher) required capital levels that can generate mandatory deferral of interest and also would have the right to prevent interest payment on the hybrid at any time. Having such 'unfettered' national discretionary powers reduces the

benefit of having European-wide regulations in the first place. A possible solution would be to have some limits or constraints on national regulatory discretion by referencing some multiple of Basel II-defined minimum capitalisation as an appropriate benchmark for permitting a call or enforcing deferral.

12. Co-ordination with the Basle Committee

We would urge CEBS to ensure that we do not have a twin-track approach to the definition of Tier 1 for European banks. The Basle committee is beginning a similar process and we would ask CEBS to ensure that, prior to the implementation of the regulations in the form of an EU Directive, there be a full co-ordination with the Basle process.

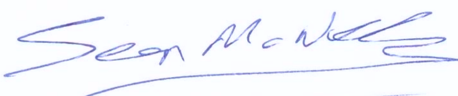
13. Conclusions

Overall, we welcome the proposed changes from CEBS. We urge caution, in particular, in relation to the proposals on the calculation of limits, write down / conversion language, and the detailed prescriptions with respect to ACSM and the cancellation of deferred interest.

In summary we believe that CEBS should give added consideration to ensuring that the proposed hybrid Tier 1 instruments remain, from an investor perspective, 'Tier 1 debt' that can be invested in by the fixed income investor base, and that from an issuer point of view, can be issued in a cost-effective and tax-efficient manner. It is, in our view, of paramount importance to ensure a correct 'balance' between the prudential requirements for Tier 1 capital and continued access for banks to this well-established fixed income investor base. We believe that this 'balance' can be best achieved by CEBS providing for 'guiding principles' rather than detailed rules on the key metrics of permanence, coupon flexibility and subordination. This guidance could impose a maximum level of divergence on each metric so as to ensure that convergence is achieved whilst ensuring that flexibility exists to allow issuing banks and local regulators alike to overcome the taxation and corporate law divergence that exists and will continue to exist for the foreseeable future across EU Member States.

We hope that the above comments and observations will provide you with useful feedback prior to the finalisation of the draft Tier 1 recommendations. We would be pleased to discuss any of the above with you at your convenience.

Yours sincerely,



Sean McNelis
Director
Head of Hybrid Capital

Doncho Donchev
Vice President
Hybrid Capital