Barclays Capital
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United Kingdom

Committee of European Banking Supervisors (CEBS)
cp17@c-ebs.org

February 22, 2008

Dear Sir or Madam,

Barclays Capital is pleased to respond to the CEBS Draft Proposals for a common EU definition of Tier 1 hybrids (CP17).

Our response is divided into two parts:

- Section 1: High Level Concerns and Specific Objections to the CEBS Draft Proposals,
- Section 2: Comments on the CEBS detailed proposals (as set out in the shaded boxes of CP 17).

In summary:

- We support the CEBS proposals relating to "Permanence" and "Grandfathering" (subject to qualifications made in Section 2),
- We have reservations about the "Flexibility of Payments" and "Limits" proposals in CP17 (subject to qualifications made in Section 2),
- We have substantial concerns regarding the CEBS proposals on "Loss Absorption" (both write-down /write-ups and conversion into ordinary equity proposals). We believe that the proposals will have significant negative consequences; specifically the loss of tax deductibility for direct Tier 1 issuance; the creation of a taxable capital gain on write-down; accounting difficulties and lack of transparency; corporate law issues; the effective subordination of hybrid Tier 1 to equity; and the negative impact on investor demand and cost.

As you will understand, this letter represents our technical view as to certain matters within our area of expertise and should not be construed as containing accounting, legal, tax or any other form of advice.

If you have any questions or comments on this matter please do not hesitate to call us.

Yours sincerely,

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SECTION 1: High Level Concerns and Specific Objections

High level concerns

1. Harmonisation

We welcome the CEBS Draft Proposal for a common EU definition of Tier 1 hybrids. We note however than any "harmonisation" in this area is necessarily limited by the lack of a common company law, insolvency or tax regime across the EU.

2. Draft Proposals are overly "rules-based"

We welcome the CEBS stated principle supporting "substance prevailing over form". However, we believe the current CEBS Draft Proposals nevertheless contain prescriptive "rules-based" recommendations, not consistent with the aim of "substance prevailing over form".

3. Timing

We understand the CEBS intends to submit its proposals for a Draft European Directive to the European Commission by end 2008. We question this timetable given that within the next two years the Basel Committee for Banking Supervision (BCBS) is expected to revisit the definition of Tier 1 hybrids. We think it would cause market confusion to have a new set of rules for European regulated entities which are likely to require modification following the BCBS review. Hence, we strongly believe that the CEBS and the BCBS timetable should be integrated.

Further, in view of the current extremely adverse market conditions, we do not believe this is an opportune time to be introducing these new proposals.

4. Subordination of hybrid Tier 1 holders

We note that the CEBS expects that "regulation of hybrids should not be more onerous than the rules on ordinary share capital" (paragraph 105 of CP17). In our view the CEBS proposed write-down mechanism is incompatible with this objective. Indeed, we believe that the mechanism would effectively subordinate Tier 1 hybrid holders to shareholders equity. Not only do Tier 1 hybrids have no voting rights, no repurchase possibility and no upside after the stress period but as proposed, there is a point where Tier 1 hybrids could be fully written-down (and redeemed at the written-down amount) while equity reserves and retained earnings remain. We expect the effective subordination of Tier 1 hybrids to ordinary shares to have a significant impact on investor demand and cost.

5. Legal framework

The CEBS states in paragraph 46 of CP17 that "it must be legally certain that under the terms of the instrument the principal can be written down on a going concern basis". We believe this objective is incompatible with the legal nature of certain instruments classified by the CEBS as Tier 1 hybrids. For example, as a matter of English law, the nominal amount of UK Core Tier 1 Companies Act preference shares cannot be written down. This would result in a perverse situation where the most "equity-like" Tier 1 hybrids in the UK could not be written-down whilst innovative Tier 1 hybrids could.

6. Accounting and Tax

We believe the write-down/write-up proposal is not achievable under IFRS, thus leading to complexity and intransparency. (We provide further comment on the expected IFRS treatment below). The proposals as drafted also give rise to material EU wide tax consequences (as to deductibility of interest on directly issued Tier 1 hybrids and a taxable gain arising on any writing-down of a liability).

7. Banking and Insurance harmonisation

We welcome the CEBS willingness to harmonize the definition of Tier 1 requirements across the banking and the insurance sectors in tandem with CEIOPS. However, we believe that this aim is at risk given the CEBS Draft Proposal may lead to more indirect issuance of hybrid tier 1 via SPVs. Such SPV structures do not currently generate recognized regulatory capital for UK insurers.

8. Impact on investors

We are concerned that the Loss Absorption proposals will both reduce demand for Tier 1 hybrids and increase their cost.

The draft proposals require investors to take manifestly higher risks. Secondly, investors will take time to digest the proposals and the resulting changes to security structures. Given investors have already absorbed several changes to Tier 1 securities in recent years, and given the potential for further changes to emerge from the BCBS process, investors may elect not to invest until the settled medium-term position is known. Thirdly, given current financial market conditions, we expect investors to react defensively to changes, both changes per se, and particularly to changes which produce increased risks.

For this combination of reasons, we are concerned that the result will be a diminution in appetite and capacity at a time when access to capital is needed.

Specific objections

1. Loss absorption

The CEBS is proposing to extend the definition of Loss Absorption in Tier 1 hybrids to *"financial stress situations*" through the write - down of principal or conversion into equity.

Whilst we understand the CEBS motivation to extend the definition of Loss Absorption, we have strong objections to the need and efficacy of this additional requirement. We could not find persuasive evidence that the proposed loss absorption mechanisms (either the write-down / write-up or conversion into ordinary shares) will practicably achieve the objectives pursued by CEBS.

CEBS proposed write-down mechanism will give rise to the following issues:

- Tax deduction on interest - Loss of tax deduction for directly issued Tier 1 hybrids in some European jurisdictions (inter alia, the UK, Netherlands, Belgium) which is expected to lead to indirect issuance through special purpose vehicles (SPVs). The use of SPVs complicates the issuer's corporate structure and generates extra inter-jurisdiction legal risk (the UK FSA in its CP155 of November 2003 considered that indirect issues of Hybrid Tier 1 via SPVs are "*undermined by their inherent complexity and the ability of the capital issued by the intermediary to absorb losses*").

- Tax impact on capital gains - The write-down mechanism would create volatility in the bank's P&L through taxable gains (upon a write-down) and losses (upon a write-up). In the event of a write-down, a taxable capital gain would generate a cash outflow at precisely the point where the bank cannot afford it. We understand this has not just UK, but EU wide capital gains tax implications.

- Accounting –We note CEBS concern in paragraph 46 of CP17 to ensure that the *"[write down] mechanism must be disclosed and transparent to the market and in the case of a principal write down must be on the issuer's balance sheet (assuming this is possible from an accounting perspective)"*. We doubt however, that the write-down / write-up mechanism is operable under IFRS and the current proposal thus also raises transparency and complexity issues.

    - Under IFRS, the presentation on the balance sheet will vary according to the classification of the Hybrid Tier 1 as a liability or equity under IFRS;

        - Liability: The principal write-down with write-up provision does not fall into the IFRS definition of liability derecognition.
        - Equity: The written down amount of the hybrid should be reclassified into another component of equity (presumably some kind of reserves), with no impact on P&L.

    - The CEBS proposed write-down mechanism not only does not absorb losses under IFRS but also creates transparency issues for investors. To address this issue a separate set of regulatory accounts may have to be published following the write-down of the Tier 1 hybrids. Such an outcome is likely to create confusion.

    We view the write-down proposal as resulting in merely a cosmetic rearrangement of the balance sheet with no obvious change to the financial capital strength of the bank.

- Writing up – As above, it is difficult to understand how the writing-up provisions should work, particularly with reference to ordinary shareholders.

- Corporate Law issues - In the UK, non step-up preference shares can be classified as Core Tier 1. However, these preference shares cannot be written down. Should the CEBS proposals be adopted in their current form, this would result in a perverse situation where the most "equity-like" Tier 1 hybrids could not be written-down, whilst innovative Tier 1 hybrids could. Core Tier 1 preference shares would then be technically "senior" to innovative Tier 1 hybrids in stress situations.

- Subordination of hybrid Tier 1 – The CEBS proposal effectively subordinates hybrid holders to common stock which is contradictory to paragraph 105 of CP17 (which states that the relative "subordination of different Tier 1 capital instruments should be respected so that the ordinary shareholders should suffer the first losses").

- Negative market impact – In addition to the wider market impact concerns stated above, while some jurisdictions (France, Denmark, Germany and Norway) have write-down / write-up provisions, the CEBS rules are more onorous and we expect that if implemented in their current form, investor demand would reduce and costs rise.

With regard to the proposed conversion into equity we see the following consequences:

- Loss of tax deduction for directly issued Tier 1 hybrids, as described above.

- Many fixed income funds are unable to buy equity instruments. Such investors would be precluded or be unwilling to hold such Tier 1 hybrids on issue or conversion. Indeed, were shares ever to be delivered they would most likely be sold immediately, hence further depressing the share price of the issuer and further complicating recapitalisation.

- Corporate law issues – The efficiency of the conversion proposal is potentially limited by the annual pre-emption limit of 5% for new issued shares. In addition, in order to satisfy the CEBS requirements for Loss Absorption through conversion into shares, the issuer will have to have specific EGM or AGM approval.

- Subordination of hybrid Tier 1, as described above.

We have the following additional concerns which relate to both the write-down and conversion into equity proposals:

- We can see no historical or current precedent in which the proposed rules would have facilitated the recapitalisation of a bank in a "stress situation".

- We are puzzled by the relevance of the 2% ratio. International banks are required to keep a minimum Tier 1 ratio above 4%. We believe that the proposed 2% level would correspond to a situation where the financial position of the bank will then be so deteriorated that it would very likely mean that many unpredictable factors would affect rescue or recapitalisation. We emphasise the importance of flexibility in such stress situations and hence are concerned that the CEBS Draft Proposal is too rules based in this regard.

- A further perverse outcome is that, under the current proposal, the holder of a hybrid in a bank which suffers a jump to default overnight would have a claim on winding up at par on a subordinated basis, whereas the holder of the same instrument in a bank which suffers a gradual decline in regulatory capital (rather than a jump to default) would suffer a write-down of its holding or receive ordinary shares at the 2% level.

We thus see significant costs (in terms of loss of tax deduction, creation of taxable capital gains, accounting difficulties and lack of transparency, corporate law issues, subordination of hybrid Tier 1, negative market impact) for no clear benefit, and we are unpersuaded the financial system would be strengthened by such proposals.

2. Flexibility of Payments

We disagree that the ACSM is "acceptable solely if it is put in place for tax reasons". Indeed, the CEBS proposals will eliminate the ability of the ACSM in the UK to secure a tax deduction on interest payments.

We do not believe the ACSM constitutes an incentive to redeem, nor does it weaken the issuer's capital or economic position and should not impede recapitalization.

Furthermore we see the following specific issues with the CEBS ACSM proposal:

- ACSM should not be exercised immediately;

  - Timing: it forces the bank to issue shares at the time of financial stress and where its stock price would be depressed (resulting in a greater number of shares issued to satisfy the obligations under the ACSM provision).
  - Legal: it could result in a situation where banks do not have necessary shareholder authorisations in place to fulfil their obligations under the ACSM.

- The ACSM should not be limited to equity shares. Deferred interest could be settled through the issuance of other Tier 1 eligible capital securities. For example, "Payment in Kind" is valuable to the UK Building Societies who are unable to issue ordinary equity.

- Shares issued under the ACSM should not be subscribed for directly by the hybrid holders. Traditional buyers of hybrid Tier 1 securities are fixed income investors (rather than equity investors) whose investment mandates prevent them from taking equity risk or exposure to share price performance.

- CEBS requests that the ACSM be exercised through the issue of authorised but unissued shares. This may not be practicable because listed companies often have limits on the amount of authorised but unissued share capital they have available.

3. Limits

We propose the CEBS maintains the 50% overall limit for inclusion of hybrids in Tier 1 capital. This limit applies in those member states which are the largest issuers of hybrid Tier 1 securities (UK, Germany, France, and Netherlands) and also in the US (where banks can issue perpetual preferreds up to 50% of their Tier 1 capital).

We agree that hybrids featuring an incentive to redeem be limited to 15% of Tier 1 capital but we would restrict this limit to *at issuance only* (as per the Sydney Press Release) rather than on an *ongoing basis*.

We propose that the limits be calculated prior to deductions.

Finally, since we do not see the ACSM as an incentive to redeem, we believe instruments featuring the ACSM should be eligible for regulatory capital treatment beyond 15%, provided they have no step-up or stock settlement mechanism.

Conclusion

We respectfully request that CEBS takes into account the considerations and analysis developed in this letter.

It is the opinion of Barclays Capital that the CEBS proposal, as currently drafted, would result in material costs for no clear benefit.

SECTION 2: Comments on the CEBS detailed proposals

PART 1: PERMANENCE

CEBS recommends that Tier 1 hybrids be undated and that early redemptions be subject to strict conditions and to prior supervisory approval

CEBS proposal on "Permanence"	Comments
Hybrid instruments are considered as permanent if they are contractually undated	▪ Agreed. It would be helpful to have clarity that short dated mandatory convertibles, with required regulatory features, are eligible from their issue date to count as Tier 1 capital
Hybrids may be callable but only at the initiative of the issuer, always subject to prior supervisory approval and 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	▪ Agreed. A statement to the effect that the replacement language need not be included in the terms and conditions of the instrument itself would be helpful
Hybrids may be callable after a minimum of 5 years if they contain a pure call option, or after a minimum of 10 years if the call option is associated with an incentive to redeem	▪ Agreed
Step ups and principal stock settlements in conjunction with a call option are considered as incentives to redeem	▪ Agreed
Step ups are permitted, in conjunction with a call option only if they are considered moderate, i.e. if they result in an increase over the initial rate that is no greater than, at national supervisory discretion, either; *- 100 basis points, less the swap spread between the initial index basis and the stepped up index basis; or* *- 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped up index basis*	▪ Agreed ▪ Step up language expressed in the SPR (100bp or 50% of the initial credit spread) should be applied across Europe
The terms of the instrument should provide for no more than one rate step up over the life of the instrument. The swap spread should be fixed at the pricing date and reflect the difference in pricing on that date between the initial reference security or rate and the stepped up reference security or rate, in line with the guidance given in the Sydney Press Release	▪ Agreed
Principal stock settlement mechanisms must contain a cap on the conversion ratio in order to limit the potential dilution	▪ Agreed
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	▪ We would suggest that CEBS also consider calls in case of an adverse "change in accounting"

PART 2: LOSS ABSORPTION

CEBS proposes that Tier 1 capital instruments must be able to absorb losses in case of liquidation, on a going concern basis ***and in stress situations*** *thus significantly tightening* ***current guidelines***

CEBS proposal on "Loss Absorption"	Comments
The instrument must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids are senior only to ordinary share capital	▪ Agreed. However, the CEBS proposal effectively subordinates Tier 1 instruments to ordinary shares and hence is not compatible with this statement
The instrument must neither be secured nor covered by a guarantee of the issuer or related entity or other arrangements that legally or economically enhance the seniority of the claim vis-à-vis the institution	▪ Agreed
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 instrument can be converted into ordinary shares*	▪ We disagree. It is not clear that the write-down and/or the conversion mechanism is beneficial in a stress situation ▪ The current 2% Tier 1 ratio proposal is remote and would not capture a financial stress situation ▪ Both mechanisms create many practical issues as detailed earlier
The mechanism must be disclosed and transparent to the market and in the case of a principal write-down must be on the issuer's balance sheet (assuming this is possible from an accounting perspective). In addition, it must be legally certain that under the terms of the instrument the principal is written down on a going concern basis	▪ We disagree. This proposal is intransparent to investors since the write-down is not reflected under IFRS ▪ May require a regulatory set of accounts diverging from IFRS which could in turn create legal, transparency and complexity issues
Future coupons are cancelled while the principal amount is written down	▪ For direct Tier 1 issues, tax deductibility will be lost in the UK and elsewhere
If the bank goes into liquidation whilst the principal is written down then the hybrid holder will have a claim for the full principal amount	▪ We question the efficiency of the write-down/write-up provisions for the reasons set out above
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	▪ We question the efficiency of the write-down/write-up provisions for the reasons set out above
The issuer must not pay any coupons until the principal is completely written up	▪ We question the efficiency of the write-down/write-up provisions for the reasons set out above

PART 3: FLEXIBILITY OF PAYMENTS

CEBS proposes that Tier 1 hybrids should be non-cumulative (i.e. any deferred interest should be settled immediately) and that the issuer must be able to stop paying its coupon whenever necessary

CEBS proposal on "Flexibility of Payments"	Comments
Issuers must be able to waive payments at any time on a non-cumulative basis and for an unlimited period of time	▪ Agreed, subject to this referring to non cash cumulation only
If the institution is in breach of the minimum capital requirement (or another level defined by the supervisor), then it must waive payments.	▪ Agreed
In addition, supervisors can require institutions to waive payments at their discretion based on the financial situation of the institution	▪ Agreed
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*	▪ Agreed, although this does appear contrary to previous published announcements
Issuers must have full access to waived payments.	▪ Agreed
Distributions can only be paid out of distributable items; where distributions are pre-set they may not be reset based on the credit standing of the issuer.	▪ Agreed
The instrument has to be non-cumulative in cash or kind: any coupon or distribution not paid by the issuer is forfeited and is no longer due and payable by the issuer	▪ We disagree. The interest should be non cumulative in cash, but should allow ACSM feature
Alternative Coupon Satisfaction Mechanisms (ACSM) 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 the coupons or dividends at all times. In addition they are only permitted if *(i) they are made out of already authorized and unissued shares,* *(ii) subscribed by the hybrid holders and* *(iii) are exercised immediately to avoid the accumulation of debt.* *These instruments are limited to 15% of total Tier 1 capital after deductions.*	▪ We disagree. ACSM should be accepted across the EU irrespective of the tax situation ▪ We disagree. Direct subscription of shares by investors would create a marketability issue since most fixed income investors are prevented to hold instruments which could deliver shares rather than cash (alternative routes involve trustees or involve the issuer which sells shares to the market and then deliver cash proceeds to the investors) ▪ We disagree. We do not understand why the ACSM should be limited to 15% as we do not agree it represents an incentive to redeem ▪ We disagree. ACSM should feature settlement in hybrid securities or in kind, in addition to ordinary shares

PART 4: LIMITS TO INCLUSION INTO TIER 1

CEBS proposes that 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, CEBS proposes that ordinary shares and disclosed reserves/retained earnings represent at least and at all times 50 % of the total Tier 1 after deductions. Instruments with an incentive to redeem and instruments with ACSM are limited to 15%

We believe limits should be calculated at issue and prior to deductions.

CEBS proposal on "Limits on the inclusion of hybrids in Tier 1 capital"	Comments
Overall limit: ordinary shares and disclosed reserves/retained earnings represent at least and at all times 70% of the required Tier 1 capital	▪ We disagree. We prefer the current FSA position to allow hybrid up to 50% of total 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	▪ We disagree. We prefer the current FSA position to allow hybrids up to 50% of total Tier 1 capital
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	▪ We disagree. We prefer the current FSA position to allow hybrids up to 50% of total Tier 1 capital
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)	▪ We disagree. We do not view ACSM as an incentive to redeem. Only Tier 1 instruments featuring step ups or stock settlement mechanisms should be limited to 15% of Tier 1 capital

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PART 5: GRANDFATHERING

CEBS proposal on "Limits on the inclusion of hybrids in Tier 1 capital"	Comments
- Instruments with an incentive to redeem: instruments remain eligible until the first call date *- The eligibility of all other instruments (including hybrids with incentives 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*	▪ Agreed, to the extent that changes to definitions are deemed necessary by the Commission, a step-up hybrid should be grandfathered on a tapered basis from its first call date onwards (if not redeemed)
Any redemption should be made at the initiative of the issuer and subject to prior supervisory approval	▪ Agreed