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By email: cp17@c-ebs.org

cc: Catherine Stynes, Nigel Howell, Charlotte Russell, Nick Kitching
UK Financial Services Authority

15 February 2008

Our Ref CJXW

Dear Sirs,

Consultation Paper of 7 December 2007 on Draft Proposal by CEBS for a Common EU Definition of Tier 1 Hybrids (CP 17)

We refer to CP 17 and your invitation therein for market participants to provide feedback on the proposals contained in that paper. As a firm of lawyers which regularly advises both regulated credit institutions as issuers and also investment banks as underwriters of hybrid capital issues, the views set out below are primarily of a legal and tax nature and focus on the impact of certain of the proposals in the context of issuers incorporated in the United Kingdom.

For convenience, references herein to paragraph numbers are to the paragraph numbers adopted in CP 17.

Background

The aim of defining "clearly the economic characteristics of Tier 1 eligible hybrid capital instruments to ensure convergence on the application of commonly agreed principles and a level playing-field across countries" (**Paragraph 10(a)**) is welcome as is the principle of "substance prevailing over form" (**Paragraphs 6** and **20(b)**). The last point, as alluded to in **Paragraph 21**, is particularly important because of the absence of common company law, insolvency, accounting and tax regimes across all the EU member states. It is therefore important that the proposals are not overly detailed or prescriptive, as seeking to achieve a "one-size-fits-all" solution from a regulatory perspective may in fact be counter-productive in achieving the principal aims of convergence and creating a level playing field in the EU for

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Tier 1 capital. As noted in **Paragraph 26**, many of the current differences in hybrid instruments are validly explicable on the basis of differences in national tax and company law.

While striving to achieve a level playing field across the EU is a welcome aim, it is important that that playing field is not out of kilter with the review of capital currently being undertaken by Basel. We agree with the view expressed in **Paragraph 10(c)** that any final position should be arrived at in tandem with Basel to avoid the confusion which may arise from the rules having to be amended more than once in quick succession and major differences of approach between EU and non-EU issuers.

In the United Kingdom, the FSA has in recent years sought to harmonise substantially the rules relating to capital resources as they apply both to banks and insurers. That too is a welcome aim. It should be borne in mind that that aim may be frustrated if, as more fully discussed below, one impact of the proposals in CP 17 is to force U.K. banks to use only indirect SPV structures to be able to issue innovative Tier 1 Capital, which structures do not currently give rise to capital for insurers because the UK adopts the "deduction aggregation" method for the calculation of group capital adequacy under the Insurance Groups Directive and Financial Conglomerates Directive by consolidating only the "proportional share" of the capital of subsidiary undertakings (whereas the "accounting consolidation" method is currently used under the FSA's rules for banks).

Permanence

Paragraph 84 refers to the need for Tier 1 hybrid instruments to be undated. This is one of the areas where reaching a common position with Basel would be desirable.

Notwithstanding **Paragraph 84**, it would be helpful to have complete clarity that dated (e.g. 3 year) Mandatory Convertible Securities (as mentioned in **Paragraph 89**) are eligible from their issue date to count as Tier 1 hybrid instruments and are not limited to 15% of total Tier 1 Capital after deductions.

Paragraph 72 makes it clear that early redemption triggered by an event "such as" a change in regulatory recognition or tax treatment will not be considered as an "incentive to redeem". It would be helpful to have clarity that the other early redemption triggers commonly seen in the market (loss of accounting treatment and loss of rating agency treatment) are also not considered as incentives to redeem and therefore that redemption for these special reasons prior to five/10 years is acceptable.

The **CEBS proposal** requires that any issuer call be (among other things) subject to replacement 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". A statement to the effect that this condition need not be included in the terms and conditions of the instrument itself would be helpful (on the basis that the local regulator would apply the test in determining whether or not to consent to early redemption).

Loss absorption

The Basel Committee's Sydney press release of October 1998, while setting out a requirement for the relevant instrument to be able to absorb losses on a going concern basis, does not (as noted in **Paragraph 90**) specify any particular mechanism for achieving this and in particular does not set out any requirement for a principal write-down feature.

Most innovative Tier 1 instruments in the UK are undated and permit unlimited deferral of coupons. Given therefore no cash sum need ever fall due in perpetuity, it is not clear to us why such instruments are considered by CEBS to be inadequate in terms of the loss absorption qualities on an on-going basis as stated in **Paragraph 95**. In this regard it would be helpful to have more clarity on precisely what CEBS

has in mind when it says in **Paragraph 104** the test of a bank being a going concern is more than it meeting its obligations as they fall due and its assets excluding its liabilities.

The second bullet point in **Paragraph 105** (in our view, correctly) states that the relative "subordination of different Tier 1 capital instruments should be respected so that the ordinary shareholders should suffer the first losses". However, some of the specific proposals seem to conflict with this principle. For example, in **Paragraphs 111** and **112**, there is reference to hybrid holders and ordinary shareholders sharing "pain" equally and the statement at the end of **Paragraph 107** seems to imply that the conventional claims of hybrid holders (i.e. which rank senior to ordinary shareholders) may hinder a recapitalisation. In addition, the proposal at the bottom of **page 20 of CP 17** that any redemption of a written-down instrument should only be made at its then written-down amount could actually place hybrid holders in a worse position than ordinary shareholders, for example in circumstances where the relevant instrument had been written down to close to zero at the time of redemption. Commercially that will likely be unacceptable to hybrid investors and is inconsistent with both the first and second bullet points in **Paragraph 105.**

If the underlying rationale for some of the proposals is indeed to share "pain" (eg in some pre-determined ratio) among both hybrid holders and ordinary shareholders, there seems no sensible, equitable or achievable basis for drafting that into the terms of the instrument from day one as it will very much depend on the circumstances as they exist at the relevant "stressed" time.

Paragraph 110 requires that for so long as the principal amount is written down, future coupons must be cancelled. In the UK, this will give rise to a problem for bank issuers in seeking to achieve a tax deduction for directly-issued hybrid capital since no tax deduction is allowable in respect of an instrument if the return to investors is to any extent dependent on the result of the bank's business. This "results dependence" rule is a wide one and has been the main tax issue associated with Tier 1 instruments in the UK to date.

The cancellation of even one coupon obligation of a directly-issued instrument by reference to a condition linked to the financial standing of the issuer is an issue given the width of the "results dependence" condition. Moreover, the presence of a results dependence feature would not simply affect the deductibility of coupons arising after the occurrence of the trigger event. It would prevent any deduction arising for any coupon from the date of issue of the instrument.

The proposals require that the temporary write-down mechanism must be transparent and "be on the issuer's balance sheet (assuming this is possible from an accounting perspective)". It is not transparent to us from the proposals what the quantum of any write-down needs to be nor (given some hybrid instruments are debt-accounted and others are equity-accounted) what in particular the significance of the reference to the accounting write-down really is. It would also be helpful to have confirmation from CEBS that, in the context of indirect Tier 1 deals (i.e. those issued through an SPV), if the write down were implemented at the SPV level, the fact that any impact on the accounting treatment of the instruments would likely only be apparent in the consolidated accounts of the Issuer (but not its solo accounts) would satisfy this requirement.

It will be important to have clear rules as to the quantum of the required write-down. In some continental EU jurisdictions which already have this feature, the quantum is expressed to be equal to the amount of ordinary share capital which would have been required to be issued to restore the bank's regulatory capital base to a prescribed level. Of course, simply writing down the bank's hybrid capital by that amount does not of itself in substance result in any new capital being created for the bank. In addition, it will be helpful to have clarity on how any write-down mechanism should pro-rate the amount to be written-down across multiple series of hybrids outstanding – current examples in the market for example do not set out with much specificity a methodology for applying the write-down to series of hybrids denominated in

different currencies or to those with floating rates of interest (as yet unknown in respect of future periods) or to those with different coupon accrual periods. The same issues of quantification and pro-rating apply in reverse in connection with writing-up principal again following a recovery.

Paragraph 111 requires any writing back up to be made *pari passu* with shareholders. As mentioned previously, this seems inconsistent with the principles set out in **Paragraph 105** and since ordinary shares do not have a specified preference (in contrast to preference shares and hybrid bonds) the methodology for achieving this is unclear to us.

While it is possible contractually to write down the principal amount of a hybrid bond it is not legally possible in the UK to write down the nominal amount of a preference share on an on-going basis (as opposed to reducing its stated preference on a liquidation). That being the case, it is not clear to us how the requirements for principal write-down/write-up can ever be satisfied by UK issuers of preference shares.

In the UK, the measure of taxable profit on a debt instrument broadly follows the accounting treatment. Accordingly, the accounting treatment of a "write-down" is likely to be important. To the extent that a write-down of a directly issued instrument gives rise to a credit as an accounting matter (whether recognised in the income statement/P&L in the case of a debt-accounted hybrid or any reserve including equity or shareholders' funds in the case of any equity-accounted hybrid), that credit would be a taxable item for a UK tax-resident issuer. Incurring an actual tax liability (albeit one which may be off-settable by losses) at a time of stress would be an undesirable consequence of principal write-down of a directly issued hybrid.

In addition there is a question of whether the write-down in principal amount of the instrument itself introduces a measure of "results dependency". The uncertainty here arises because the results dependency rule does not simply speak about "interest" being "results dependent". Rather, it asks whether the "consideration for the use of the principal" is results dependent leading to a concern that the "consideration for the use of the principal" is the totality of promises embodied in the instrument (including obligations relating to principal). If that were right, it could cause any "results dependency" associated with the principal amount of the hybrid to prevent any interest from being tax-deductible.

If the bank goes into liquidation whilst the principal is written down, the hybrid holder's claim for the full principal amount is restored under the CEBS proposals. We agree with this, but it is not clear to us in a UK context what additional loss-absorbency is achieved by principal write-down either on an on-going basis or in terms of facilitating a recapitalisation. Indeed, the feature may achieve the opposite effect because of the negative tax consequences described above.

Paragraph 112 contemplates conversion into ordinary shares. This will create a very different economic instrument from a conventional hybrid (being a "preferred" instrument), since at the time it matters most, the relevant holder's preference will cease to exist. It is not clear from the paragraph how the relevant number of ordinary shares should be calculated and hence how much loss the holder should bear. The conversion feature means banks either will have to observe or disapply (by means of shareholder resolution) pre-emption rights at the time of issuing the hybrid instrument. It seems an arbitrary and inequitable outcome that the holder of a hybrid instrument in a bank which suffers catastrophic overnight failure and is placed in liquidation immediately will have a preferred claim for par whereas the holder of a similar instrument in a bank which suffers a period of sub-2% ill-health will irrevocably become an ordinary shareholder and suffer a loss at the time of conversion.

For all of the above reasons, the economic consequences of the two proposals in **Paragraphs 111** (temporary write down) and **112** (conversion into ordinary shares) are very different and we assume the option in **Paragraph 112** will therefore not be widely adopted in practice. In addition from a tax

perspective, the proposal in **Paragraph 112** will give rise to most of the same issues described above in relation to the temporary write-down option. Since the value of the ordinary shares into which the instrument converts would not be equal to the value of the bond, conversion into ordinary shares would appear to have the same effect on principal as a write-down. Therefore, the same concerns as to "results dependency" upon the instrument's principal amount reducing would apply.

Flexibility of Payment

The observation in **Paragraph 139** that dividend stoppers are not desirable since they operate as a restriction on the flexibility of payments on common shares as mentioned above appears to give rise to some tension with the principles outlined in **Paragraph 105**.

As noted in **Paragraph 133**, direct issue innovative hybrids in the UK contain ACSM features to achieve tax deductibility. However, the restrictions on the operation of the ACSM set out in **Paragraph 57** and on **page 25 of CP 17** could cause problems for UK issuers. First, there is a requirement that the ACSM utilises authorised and unissued shares. The current UK rules permit the use not only of ordinary shares but also other forms of Tier 1, including payment-in-kind (PIK) securities of the same type as the relevant hybrid itself. This flexibility is especially important for issuers such as Building Societies which do not have ordinary share capital. Secondly, the requirement that the ACSM securities be subscribed by the holders of the hybrid is more onerous for issuers than the current mechanism whereby the securities are delivered to a trustee on behalf of hybrid holders and the trustee enters into arrangements to procure the placement of the securities with market counterparties and delivers the cash proceeds of the placement to the hybrid holders. The current mechanism avoids the difficulties of complying with securities laws in every jurisdiction where hybrid holders happen to reside (including satisfying prospectus and other public offer requirements, which would be especially undesirable in the context of multiple exercises of the ACSM) and dealing with hybrid holders who are not authorised to receive ordinary shares. Thirdly, the obligation to exercise the ACSM immediately to avoid the accumulation of debt means the issuer may be forced to issue shares at an inopportune time when the share price is likely to be depressed, therefore increasing the dilutive impact of the operation of the ACSM. In addition, if the relevant coupon payment date falls in a "close period" or at any other time when the preparation of a prospectus is difficult, it may place the issuer in a difficult, if not impossible, position.

Page 25 of CP 17 requires that issuers "must be able to waive payments at any time" and (within the same set of proposals) provides that "dividend pushers are acceptable". These two provisions are contradictory to each other and clarification is therefore requested.

Page 25 of CP 17 also requires that "issuers must have full access to waived payments". The meaning of, and intention behind, this requirement is unclear and clarification is therefore requested. If CEBS' intention behind this proposal is to ensure that payments are non-cumulative, we would suggest that the "full access to waived payments" proposal should be removed (on the basis that the "non-cumulative" requirement is already clearly stated, and repetition of the same requirement, but using different language, introduces legal and interpretative uncertainty).

Paragraph 52 and **page 25 of CP 17** require a mandatory waiver of payments if the bank is in breach of its minimum capital requirements. That feature will presumably require the relevant bank to make public disclosure of its normally private individual capital requirements.

From a tax perspective it is important that the ACSM securities have a value at least equal to the "missed" interest payment - otherwise "results dependence" concerns arise again. In addition the holder's claim for any "missed" payment which has not been settled prior to a liquidation (by means of the ACSM) should be preserved in the liquidation otherwise "results dependence" will arise again.

Limits to inclusion in Tier 1

Page 29 of CP 17 provides that instruments including an ACSM feature must be limited to the 15 per cent. "bucket". The rationale for this proposal is unclear, especially when considered in the context of the separate proposal that an ACSM should only be satisfied through the issuance of ordinary shares (the most junior ranking securities).

Conclusions

While welcoming the aims CEBS is seeking to achieve with these proposals, we are very concerned with the impact of the proposals in three key areas:

First, the confusion which may arise as a result of these changes being introduced ahead of an agreed position being reached under the imminent Basel review.

Secondly, as more fully outlined above, the impact of some of the proposals in the UK will be to render hybrid issues in direct format not tax deductible and will (assuming SPV structures with write down mechanisms at the SPV level only are accepted by CEBS) likely force banks to consider using indirect issues which are more complex structurally to establish and document. As such, it may foster greater structural diversity across the market in the EU, rather than achieving harmonisation.

Finally, proposals such as the write-down and the requirement for ACSM to utilise ordinary shares do not take account of local market conditions - the write-down mechanism will not work in the context of preference shares (see above) and for some issuers (e.g. building societies or banks whose shares are not listed) the proposed ACSM feature will not be feasible.

If any of the above comments are unclear or you would like to discuss any of the legal or tax analyses above, please feel free to contact Carson Welsh (carson.welsh@linklaters.com or 020 7456 4602).

Yours faithfully

Linklaters LLP