

Morgan Stanley

Capital Products Group  
Global Capital Markets

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Mr. Andrea Enria  
Secretary General  
Committee of European Banking Supervisors  
Floor 18, Tower 42  
25 Old Broad Street  
London EC2N 1HQ

## **CEBS PROPOSAL FOR A COMMON EU DEFINITION OF TIER 1 HYBRIDS**

Dear Mr. Enria,

Thank you very much for your proposals for new Tier 1 regulations for the European Union. We have considered these proposals, discussed them with many of our clients, and offer you some points and considerations. We have grouped our discussion points into the following key headings: Objectives, Permanence, Loss Absorbency, Deferral, Limits and Grandfathering.

### **The Objectives**

While we understand and support the committee's objectives of **harmonizing and simplifying** hybrid rules across Europe, we are concerned about several broad implications, as explained below:

- We question whether the **timing** of these proposals is appropriate given the Basel Committee on a global basis is undertaking an initiative to examine the use and structure of bank capital instruments. We fear the possible upheaval that could be created when our clients first adhere to a European wide standard and then readapt to a new global basis laid out by Basel.
- A second point relates to your suggestion of using a principles based regulatory framework. Whilst we and the vast majority of our clients welcome a principles based approach, we were surprised to find how **prescriptive** the proposals actually are. A prescriptive set of rules may prove inflexible, particularly in light of the never-before-seen challenges facing the banking sector today.
- Although we do agree that harmonisation of Tier 1 hybrid structures is advantageous from both an issuer and investor perspective, we feel that the discrepancies of individual member states' tax and legal frameworks pose some serious and prohibitive challenges. As a result of the prescriptive proposals, we are likely to see more **divergence among structures** rather than convergence. For example, many countries had moved to direct issue Tier 1 structures over the years, but now the UK will probably shift back to SPV structures to preserve tax deductibility.

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As regards the other objective of **improving** the quality of capital, we would urge the CEBS committee to exercise caution in this regard. The Tier 1 investor base has evolved as a sub-section of the fixed income investor base and has become a very important component of a bank's capital structure. In our view the risks already accepted by investors in fixed income hybrids are appropriate for Tier 1 capital and do not require improvement. Proposing new features may not actually be helpful in supporting a bank's capital position if the result is to alienate this significant source of support. Features like write-down requirements and conversion provisions will run afoul of the investment restrictions for a portion of the hybrid investor base, thus reducing capacity for hybrid capital and the goal of 'improving' bank capital may not actually materialise.

## **Permanence**

We recognise that in this area the CEBS proposals raises very few contradictions with existing regulation in Europe, and indeed among existing regulation there is little discrepancy from country to country. That said, on the subject of step-ups, we urge the committee to require regulators to accept the greater of 100bps or half of the new issue spread in order to reflect both benign and volatile market conditions.

## **Loss Absorbency**

We consider this to be the most controversial area of the new proposals. In this regard our concern over the prescriptive nature of the rules is most pronounced, and we suggest that a greater degree of regulatory oversight should be employed instead of prescriptive rules which may prove inflexible. **Bank failures are idiosyncratic** and no two failures can really be considered the same. We suggest that the committee can instead successfully outline broader objectives and guidelines for European bank regulators to follow with sufficient discretion to allow optimal outcomes in individual situations.

Furthermore, we are concerned that the proposals put forward to require either write-down or conversion provisions are unnecessary and possibly detrimental.

First, we believe that required **conversion** into common equity will severely diminish investor appetite as a significant number of fixed income investors may not even be able to hold such instruments. Such instruments may require AGM approval for issuers, which limits flexibility on timing, and convertible instruments are not available at all for our unlisted or co-operative banking clients. Also there may be potentially destructive implications of a massive dilution if a bank were forced to convert Tier 1 obligations into common shares. Prior to conversion the damaging effects could still be significant through an 'overhang' or uncertainty regarding timing or magnitude of a possible dilution. We suggest that such disruptive pressure could materially impact the appetite and likelihood of a bank recapitalisation and may not achieve the committee goal of improvement of quality of capital.

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Second, regarding the proposed **write-down** suggestions, we question the additional value that these mechanisms will actually bring. Tier 1 hybrids in virtually all jurisdictions in Europe pose no obligation to redeem and allow issuers to escape payment obligations in almost all circumstances and particularly in distressed scenarios. Further, taking the UK example of preference shares, these instruments actually count as equity when assessing a bank's solvency position. We wonder whether the write-down mechanism actually achieves any additional 'loss absorption' particularly in a country like the UK where the instruments are considered equity for insolvency purposes or whether the proposed write-down feature is more cosmetic in nature.

If the committee chooses to go forward with the requirements to include write-down or conversion, we have a few specific comments on the rules:

- Regarding the '**stress trigger**' of 2% of Tier 1, we consider this to be too early because hybrid investors will be participating in losses prior to the level at which equity has been entirely written off. Hybrid investors understand they must participate in losses but only after equity has been written off.
- Similarly, we suggest that a **write-up** of the instrument's value should occur in advance of a write up in equity value. As stated the Tier 1 investor base can accept equity like risks but for a number of reasons they are not equity investors and so should not rank *pari passu*.
- With regard to the **redemption at a potentially written-down amount**, we suggest that a floor should be included. If in a severely distressed scenario when the hybrids may have been written down to say 20% of initial nominal value then a potential new entrant into the bank may have an incentive to redeem the hybrid instruments to 'gain' from the temporarily low price. We suggest that hybrid instruments cannot be redeemed at less than 50% of their initial nominal value or that hybrid investors should be allowed to reject a redemption below par.

## Deferral

We broadly support the suggested discretionary, non-cumulative deferral provisions, and we support the acceptance of ACSM to smooth the structuring complexities in certain countries. We offer a few comments on the mechanism for your consideration.

It has been suggested that **ACSM should be immediate** and that the obligation to settle should extinguish **within one year**. In certain jurisdictions, in order to preserve tax deductibility, the claim to deferred interest must never fall away and if it does after one year then tax deductibility will be jeopardised. In addition, the proposal to deliver shares **directly to investors** may diminish the appeal among Tier 1 investors, as they are not equity investors and we see no difference from a regulatory perspective of issuing shares to a trustee who monetises them or issuing shares direct to investors. In certain jurisdictions the delivery of shares direct to investors may not actually be feasible. From a legal perspective, in some countries shares need to be sold for some consideration - there needs to be some form of paid-in capital to add to the balance sheet. We understand one concern relates to finding a market for such shares. In practical terms the amount of shares required to settle coupons (approx. 5 to 6% of 15% of Tier 1) is very

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small relative to bank market capitalisations such that monetisation opportunities are likely to be readily available.

Finally, we question **why ACSM should be limited** at all. ACSM can only be conducted through the means of issuing equity. Equity is not cash and has no detrimental effect on the leverage position of a bank. There is no difference from a leverage perspective of skipping a coupon payment and paying one in equity and so where ACSM is required we see no reason for limits.

### **Limits**

Our first point with regard to limits relates to **deductions**. We were slightly unclear and have heard different interpretations among the community as to whether Tier 1 limits will be net of a broad set of deductions or just the deduction of goodwill under the Sydney Press Release. We suggest that the committee propose to include only the goodwill deduction for the purpose of calculating limits.

Related to this point, we understand that there is a proposal to employ a 15% limit on hybrids with incentives to redeem and that the **limit must apply at any time**. We note the contrast with the Sydney Press Release which instead calls for compliance with a 15% limit at the time of issuance. In the dynamic environment in which banks operate we consider it unduly harsh and possibly quite destructive to create a changing limit depending on bank profitability. This may cause spiralling downward circumstances whereby when banks start to make losses then a decreasing quantity of hybrids will be eligible as Tier 1.

### **Grandfathering**

It has become clear to us through our discussions within the community that your proposals for the grandfathering limits have been interpreted in different ways and possibly incorrectly. We would appreciate some clarity on the exact working and dynamics of the proposals.

Finally, we have a few specific questions:

**Disclosure:** Are you advocating that banks must disclose the full terms of the instrument, the component of their capital, as well as the Tier 1 requirements met on an ongoing basis?

**Maturity:** Several banks have employed calls without incentives to redeem at year 5 (i.e. par calls) within their otherwise standard instruments that have step-up features beginning in year 10. We propose that the wording be clarified as that structure would (unintentionally) not be allowed under the current proposal.

**Guarantees:** In paragraph 44 of your proposal you exclude the use of guarantees or credit enhancements from parent entities. Can you clarify that this excludes the case of issuance from an SPV where a guarantee to ensure direct credit claim to parent has been granted? This guarantee acts solely to protect the performance of the SPV and has been employed in all SPV structures across Europe.

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**UK SPV Issued Tier 1 transactions:** Some of these transactions have provisions whereby upon a breach of minimum capital requirements the SPV issued Tier 1 converts into a directly issued preference share. Will the new preference shares when or if issued in the future be eligible for grandfathering at the point of issuance in the future? Clarity on this and the other points raised above would be appreciated.

In summary, we have several suggestions with regard to your proposals. We feel that the most controversial area is that of loss absorbency as you know. Nonetheless, we commend the tremendous amount of research, discussion and effort that your team has undertaken to arrive at a balanced compromise proposal. We hope that you find our comments and insights useful and are of course welcome to discuss any with you at your convenience.

With Kind Regards,



Jennifer Moreland  
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Global Head of Capital Products Group