Allied Irish Banks, p.l.c.
comments on the
Proposal for a common EU definition of Tier 1 hybrids

Allied Irish Banks, p.l.c. (AIB) welcomes the opportunity to respond to the CEBS draft proposal for a common EU definition of Tier 1 hybrids (the "Draft Proposals").

General observations:-

1. The Draft Proposals blur the lines between equity capital and other forms of Tier 1 Capital. We believe that investors will start to treat instruments that would be required to be issued under this proposed regime as equity and will price them accordingly. This will increase the cost of capital issuance and may reduce the availability of capital.

2. We also believe that the Draft Proposals place such onerous conditions on hybrids that make the distinction between core and non-core unnecessary and should the Draft proposals be implemented without amendment, we would see no reason to have a regulatory limit on the amount of Regulatory capital that could comprise hybrids.

3. The Draft Proposals may place European financial institutions at a competitive disadvantage to non-European institutions. Many European institutions access the US Markets for capital. We have not heard of proposals for changes in rules in the US, so market participants would naturally choose instruments that do not have write-down features before those that do. We would request that CEBS proceed with caution on making changes to the rules without engaging with other Supervisors. Perhaps Europe should await the Basle review on the definition of eligible capital.

4. We note the findings of the survey conducted by CEBS on hybrid capital instruments with regard to the significant volume of 'hybrid' instruments. We can understand why there may be a call for convergence. However there does not seem to be any evidence from the work carried out by CEBS that any hybrid instrument did not perform in the manner in which it was supposed to.

   In such a circumstance, we specifically fail to understand the reason for a proposal that requires all hybrid instruments to have a write down feature when: -
   - there was no evidence of the write down feature been utilised in the case of instruments with such a feature; and
   - there is no evidence of instruments without such a feature, not performing in line with expectations.

5. Terminology
   The Draft Proposal refers to hybrids as:-

   (a) innovative instruments (i.e. instruments with incentives to redeem such as step-ups);

(b) non-innovative instruments (i.e. instruments with do not have incentives to redeem); and
(c) non-cumulative preference shares, which some members treat as 'Core Tier 1 capital'.

AIB does not believe that it is appropriate to treat non-cumulative preference shares directly issued by a licenced financial institution as hybrids.

Irish Companies legislation permits the issue of redeemable preference shares. Preference shares can be redeemed under Irish Law only:-

> *Out of profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purpose of the redemption.*

We believe that the legislative requirement to repay such preference shares, out of new issues of shares, or out of distributable reserves, should be sufficient not to have them classified as 'hybrids'.

Considering that preference shares are enshrined in Irish legislation, the loss absorption proposals contained in this draft proposal may not be compatible with the legislative provisions.

6. We believe that the concepts of loss absorption, permanence and flexibility of payment are closely interwoven with one another and that it is not possible to make a clear distinction between those criteria as the Draft Proposal attempts to do. In contrast we believe that the permanence of an instrument and the issuers discretion concerning distributions on same, play a major role in the instruments ability to absorb losses.

   We have however attempted to deal with each of the matters raised in the CEBS document on an individual basis.

Part 1: Permanence

7. We believe that the 'call option' conditions set out in the Sydney Press Release ("SPR") are sufficiently clear and do not need significant amendment.

8. We have no objection to the proposals that instruments must be undated to qualify as Tier 1 instruments although we could see how a dated instrument with a 'lock in' feature (where capital could not be repaid at maturity date, without the permission of the Regulator, or if to do so would breach the capital requirements) could meet the permanence criteria.

9. We believe that early redemption (subject to replacement with qualifying capital) should be permitted at all times, including within the first 5 years, for events such as a change in the tax treatment of the instruments. We strongly support the possibility of early redemption for tax purposes at all times, as not to permit such redemption would increase the cost of the capital issue and reduce the capital resources available to the organisation.

10. We are unhappy that CEBS have used a change in Regulatory Recognition as a reason for redemption. Significant costs are incurred in the issue of Capital and we believe that once an instrument has been granted a regulatory status on issue (say, for example Tier 1 qualification) it should not lose that status through a change in the regulatory recognition rules.

    Institutions should not be required to operate in an environment whereby a previously issued instrument would lose its capital status as a result of a change in regulatory rules. Therefore, once approved as a Tier 1 instrument, an instrument should always qualify as Tier 1. Consequently there would not be any need to have a clause for early redemption for a change in regulatory recognition.

<u>Part 2: Loss absorption</u>

11. It is not clear what the rationale for the proposed change to the loss absorption criteria is. The SPR stated that 'all instruments included in Tier 1 must be able to absorb losses within the bank on a going-concern basis'. Have there been any cases since 1998 whereby an instrument has failed to meet the loss absorbance test? We are not aware of any cases where the instrument has not met the SPR criteria.

12. Although the Draft proposal indicates that CEBS paid due consideration to the following principles:-

    - Regulation of hybrids should not be more onerous than rules on ordinary share capital; and
    - The relative ranking of subordination of different types of Tier 1 Capital instruments should be respected so that ordinary shareholders should suffer the first losses.

    it is not evident from the Draft Proposal that the considerations above influenced the discussions and the conclusions reached.

13. In our view there are a number of features, which if embedded in hybrid instruments, would meet the objective of loss absorption:-

    - Non cumulative dividends;
    - Perpetual, and not subject to mandatory redemption provisions; and
    - The holder does not have any rights to repayment or to institute proceedings for liquidation in the even of non payment of a distribution.

    We do not share the view that loss absorbtion is improved by having a concept of a write down of a hybrid.

14. The temporary write-down is advocated on the basis that it allows an issuer to reduce future expenses to the extent that coupons are cancelled while the principal amount is written down.

A 2% Tier 1 ratio is the definition of a circumstance that might require a write-down. In practical terms, no institution would be in a position to make payments on a capital or hybrid instrument if it had a 2% Tier 1 ratio. The cancellation of distributions can be (and currently is) achieved through the non-cumulative terms and is covered under Flexibility of payment, below. It does not require mandatory write-downs to achieve same.

15. The practical application of a write-down needs further examination.

    (a) How much of a write-down should be taken?
    (b) Do all hybrid instruments have to be written down on a 'pari-passu' basis?

16. We are also extremely concerned about the impact that such a term would have on accounting for hybrid instruments and the accounting impact of such a write-down, and re-instatement. The write down could conceivably generate profits although the underlying performance would be negative.

17. We don't agree with the suggestion in paragraph 114 that insisting that hybrid holders must also absorb losses helps ensure that the bank remains a going concern.

    The write-down of hybrid does not change the amount of capital available to the bank.

    If a bank with hybrid capital has a Tier 1 ratio of 2%, there is nothing that the holders of the hybrid instruments can do that will change the ability of the institution to remain as a going concern, whether the hybrid is written-down or not.

18. It was suggested at the November 2007 meeting that a write-down feature would help the recapitalisation of the institution through the introduction of new investors. Any new investors to a company (particularly a troubled bank with a 2% Tier 1 ratio) will negotiate with the existing shareholders regarding dilution of their interest. The new investors will also, if they deem necessary, negotiate with existing bond holders both subordinated and senior. These negotiations will take place, whether or not a write-down of the hybrid has taken place. We do not believe that the introduction of the write-down requirement will benefit recapitalisation, and the ability to continue as a going concern, as when profits have been built up under the proposal the hybrid instrument will be re-instated.

Part 3: Flexibility of payment

19. We concur with the requirements that:-
    - Issuers must be able to waive payments at any time on a non-cumulative basis and for an unlimited period of time; and
    - If the institution is in breach of the minimum capital requirements (or another level defined by the supervisor), then it must waive payments.

Part 4: Limits to inclusion in Tier 1

20. As described in our opening comments, should CEBS proceed with the Draft Proposals in parts 1 to 3, without amendment, then we would see no reason why hybrids would be limited as a percentage of Tier 1 capital. This is because in our view, investors would treat and expect a return on these instruments equivalent to equity.

21. We understand why CESB's might consider that innovative instruments with an incentive to redeem should be limited. However, in recent months many instruments with 'incentives to redeem' are trading above their 'stepped-up margin'. In such a circumstance the incentive to redeem has diminished.

22. Because redemption can only take place with the permission of the Regulator and with replacement (unless it is determined that the institution has surplus capital) we do not believe that the limit on hybrids as a % of Tier 1 Capital is necessary.

23. Subject to comments made in paragraph 20 above regarding the need to restrict hybrids, we do not have any objection with the proposals that an institution's minimum Tier 1 ratio shall be met with 70% of ordinary shares/ disclosed reserves/retained earnings.

24. However, we believe that any limit on hybrids should only apply at time of issuance. This is consistent with the opening sentence on paragraph 154.

    Hybrid instruments are currently included in Tier 1 on the eligibility criteria at the date of issuance.

25. This particular matter was discussed at the November 2007 meeting. It is our view that the qualities of a capital instrument and its ability to meet the criteria of permanence, loss absorption and flexibility of payment should be determined at date of issuance. They should not be impacted by movements in levels of other capital.

    This is best explained in the example set out in Appendix 1.

    In the example the losses that have been sustained under Scenario 1 have reduced the Core Tier 1 capital so that hybrids exceed 50% of Tier 1. The proposed limitation on hybrids requires the institution to disallow €100m of hybrids from its capital. (Of course as the Tier 1 is built up again from retained earnings, the hybrid will qualify again).

In our view the terms and conditions attaching to the hybrid capital have not changed and it does not make sense to disallow the excess from Tier 1.

26. The position becomes even more counter intuitive when there is a significant loss, i.e. Scenario 2. The disallowance of hybrids in such a situation could cause a breach of a capital ratio even though all of the hybrid capital remains in place. Indeed a disqualification of capital could trigger a requirement (within the terms and conditions of the Instrument) for the issuer to make the coupon payments as the capital no longer qualifies for regulatory purposes. In addition, a capital disqualification may restrict the Regulator's ability to stop the Issuer from repaying.

27. The proposed guidelines of: -

    Core Tier 1 – 50 : 50 – Hybrids

    switching to

    Core Tier 1 – 70 : 30 - Hybrids

    when the minimum capital requirements are breached are also counter intuitive. It creates a 'cliff' effect during distressed situations and increases the volatility of the capital ratio.

    This all strengthens the argument that if a hybrid instrument qualifies at date of issuance, it should always continue to qualify irrespective of what has happened in terms of core Tier 1. If required, the regulator could build in a 'safety net' to stop institutions from buying back shares or paying excess dividends if such an action was to reduce the core Tier 1 below the required percentage of hybrids outstanding.

28. We must re-iterate that we do not agree with the proposals that require a write-down of hybrid securities which, under the 70:30 rule, may no longer qualify as Regulatory Capital.

Part 5: Grandfathering

29. All of AIB's existing 'hybrid' Capital instruments met the requirements of the SPR at issue. None of these instruments contain a write-down provision. It is of major concern to us that the Draft Proposal would render all our current issuance ineligible.

    All existing instruments in issue should continue to qualify without limitation so the grandfathering provision should be unqualified. We have already noted our objection to the view that Regulators can change the rules to qualification of existing issues for Tier 1. It is not appropriate for Banks to be operating in a capital environment whereby a previously qualifying capital instrument can be rendered ineligible by a change in the rules.

30. The Grandfathering rules are confusing.

The first bullet point states that: -

- instruments with an incentive to redeem remain eligible until the first call date.

Does this mean that they do not have to be counted within the limit for Grandfathering until after the first call date has passed, or does it mean that they are not eligible after the first call date?

The second bullet point states that: -

- ....hybrids with incentives to redeem which are not callable and those that are callable but have not been redeemed will be gradually reduced over a 30 year period

This would seem to indicate that an instrument will remain eligible after its call date.

These statements seem to conflict with each other?

31. We have Tier 1 instruments, issued through subsidiaries, which can be converted into Preference Shares of the parent company, under certain circumstances, at the request of the Financial Regulator. The terms and conditions of these new Preference Shares (which will also be hybrid instruments under the CEBS definition) cannot be dissimilar from the terms of the original issue. Under the Draft Proposals these replacement Preference Shares would not qualify as Tier 1 capital. Thus the purpose of replacement would be lost from an entity's capital ratio perspective.

- Ends -

Appendix 1

Company A has a minimum Regulatory Tier 1 Capital requirement of 4%, of which 70% must be core Tier 1 Capital. It has the following capital position.

Capital	
Core Tier 1	500
Hybrids	400
Tier 1 Capital	900
Tier 2 Capital	300
Total Capital	1,200
Risk Weighted Assets	10,000

Ratios	
Tier 1 ratio	9%
Tier Capital ratio	12%

Scenario 1

Assume the company suffers a profit and capital hit of €200m. Its position is now as follows:

Capital	
Core Tier 1	300
Hybrids	400
	700
Regulatory deductions(1)	100
Tier 1 Capital	600
Tier 2 Capital	300
Regulatory add on(1)	100
Total Capital	1,000
Risk Weighted Assets	10,000

Ratios	
Tier 1 ratio	6%
Total capital ratio	10%

(1)Assumes that hybrids will be limited to 50% of Tier 1 Capital and any amount not qualifying as Tier 1 will qualify as Tier 2, subject to overall limits.

Scenario 2

Assume the company suffers a further profit and capital hit of €100m. Its capital position is now as follows:

Capital	
Core Tier 1	200
Hybrids	400
	600
Tier 2 Capital	300
Risk Weighted Assets	10,000

Application of the proposed rules would have the following consequences:-

1. Because the Company's Core Tier 1 ratio is only 2%, the hybrid capital is restricted to 30/70 of Core, i.e. €86 million, giving a Tier 1 ratio of 2.85% of which 70% is core capital.
2. €314 million of hybrid capital is disallowed under the draft proposal although it would make more sense from a permanence perspective if it continued to qualify as capital as it would support the company as a going concern