BARCLAYS

Barclays Treasury
9th Floor
1 Churchill Place
London
E14 5HP

Tel +44 (0)20 7773 3700
Fax +44 (0)20 7773 5539

www.barclays.com

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Committee of European Banking Supervisors (CEBS)

Feedback to CEBS on the Draft Proposal for a Common EU definition of Tier 1 Hybrids dated 7 December 2007 ("the discussion paper")

Dear Sirs,

We welcome the opportunity to provide feedback on the discussion paper setting out the CEBS proposals for a common EU definition of Tier 1 hybrids. We are submitting this response in our capacity as an issuer of hybrid instruments. Please note that Barclays Capital is submitting a separate response in its capacity as a structurer, advisor and distributor.

We are supportive of the CEBS objectives of developing general principles for hybrid eligibility, following the tenets of the Sydney Press Release as a starting point, with a view to achieving greater convergence across the EU. However, we have a number of areas of concern, on both the discussion paper as a whole, as well as specific proposals set out therein. We set these out below.

A. General points

1. Co-ordination with the Basel Committee for Banking Supervision ("the Basel Committee")

Our understanding is that CEBS will present its proposals to the European Commission at the earliest in October 2008 with Parliament enactment envisaged by end 2009. We note from the dates within the grandfathering rules that the proposals would become effective on 1 January 2010 and we would appreciate further clarity and detail on the likely implementation timetable.

We believe that it is important that the timetable for this process be co-ordinated with that of the Basel Committee in order to avoid any two-step changes, with CEBS proposals being introduced and then having to be aligned subsequently with further Basel Committee recommendations.

A two step change risks the following undesirable consequences:

- Any changes to terms and conditions of hybrid instruments which are perceived by investors to expose them to a greater degree of risk (particularly applicable to the proposals on temporary write-down/conversion – see below) may have negative consequences for both pricing and availability of capital. Having two sets of changes in succession increases the risk of market disruption and may negatively impact the ability of European banks to raise capital from a diverse investor base on a cost-effective basis when most needed; and
- As the European Committee legislation is likely to pre-date the Basel Committee recommendations, there is a risk that European banks may ultimately be at a disadvantage relative to their global counterparts, where the Basel Committee proposals for Tier 1 capital are less restrictive than the proposals being put forward by CEBS.

2. Detailed nature of the proposals

We agree with the CEBS objective of developing a principles based framework, with hybrid eligibility being based on the three criteria of permanence, loss absorption and payment flexibility. However, we believe that the proposals set out in the discussion paper are far more detailed than would be expected in a principles based framework.

Applying a prescriptive framework across different jurisdictions with different corporate law and tax legislation will result in divergence. rather than the convergence. (For an example of this, see the discussion around indirect issuance in the UK in B.2.c) below). We believe that convergence would be achieved best by setting out broad principles based on substance rather than form, with the application of these principles being left to regulators to implement taking into account the applicable corporate law and tax legislation.

In addition to these general points, we have concerns on a number of specific proposals contained in the discussion paper set out below.

B. Specific proposals

1. Loss absorption – preference shares

Our legal analysis indicates that the write-down proposals set out in the discussion paper are difficult to achieve for instruments such as UK preference shares issued under UK company law, as it is not legally possible to write down the nominal amount of a preference share. With the alternative of conversion into ordinary shares not being considered workable for the reasons outlined in the section below, this would mean that no type of preference share could be issued in compliance with CEBS requirements.

Our legal analysis of the CEBS proposals as they currently stand indicates that the only type of capital which UK banks could issue which would qualify as non-innovative Tier 1 is equity.

2. Loss absorption - principal write down

"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 agree with the CEBS objective of ensuring that Tier 1 hybrids are able to absorb losses on a going concern basis, in stressed situations and in liquidation. However, we believe that the implementation of the CEBS proposals as they stand will have a number of adverse consequences, as follows:

a) Investors

- The write-down/up feature is likely to result in a perception by investors that they are required to bear more risk. Whilst the remote risk of a temporary write-down (which only applies once the Tier 1 ratio falls below 2%) may be disregarded by investors during periods of favourable market conditions, it is likely to have an unfavourable effect on investor demand and/or pricing during periods of market stress. Consequently, a bank's ability to raise capital from a wide variety of sources on a cost-effective basis will be impaired at precisely the time that it is needed most.

- The write-down/up feature will result in equity classification under the current rules of the National Association of Insurance Commissioners in the US. As US insurers are required to hold a higher level of capital against equity investments, they have a more limited capacity to invest in equity. Therefore the US market capacity for European hybrid capital would shrink. US insurance companies have historically been significant investors in US$ institutional issues. These proposals would put European banks at a disadvantage to non-European banks when raising capital from what has been a significant source of funding during both favourable and unfavourable market conditions.
- Our discussions have also indicated that writedown provisions would not be readily accepted by US retail investors, due to a lack of familiarity with the features. Such provisions would create confusion with a change which is inconsistent with the US domestic markets and would restrict European banks from a further source of capital which has proved to be particularly resilient in the face of market stress.

b) Accounting

- Our accounting analysis indicates that a temporary write-down would be ignored under IFRS, causing asymmetry between the stock of regulatory capital and of accounting capital.
- However if the temporary write-down could be recognised under IFRS, (which requires clarification), there are adverse tax consequences as described in section (c) below.

c) Taxation

- If a temporary write-down can be recognised for accounting purposes then to the extent the instrument is legally debt the increase in equity will be subject to UK tax.
- The requirement to cancel coupons in the event of a write down is likely to mean that no UK tax deduction is available for <u>any</u> coupon payments on a direct issue. This would apply from the date of issue of the instrument, regardless of whether or not a write down actually occurs.[1]
- This lack of tax deductibility is likely to encourage UK issuers to use indirect structures through an SPV, which achieves tax deductibility. These structures are more complex and less transparent to the market. We also expect this to be mirrored in other EU jurisdictions.

3. Loss absorption – conversion to ordinary shares

We believe that conversion to ordinary shares will be unacceptable to many institutional investors whose mandates do not allow investment in instruments with convertibility features. As a consequence, this may restrict supply of capital to European financial institutions.

Furthermore, conversion into ordinary shares at a time when a bank is in a financially stressed situation is likely to be at a low share price, resulting in increased dilution of ordinary shareholders. Fixed income investors, whose mandates prohibit holding equity instruments, would be forced to sell shares, further depressing the share price. This, together with the shareholder dilution, could act as a disincentive to any recapitalisation.

We note from section 101 of the draft proposal that currently, only 1% of hybrid instruments issued by financial institutions across the EU can be converted into ordinary shares. Given the

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[1] Section 209(e)(iii) ICTA 1988 provides that a distribution includes "any interest … where the securities are securities under which the consideration given by the company for the use of the principal secured is to any extent dependent on the results of the company's business or any part of it". Section 337A ICTA 1988 and paragraph 1(1) Schedule 9 FA 1996 provide that distributions are not deductible for the purpose of UK corporation tax.

above, we consider it unlikely that European institutions would wish to include such convertible language in hybrid issues going forward and it is thus less likely to be adopted.

4. Loss absorption – alternative suggestion

We suggest that as an alternative to the loss absorption proposals set out in the discussion paper, a model similar to that in Italy be introduced. This would involve a suspension clause that would become effective when the Tier 1 ratio falls below 2% and suspends all principal and interest payments and redemptions. This has a number of simple and straightforward advantages, as follows:

- provides support in a going concern stress scenario;
- recognises the relative subordination of ordinary shareholders and hybrid investors; and
- avoids the negative tax, accounting and investor implications discussed previously.

5. Flexibility of payments - ACSM

"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."

The requirement for immediate payments under the ACSM mechanism, rather than deferral allowed under current mechanisms, compounds pressure on the share price as bondholders would sell shares received to realise their coupon proceeds.

In terms of the CEBS proposals, shares issued under the ACSM are required to be issued directly to bondholders. This differs from current mechanisms where shares are issued in the market and the proceeds of the issue are used to settle deferred coupons. We believe that this proposal will cause unintended consequences, as shares issued directly to bondholders will likely be resold immediately, resulting in a decrease in the share price of a bank already in a stress situation, and limiting future recapitalisation.

Given that most ACSM mechanisms as currently structured:

- do not constitute an incentive to redeem;
- do not weaken the issuer's capital or economic position; and
- do not impede recapitalisation during times of financial stress;

it is not clear why instruments with an ACSM feature are limited to 15% of Tier 1. We believe that there should be no limit on the proportion of instruments with ACSM features.

6. Permanence

"Principal stock settlement mechanisms must contain a cap on the conversion ratio in order to limit the potential dilution."

It is difficult to comment on the requirement that principal stock settlement mechanisms contain a cap on the conversion ratio, in the absence of any further detail on how this would work.

7. Limits

"Overall limit: 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, ordinary shares and disclosed reserves/retained earnings represent at least and at all times 50 % of the total Tier 1 after deductions."

We would propose a simple rule, requiring that an institution holds at least 50% of Tier 1 capital in the form of ordinary shares and disclosed reserves/retained earnings, rather than a twin limit based on an absolute level of Tier 1.

In addition, we believe that the limits should apply at issuance only, otherwise there is a risk that losses affecting Tier 1 capital could lead to a more highly leveraged reduction in eligible Tier 1 hybrid capital at a time when capital is most required. There would be no deterioration in the quality of the hybrid instruments, and therefore there should be no reduction in eligibility.

8. Grandfathering

We are comfortable with the limits and timing of the grandfathering proposals.

We trust that you find these comments constructive. If you should have any questions, please do not hesitate to contact us. We look forward to your confirmation of the proposed implementation timetable.

Yours sincerely

Jon Stone
Barclays Group Treasurer