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Barclays Group and Barclays Capital are pleased to respond to CEBS' Request for Comment on CP 27. We are grateful for the opportunity to participate in the debate on these important matters.

General

- We are supportive of CEBS providing this CP as part of its remit to elaborate guidelines for the convergence of supervisory practices with regard to hybrid instruments, as we consider it vital that there is a level European playing field in this area.

- We believe that the key to the creation of a level playing field lies in adequate and transparent disclosure of features of hybrid instruments that provides clear information on the ranking of the instrument together with appropriate disclosure of meaningful statutory and contractual mechanisms. We also recognise the importance that Pillar 3 and international accounting standards will play in ensuring that stakeholders are correctly informed of the nature and status of the capital securities held by an institution.

- We support the principles-based approach advocated by CEBS, subject to national regulators interpreting these principles in a manner which promotes flexibility but does not distort the level playing field.

- Whilst we agree that there must be key criteria for the eligibility of hybrid instruments as own funds, we feel that undue importance has been placed on permanence of capital. The difficulty in having truly undated instruments is the possible lack of investor appetite for them, especially when they are coupled with strict mechanisms for loss absorbency and coupon flexibility. If this results in only the best quality names attracting demand, and even then, with very high coupons, the institutions that require hybrid capital most will be unable to access the market, or, at the very least, be forced to pay high credit spreads for this accessibility.

- We also feel that the efforts to improve legal certainty and transparency will be hampered as a consequence of the different legal, tax and accounting regimes existing within European countries, thus preventing complete harmonisation. It will therefore be important to retain some flexibility through a principles based approach to regulation.

- On permanence, in addition to our views given above, we agree that the definition of moderate incentive to redeem should be extended to most principal stock settlement mechanisms, as there is a current expectation in the market that the vast majority of these instruments will be redeemed on their first call date. However, we feel that the recommendations restricting buy backs prior to five years need not apply as further explained in the main body of this response.

- We believe that the recommendations made by CEBS in relation to buy-backs go beyond that of principles based regulation, resulting in overly restrictive regulation. Buy-backs should be allowed to occur as part of an institution's capital management process, but should not be subject to the same rules as redemption. Additionally, the flexibility to buy-back prior to 5 years may prove useful to issuers as well as competent authorities.

- On flexibility of payment, we feel that the requirement for cancellation of payment and the prevention of Alternative Coupon Satisfaction Mechanisms (ACSM) in compromising the instrument's capacity to absorb losses may have significant tax implications in the UK, that will prevent UK financial institutions from directly issuing hybrid instruments (as we discussed in our response to CP17 in early 2008). In addition we feel that CEBS has omitted the impact of dividend pushers/stoppers on pari passu instruments, which needs to be discussed in the current economic climate.

- We agree that for instruments to be loss absorbent they should allow the institution to continue operating as a going concern, as well as protect depositors in a winding up scenario. However, we question the importance of permanence in being described as a key condition in helping prevent insolvency. If appropriate loss absorbing triggers are in place, then the presence of a dated instrument (which requires replacement with similar capital upon redemption) could be valuable in attracting fixed income investors to these sorts of instruments without compromising their loss absorbing characteristics. We note that the CRD has become stricter in its view that instruments should be able to have coupon/dividend payments cancelled as opposed to deferred.

- CEBS needs to consider whether the potential size of the credit spread of these instruments may become unduly burdensome as a consequence of the type of capital it is aiming to create, thus outweighing the benefits of the regulatory capital created.

- We do not have any specific comments in relation to limits. However, we are encouraged to note that CEBS does accept that these limits may be temporarily changed to accommodate institutions under stress.

- We have no specific comments regarding the matter of hybrids issued through Special Purpose vehicles (SPVs).

- We would like further clarification regarding transitional measures of hybrid instruments, particularly considering that CEBS has not produced any additional guidance on the CRD text, nor has it given any advice that may prevent arbitrage.

A. Permanence

1.1 Are the guidelines in relation to "incentive to redeem" sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

- It appears that the definition of "incentive to redeem" extends beyond what was suggested in the Sydney Press Release 1998. Anything that provides an expectation of the hybrid instrument being redeemed at the call date can be viewed as an incentive to redeem. In that respect therefore, any incentives to redeem must be moderate. We agree that competent authorities would carefully review whether any other feature coupled with a call option may be considered an incentive to redeem. However, the difficulty will be considering what will be regarded as a "moderate" incentive away from interest step-us and stock settlement mechanisms, as this has not been defined by CEBS[i].

- We believe that recent market conditions have shown the problems of a set definition of a step-up in being defined as a "moderate" incentive to redeem. For example, in the current climate, where Tier 1 credit spreads are higher than seen in previous years, an instrument issued ten years ago in a low credit spread environment is more likely to be extended by the issuer, as the costs of refinancing far outweigh the step-up. This may have been the reason for Deutsche Bank's decision not to call its 7.872% Tier 1 issue, which now pays coupons of 3 month $ LIBOR + 297bps. If Deutsche had chosen to refinance in June 2009, the cost would be significantly more in terms of coupon payments. On the other hand, Societe Generale's recent innovative Tier 1 9.375% instrument steps up to 3 month £ LIBOR + 890bps, as a consequence of the spreads at the time of issuance, which means it is far more likely that the instrument will be called at the step-up date. Both step-ups are defined as "moderate" incentives to redeem but, due to timing differences, the regulatory test has become somewhat distorted.

- We therefore recommend that some other solution be created with regards to the size of the step-up that will be regarded as a moderate incentive to redeem. We suggest this be addressed by BCBS.

- We view paragraph 62 requesting an issuer to schedule an application to call or redeem "well in advance of the call or redemption date" as unduly onerous. Rather we expect the possibility of the redemption or call of a hybrid capital instrument to be addressed either in the annual ICAAP/SREP process with recognition by the regulator at that time that such a capital management exercise may be undertaken on the relevant date unless a material change in the issuer's capital position occurs subsequently, or in the course of regular dialogue with the regulator.

1.2 Please describe the potential impact of a cap of 150% relating to stock settlement of the conversion ratio. Please provide evidence.

- We have analysed the Lloyds 7.375% €430m step-up preferred security that has a principal stock settlement mechanism, and one that does not appear to have a cap on it. It is currently trading at 85/87[*] in cash terms. Similarly, the RBS 9.118% US$1bn Tier 1 security, which also has principal

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[i] The FSA currently defines in GENPRU 2.2.115G any feature that in conjunction with a call would make a firm more likely to redeem a tier 1 instrument… would normally result in classification as innovative tier 1 capital resources. A suggestion would be to define "moderate incentive" in accordance with this guidance in order to give more clarity to issuers and competent authorities.

[*] As of 23/09/2009

stock settlement mechanisms, is trading at 93/95*, far higher than any of the other Lloyds or RBS Tier 1 instruments. This clearly indicates a strong expectation that those securities will be redeemed, because their stock settlement mechanism would allow investors to convert their securities into ordinary shares, thus resulting in significant share dilution, particularly for the UK government.

- We therefore agree that a conversion cap of 150% may reduce the incentive to redeem. However, there is great difficulty in judging whether this percentage will be an appropriate one through the cycle, and we encourage CEBS to review this in the future, with a view of changing the conversion cap once instruments have been tested through the use of this conversion ratio.

2.1 Are the guidelines in relation to "buy back" sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

- We believe that CEBS is providing guidance beyond its remit here, as the CRD Amendments mention nothing about buy-backs. In addition, we do not believe that a buy-back is to be viewed in the same light as a redemption or a call. A buy-back is voluntary for investors to participate in, whereas this is not the case for a redemption or a call.

- CEBS has also not provided guidance on buy-backs of instruments which are tendered or exchanged at a significant discount to par. We have seen a number of these cases over 2009, and to the extent that they can create core tier 1, they have been permitted.

2.2. CEBS is considering whether buy backs should under certain conditions also be permissible before five years and without replacement. A number of CEBS members would support such a provision under strict conditions and subject to prior supervisory approval, notably if the buy back responds to exceptional circumstances, is acceptable from a prudential point of view and results in a lasting improvement of the institution's solvency situation. A number of other members have concerns regarding such an exemption, in particular as it may compromise the permanence of the hybrid instrument by enhancing investors' pressure on banks to buy back outstanding hybrids and by providing incentives for banks to reduce their overall capital position at times when their own credit quality is decreasing.

As a basis for its decision CEBS therefore wishes to gather further evidence on the following points:

2.2.1. What would be the impact if buy-backs before five years after the issue of the instrument were only allowed under the conditions described in paragraph 72? Please provide evidence.

- Restricting the buy back of hybrid capital instruments in the first five years of their issuance date would materially limit the flexibility of a bank to manage its capital structure. In addition it could persuade banks to buy back higher quality capital than hybrids because of the lack of limitation for buying back ordinary shares during the first 5 years and the non-specific requirement of regulatory approval.

2.2.2. Please describe circumstances – other than current market conditions - in which a buy-back at an earlier stage without the requirement to replace them with instruments of the same or better quality would be justified from a prudential perspective.

- It would be appropriate for banks to retire capital instruments when reducing their risk-weighted balance sheet, or when profitability rises, so that retained earnings grow the core tier 1 ratio substantially.

- Further to this, as long as banks have enough regulatory capital to support themselves during suitably stressed scenarios (as part of the ICAAP/SREP process), then they should be able to retire those capital securities that are surplus to requirements, as well as be allowed discretion in changing the capital structure in a manner they believe fit to meet the risks that exist on their balance sheets.

- In addition, it is important to note that a buy back made when an instrument is deeply discounted will ultimately benefit the issuer by creating core tier 1 capital, which helps the institution prevent insolvency. One could argue that existing capital instruments have actually absorbed losses through the liability management activity of 2009 to date where more than 100 capital securities issued by European issuers have been tendered or exchanged at prices as low as 35% of par. Competent authorities should be mindful of this and sympathetic to the motivation for this activity. Also, if a financial institution is able to buy back a deeply discounted instrument in order to create additional core tier 1 capital, this will increase the size of the limits to which it can issue other forms of tier 1 instruments, which promotes flexibility in prudently managing the capital base from a regulatory perspective.

2.2.3. Which criteria should be provided in order to address the above mentioned concerns, and in particular to avoid setting incentives to deplete the capital base of banks whose credit quality is decreasing?

- We feel that each decision regarding buy backs should be made on a case by case basis, the outcome of which depends on the decision of the competent authority. It is important that the authorities receive and carefully review information from the issuers, in order to accept or reject the buy back proposals.

2.3. What would be the impact of limiting the amount of repurchased instruments held by the institution at any time to 5% of the relevant issuance? Please provide evidence.

- We feel that limiting the amount of repurchased instruments to 5% of the relevant issuance at any one time reduces the flexibility of banks in managing their capital structure.

- In addition, we believe that setting a limit will be inadequate in generating the quantum of core tier 1 benefits that were seen to benefit financial institutions over 2008/9.

B. Flexibility of Payments

- CEBS state that, as per the CRD, the conditions of the instrument must enable the institution to cancel coupons/dividend payments, when necessary, on a non-cumulative basis, and so any coupon that is not paid is forfeited by the investor. The concept of a coupon being “cancellable” rather than “deferrable” is a new one introduced through the CRD Amendments, and we are conscious of the tax implications that this may have, as well as for accounting classifications, on directly issued hybrids in the UK. Thus, while we appreciate that this is a move towards a greater degree of regulatory prudence, we are unsure whether these types of instruments will be marketable in the future, making it harder for banks to raise additional capital as they emerge from the current crisis.

- We also note that the terms of future hybrids will have to allow for the competent authorities to intervene in the decision of whether or not to pay a coupon/dividend, based on the information that they receive. We once again question the attractiveness of these instruments to investors, especially when regulatory intervention at any time can force the cancellation of coupons.

3. Are the guidelines in relation to dividend pusher or stopper sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended?
What would be the impact of the restriction on the use of dividend pusher and stopper? Please provide evidence.

- CEBS has described dividend pushers and stoppers in relation to more junior instruments, but has omitted any discussion regarding pari passu instruments. This is a contentious topic that requires further guidance from CEBS. An example of this was the event where KBC Bank suspended coupon payments on certain hybrids and did not allow the dividend pusher mechanism to be triggered despite having paid coupons on what was previously regarded as a pari passu instrument.

- CEBS therefore needs to give further guidance on the clarity of information that should be provided regarding pari passu ranking instruments and junior ranking instruments, for the avoidance of this sort of uncertainty in the future.

- Alternatively it may be the case that dividend pushers only apply with regards to junior ranking securities, which means there is less scope for debate and confusion as with the example highlighted above.

- The guidance provided regarding loss absorbency of dividend pushers/stoppers will be discussed in part C. Again the ability of the competent authority to suspend these mechanisms when they feel necessary will actually reduce legal certainty for investors, meaning that this will have to be priced into the coupon that the instrument will carry.

4.1 Are the guidelines in relation to ACSM sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals on how the text could be amended.

- Yes.

4.2 What would be the impact of implementing these guidelines on ACSM mechanisms? Would you propose any other options?

- We understand that CEBS wishes for the ACSM or any other substitution mechanism to operate in a manner that is similar to the cancellation of a coupon. Introducing the requirement for the ACSM mechanism to settle the coupon payment without delay reduces the element of flexibility that banks look for so that they can avoid issuing shares when market conditions are unfavourable. This makes such an instrument less attractive to an investor.

- A further concern arises in relation to paragraph 92 where the possibility of immediate cancellation of the use of ACSM is created. In the UK in particular, an instrument containing such a mechanism may be determined as results dependent, and therefore no longer be tax deductible, which would affect the market for directly issued innovative Tier 1 instruments in the UK. This would result in the use of indirectly issued offshore structures by UK financial institutions which would increase the complexity of both the capital raising exercise and any subsequent unwinding or recapitalisation of the issuer. Again such measures are likely to reduce the attractiveness of these instruments to investors.

- Other mechanisms should be considered to avoid accumulation of deferred interest. If the ACSM mechanism cannot be operated immediately, CEBS should consider subordinating further remaining deferred interest rather than cancelling it and potentially making it rank pari passu with ordinary shares in a winding-up scenario. This further subordination would ensure that deferred interest does not hinder recapitalisation, thus potentially allowing directly issued hybrid capital instruments to remain tax-deductible in the UK.

C. Loss Absorbency

5.1 Are the guidelines relating to the definition of loss absorbency in going concern sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

- We agree with paragraph 103 – Instruments of the same quality should rank pari passu to each other. Along with this, there should be more transparency provided within the terms of the instruments, so that ranking is easily established. If this were to take place, then situations of market uncertainty would be avoided, such as in the KBC example mentioned earlier. The paramount importance of market certainty has been demonstrated throughout the recent crisis.

5.2 Do you agree with the definition of loss absorbency in going concern?
If not why and what alternative would you propose?

- We agree that hybrids should help at preventing an issuer's insolvency and we are of the view that existing instruments already achieve this because they meet the four pre-conditions stated in paragraph 106.

- We agree with the definition as stated in paragraph 105a) but believe that 105b) is unduly restrictive, for no apparent reason. If it is a case that banks start suffering unexpected losses or lose the confidence of their creditors, then there is no reason why this should not be reflected by the auditor's definition of a going concern.

5.3 Do the guidelines provide sufficient flexibility for institutions to design mechanisms that fulfil the objective of loss absorbency in going concern? What alternative would you propose? Does this flexibility raise level playing field issues?

- We believe that issuers and structurers should have the ability to facilitate innovation and this may only be done through a principles-based approach which provides an element of discretion and flexibility for the national regulators.

- The requirement that hybrid instruments contain a statutory or contractual mechanism to make recapitalisation more likely should be principles-based in order to avoid impeding innovation. We would like CEBS to clarify that suggested permanent and temporary write-downs, and conversion into equity mechanisms, are purely examples and do not constitute an exhaustive list of ways to achieve the objective of not hindering recapitalisation.

- As we previously wrote in our response to CEBS CP17, we see the following negative consequences with regard to the proposed write down and conversion into equity mechanisms:
  - 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.
  - 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 a bank could not withstand it. We understand this has not just UK, but EU wide capital gains tax implications.

- IFRS: We do not consider that the write-down / write-up mechanism is operable under IFRS and the current proposal thus also raises transparency and complexity issues.
- Many fixed income funds are unable to buy equity instruments. Such investors would be precluded or 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 obtain specific EGM or AGM approval.

5.4 Do you think that different levels of subordination allow sufficient transparency on the ability of these instruments to cover losses in liquidation? Alternatively, would you prefer to completely preclude different ranking between hybrids?

- We would like all hybrids that are within the same bucket to rank pari passu to each other in liquidation. The rationale behind this is that it may avoid problems with regards to dividend pushers and stoppers in the future, as a well as market uncertainty that has already been created as a consequence of the KBC Bank example described earlier.

D. Limits

6.1 Are the guidelines relating to the assignment of hybrids instruments to one of the three limits sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

- For hybrids included within the 15% limit, we believe that dated instruments suggested by CEBS will prove difficult to market. A 30-year dated instrument with no call option is regarded as a greater commitment for many investors than a perpetual instrument with a minimum call option of 10 years (if it also has an incentive to redeem), especially where its redemption can also be postponed by the competent authorities.

- With regards to the 35%-50% bucket, CEBS goes beyond the CRD Amendments to recommend that these instruments have no call option. If this is the case, then these capital instruments may be mandatorily converted upon a trigger point breach, and will not be callable pre-trigger or post-trigger

- With regards to mandatory conversion or principal write-down in “emergency situations”, we urge there to be transparency in the documentation of the instrument terms, so that there is little or no uncertainty with regards to the trigger points. We also trust that competent authorities are mindful of creating an unlevel playing field by setting higher limits for institutions compared to other jurisdictions.

- We agree that limits may be extended in emergency situations; however, the definition of an emergency situation should be further clarified and consistently applied.

6.2 Do you believe that the conditions imposed to mandatory convertible are proportionate and balanced? Would you propose any other options?

- There is a risk that the question asked here could be somewhat misunderstood. Mandatory convertibles are known in the financial world as liability classified instruments (they do not necessarily have to be capital instruments, as they can also be senior debt) that will convert mandatorily into equity after a predefined number of years. This is different to CEBS' version of mandatory convertibles, which are capital instruments that will convert into ordinary shares or instruments that rank pari passu to ordinary shares, upon a predefined trigger point, or at the option of the competent authority, irrespective of whether it mandatorily converts at a predetermined date. We therefore ask that CEBS clarifies this, and does not refer to capital instruments that are converted under emergency situations as mandatory convertibles, but rather use another name so as to avoid confusion.

- We would like to take this opportunity to discuss mandatory convertible capital instruments, that is, capital instruments that will convert at a predefined date into a more junior ranking capital instrument. Assuming that the instrument is categorised beyond the 35% limit, and also has trigger points and the competent authority has an option to convert into instruments ranking pari passu to ordinary shares, we make the assumption that those conversion options are never exercised during the life of the instrument. Rather, the instrument converts into equity at a predefined date.

- Currently, we feel that there is an inconsistency in the regulatory treatment of mandatory convertible capital instruments compared to capital instruments issued in conjunction with warrants. Under International Financial Reporting Standards (IFRS), both examples are split accounted for (i.e. bifurcated between liabilities and equity), but under regulatory treatment, the mandatory convertible will be assigned fully to liabilities (depending on the accounting classification of the initial form that the capital instrument takes pre-conversion).

- Whilst we accept this to be a prudent measure, we also feel that, in both cases, there is accretion whereby the liability is "pulled to par", thereby incurring an additional income statement charge. Accretion takes place in order to "pull to par" the liability component of the instrument, in recognition of the fact that the liability component of the instrument will be redeemed at a higher value than the amount initially recognised[*].

- However, under the warrants example, there is at least the benefit of upfront recognition of core tier 1 capital (i.e. the fair value of the warrant), that gets accreted down to zero over time.

- This is not the case with convertibles, as there is neither recognition of the equity component of the convertible instrument, nor is there a filter to remove the accretion from the interest payments. The effect is that there is **double counting** (i.e. - the opportunity cost of not having an upfront core tier 1 gain, PLUS a core tier 1 loss created through the accretion over time.) which is disadvantageous to firms trying to manage their capital structure in a prudent and efficient manner.

- We ask that CEBS discuss this carefully in order to consider an appropriate filter to remove the accretion.

- We also wish to clarify the definition of a step-up for mandatory convertibles or capital instruments issued alongside warrants. It seems to us that a sensible starting point for step-ups would be the 'unsweetened' or implied gross credit spread, rather than the reduced coupon as a consequence of the "sweetener" provided by the conversion option or the warrants.

[*] This is on the assumption that there will be a call option on the convertible, or an incentive to redeem

- In the case of a convertible capital instrument, if the issuer decides to extend the security so as to pay the stepped up rate, then it seems logical that the stepped up rate should be calculated off the coupon rate that would have existed without the option to convert. This is because that option no longer exists, which formed the only basis for pricing a lower coupon rate in the first place.

- The same principle could be applied to a capital security with warrants. If the specified warrant period giving the investors the right to buy ordinary shares at a certain price was to lapse, and should a step up take place thereafter, the absence of the warrants should ensure that the step up should be calculated from the coupon rate that would have originally been priced without the warrants being issued in the first place.

E. Hybrid instrument issued through an SPV

7 Are the guidelines relating to the indirect issues of hybrids instruments sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

- Some of the proposed changes, such as the cancellation of interest if ACSM is not effected immediately or the more specific loss absorption mechanisms, will give rise to material EU wide tax consequences. This in turn will lead to increased indirect issuance of hybrid capital instruments through 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*")

Grandfathering

- We note that CEBS has remained silent on the grandfathering arrangements provided in the CRD.

- We would welcome further guidance on precisely how the proposed limit structure would apply to grandfathered instruments.

- We would also seek reassurance that the final interpretation of the text in relation to instruments eligible for grandfathering is a matter for national regulators.

Sincerely,

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