

Executive Summary

Introduction

RBS welcomes that the EBA has developed draft RTS based on the proposed legislative texts for the CRR/CRD IV and has given the opportunity to provide comments. The Key Comments section immediately below outlines what we believe to be the essential considerations in the debate on whether further regulation may be appropriate; this is followed by more detailed comments on the individual questions posed in the Consultation Paper.

We would be happy to elaborate further on any of the points made in this response and look forward to engaging with the Commission in this area. In the first instance, please address any enquiries to:

Rajan Kapoor
Group Chief Accountant
The Royal Bank of Scotland Group
Level 12, 280 Bishopsgate
London
EC2M 4RB

Tel: 0207 672 0020 / 0131 626 3768

Email: rajan.kapoor@rbs.co.uk

Key Comments

The issuance of Additional Tier 1 ("AT1") is of vital importance to the management of the capital structure of any bank, as it allows the risk of absorbing losses on a going-concern basis to be spread across different classes of investors in a more efficient manner. We welcome the EBA's efforts to put forward a framework that attempts to balance the interests of various investor constituencies and respects the proposed CRR. We nevertheless would like to suggest some important amendments that we feel would be vital to the success of an AT1 market going forward. We also provide some arguments as to why we feel that our proposals should be adopted.

We have purposely not sought to address the specific questions raised in EBA/CP/2012 as we believe a more qualitative response to the proposals for AT1 will provide a more comprehensive analysis of the salient issues, specifically the provisions for temporary write down.

These detailed proposals are contained in the Appendix to the Detailed Comments section.

Detailed Comments

Article 1 (Subject matter) – no comment

Article 2 (Meaning of foreseeable charge or dividend under Article 24(2)(b) CRR)

Q01. Are the provisions on the meaning of foreseeable when determining whether any foreseeable charge or dividend has been deducted sufficiently clear? Are there issues which need to be elaborated further? What would be your definition of foreseeable?

The provisions on the meaning of foreseeable are clear with respect to a legal entity but we would welcome further guidance on the application of Article 2 to intra-group dividends where subsidiaries are required to 'pay up' their profits.

With respect to Article 2(7), we would not that interim or year end profits have to be reviewed by the institution's external auditors which should give the competent authorities the comfort they require in all but the most exceptional circumstances.

Article 3 (Type of undertaking recognised under applicable national law as a mutual, cooperative institution or similar institution under Article 25(1)(a) CRR) – not part of this consultation

Article 4 (Capital instruments of mutuals, cooperative societies or similar institutions in CET1 items under Article 25(1)(c) CRR) – no comment

Article 5 (Definition of market stress under Article 25(1)(c) CRR) – no comment

Article 6 (Applicable forms and nature of indirect funding of capital instruments under Article 26(1)(b) and Article 49(1)(c) CRR)

Q02. Are the provisions on the applicable forms of indirect funding of capital instruments sufficiently clear? Are there issues which need to be elaborated further?

The provisions in Article 6 on applicable forms of indirect funding of capital instruments are clear.

Q03. How do you assess the provisions on related parties regarding the necessity to assess on an on-going basis that the related party has sufficient revenues?

Article 7 (Distributable items under Articles 26(1)(h)(ii) and 49(1)(l)(i) CRR) – no comment

Article 8 (Limitations on redemptions of own funds instruments issued by mutuals, cooperative societies and similar institutions under Article 27(2)(b) and 73(2) CRR)

Q04. Are the provisions on the limitations on redemption of own funds instruments sufficiently clear? Are there issues which need to be elaborated further?

Q05. How would you assess the impact of documenting decisions on redemptions?

Q06. How would you assess the cost impact of including in the provisions of the instruments criteria as listed in paragraphs 2 and 3? *(please note that the CRR requires in point (b) of Article 27 (2) that where the refusal by the institution of the redemption of instruments is prohibited under applicable national law, the provisions governing the instruments shall give the institution the ability to limit their redemption).*

Not applicable to the Group

Article 9 (Concept of gain on sale under Article 29(1)(a) CRR) – separate consultation

Article 10 (Additional value adjustments under Article 31(1) CRR) – not part of this consultation

Article 11 (Deduction for losses for the current financial year under Article 33(1)(a) and 24(1)(c) CRR)

Q07. Are the provisions on the deductions related to losses for the current financial year, deferred tax assets, defined pension fund assets and foreseeable tax charges sufficiently clear? Are there issues which need to be elaborated further?

The provisions in Article 11 on the deductions related to losses for the current year are clear.

Article 12 (Deductions of deferred tax assets that rely on future profitability under Article 33(1)(c) CRR)

We do not consider that DTAs and DTLs arising on consolidation should be taken into account for capital purposes and would welcome confirmation on this point.

Article 13 (Deduction of defined benefit pension fund assets under Article 33(1)(e) and Article 38(1)(b) CRR) – no comment.

Article 14 (Deduction of foreseeable tax charges under Article 33(1)(l)).

We believe the EBA should make clear that Article 33(a)(l) shall not apply to any increase in capital associated with the write-down of Additional Tier 1 instruments for purposes of calculating the CET1 generated by such write-down.

Article 15 (Other deductions for capital instruments of financial institutions under Article 33(2)(b) CRR)

Q08. Are the provisions on the types of capital instruments of financial institutions, third country insurance and reinsurance undertakings, and undertakings excluded from the scope of Directive 2009/138/EC in accordance with Article 4 of that Directive that shall be deducted from the following elements of own funds sufficiently clear? Are there issues which need to be elaborated further?

Q09. How would you assess the impact of operating a deduction from Common Equity Tier 1 items? (*linked to immediate previous question*)

In the case of unregulated financial institutions, Article 15 requires all dated and undated subordinated instruments to be deducted from CET1. This is out of step with the CRR text which stipulates a corresponding deduction approach. Whilst it is unlikely that the subordinated debt of unregulated financial institutions would meet the stringent criteria for AT1 or T2 instruments, it would be more appropriate to deduct such holdings from AT1 rather than CET1.

Article 16 (Capital instruments of third country insurance and reinsurance undertakings under Article 33(2)(b) CRR) – no comment

Article 17 (Capital instruments of undertakings excluded from the scope of Directive 2009/138/EC under Article 33(2)(b) CRR) – no comment

Article 18 (Exemption from, and alternatives to deduction where consolidation is applied under Article 46(3)(b) CRR)

Q10. Are the provisions related to the requirements for cooperative networks sufficiently clear?

No comment

Article 19 (Form and nature of incentives to redeem under Article 49(1)(g) and 60(h) CRR)

Q11. Would you agree on the types of incentives to redeem as described in paragraph 2 of article 19? Should other types of situations be considered as incentives to redeem?

For comments on Articles 19 – 24 and questions 11 – 13 – see appendix

Article 20 (Nature of the write down of the principal amount under Article 49(1)(n) CRR)

Q12. Are the provisions on the procedures and timing surrounding a trigger event and the nature of the write-down sufficiently clear? Are there issues which need to be elaborated further?

Q13. How would you assess the impact of the provisions to be applied to temporary write-downs and write-ups?

For comments on Articles 19 – 24 and questions 11 – 13 – see appendix

Article 21 (Procedures and timing for determining that a trigger event has occurred under Article 49(1)(n) CRR) – For comments on Articles 19 – 24 and questions 11 – 13 – see appendix

Article 22 (Procedures and timing for notifying the competent authorities and the holders of the instruments under Article 49(1)(n) CRR) – For comments on Articles 19 – 24 and questions 11 – 13 – see appendix

Article 23 (Features of instruments that could hinder recapitalisation) – For comments on Articles 19 – 24 and questions 11 – 13 – see appendix

Article 24 (Use of special purposes entities for indirect issuance of own funds instruments under Article 49(1)(p) CRR) – For comments on Articles 19 – 24 and questions 11 – 13 – see appendix

Article 25 (Indirect holdings arising from index holdings – extent of conservatism required in estimates for calculating exposures used as an alternative to the underlying exposures under Article 77(1) CRR)

Q14. Are the provisions on indirect holdings arising from index holdings sufficiently clear? Are there issues which need to be elaborated further?

The provisions of Article 25 are clear

Article 26 (Indirect holdings arising from index holdings – meaning of operationally burdensome under article 71(2) CRR)

Q15. How would you assess the meaning of operationally burdensome and which circumstances would be considered as operationally burdensome?

We would welcome clarification of phrases such as 'low materiality', 'low net exposure', 'short duration', and 'short duration'.

Q16. How would you assess the cost of conducting look-through approaches vs structure-based approaches for the treatment of indirect holdings arising from index holdings?

We are not in a position to comment at this time

Article 27 (Meaning of sustainable for the income capacity of the institution under Article 73(1)(a) CRR)

Article 28 (Process and data requirements for an application by an institution to carry out redemptions, reductions and repurchases under Article 72(b) CRR)

Article 29 (Submission of application by the institution to carry out redemptions, reductions and repurchases under Article 72(b) CRR)

Q17. How would you assess the levels of the thresholds for market making purposes (identical for hybrid instruments to the ones provided by CEBS/EBA guidelines on hybrid instruments published in December 2009) for competent authorities to give a prior consent (Article 29)?

Article 30 (Content of the application to be submitted by the institution under Article 72(b) CRR)

Article 31 (Timing of the application to be submitted by the institution under Article 72(b) CRR)

Q18. How would you assess the impact of the proposed timing of 3 months for the submission of the application (Article 31)?

A three month notification period is excessive in our view. It will reduce issuer flexibility, which could be a hindrance to the efficient management of capital structures, especially in volatile markets or in the presence of continued regulatory uncertainty. It may also have the unintended consequence of increasing the burden on regulatory authorities if applications are submitted for speculative, rather than likely, capital actions which might become viable as markets develop over a three month period. We believe a period of one month should be sufficient.

Article 32 (Applications for redemptions, reductions and repurchases by mutuals, cooperative societies or similar institutions under Article 72(b), CRR)

Q19. How would you assess the levels of the thresholds for the non-materiality of the amounts to be redeemed for mutuals, cooperative societies or similar institutions (Article 32)?

Not applicable to the Group

Article 33 (Temporary waiver from deduction from own funds under Article 74(1) CCR)

Q20: The EBA is considering setting a time limit that the temporary waiver from deduction from own funds shall not exceed. This time limit would be set up at a maximum of 5 years and a lower time limit could also be considered. Which time limit, within a maximum of 5 years, would you find appropriate?

We would prefer a minimum of 5 years and possibly longer.

Article 34 (The meaning of minimal and insignificant regarding qualifying AT1 and T2 capital issued by a special purpose entity under Article 78(1) CRR)

Q21. Would you assess the limit on the amount of assets set at 0.5% of the average total assets of the special purpose entity over the last three years as appropriate?

The limit of 0.5% would seem appropriate.

Q22. How would you assess the impact of setting the limit at 0%, meaning keep only the possibility offered by paragraph (a)?

We consider that keeping only paragraph (a) could be unintentionally restricting and could result in the exclusion of AT1 instruments issued by the SPV even where it is clear that the only assets of the SPV are investments in the subsidiary's own funds.

Article 35 (Risk weighting and prohibition of qualifying holdings outside the financial sector under Article 84(1)(b) CRR) – not part of this consultation

Article 36 (Own funds requirements for investment firms based on fixed overheads under Article 92(1) – (3) CRR) – not part of this consultation

Article 37 (Additional filters and deductions under 461(1) CRR) – no comment

Article 38 (Items excluded from grandfathering in CT1 or AT1 in other elements of own funds under Article 465(1) & (2) – no comment

Appendix - Additional Tier 1 Capital (Articles 19-24, Questions 11-13)

The issuance of Additional Tier 1 ("AT1") is of vital importance to the management of the capital structure of any bank, as it allows the risk of absorbing losses on a going-concern basis to be spread across different classes of investors in a more efficient manner. We welcome the EBA's efforts to put forward a framework that attempts to balance the interests of various investor constituencies and respects the proposed CRR. We nevertheless would like to suggest some important amendments that we feel would be vital to the success of an AT1 market going forward. We also provide some arguments as to why we feel that our proposals should be adopted.

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General

The CRR contemplates that an AT1 instrument bears 100% of any loss once the 5.125% CET1 ratio is breached. At this point, the AT1 holder's position in the hierarchy of the capital structure becomes perversely inverted with common equity holders of an institution, who, by more traditional notions of corporate finance should bear the first and greatest share of losses as they arise. We question why the hierarchy of the capital structure is not protected so that at the trigger point, AT1 does not absorb losses on a pro rata basis with CET1.

Notwithstanding the foregoing, we herewith make the following proposals:

PROPOSAL 1: There should be equal treatment with other forms of going-concern loss absorption while the bank is within capital conservation restrictions

It has been suggested by some that temporary write-down AT1 is meant to be treated the same as AT1 convertible into shares at the 5.125% trigger and that AT1 holders need to be limited in their ability to receive a portion of future profits so as not to hinder recapitalisation of the bank. If this is true, then we would argue that investors in temporary written down AT1 instruments should receive the same amount of profit share as if they had received equity (and corresponding dividends from those shares). Equally, we think that temporary written-down AT1 holders should be treated in a similar fashion to permanently written-down AT1 holders in terms of coupon payments on the residual / unwritten-down portion of their investment.

An AT1 instrument convertible into shares is, in our view, no different than a permanent write-down AT1 with the delivery of equity at the trigger point. Indeed, we would highlight that for AT1 instruments convertible into equity, if not all of the AT1 is convertible into equity, the remaining portion of the AT1 should, according to the draft EBA RTS, receive discretionary coupons. By the same token, a temporary write-down instrument should, in our view, be no different than a permanent write-down AT1 with the delivery of the possibility of future AT1 (rather than equity) at the trigger point.

On that basis, we would suggest the following as our key recommendations to amend the existing write-up and distribution mechanics for AT1 temporary write-down instruments:

1. Allow the bank the discretion to pay coupons on the unwritten-down portion of a temporary write-down AT1.

This allows the AT1 holder to receive a share of the profits on both a *pro rata* and *pari passu* basis with equity and also treats the temporary written down AT1 holder the same as the permanent written-down AT1 holder. Fair and equitable treatment will be assured and investors will be more supportive with this allowance included in the terms of the instruments.

2. Allow the bank to treat the portion that is written down as equivalent to partial conversion into equity for purposes of the payment of dividends on common shares.

If a bank is permitted to pay dividends on equity, the portion of an AT1 instrument that is temporarily written down should receive its equivalent *pro rata* share of any dividends as if that written-down portion were converted into equity. Here, we would propose that instead of an actual dividend on this amount, the equivalent amount of such dividend would be used in the form of a write-up of the principal amount. This should permit the temporary written-down AT1 to be treated as if they had received shares for the portion that was written down but still with the 'upside' being capped. This latter point is important because it is this point which really should be used when evaluating whether any write-up of the instrument would hinder recapitalisation of the bank. The retention of earnings in this manner is also supportive to the broader notion of bank recapitalisation.

Notwithstanding the foregoing, we do not find any formal guidance in the CRR that specifically requires that an AT1 instrument be treated like CET1. If the EBA is intending to address the meaning of "not hindering recapitalisation" by suggesting that an AT1 instrument should be

treated like CET1 for purposes of the write-up, we would submit that investors would expect their 'upside' to also reflect this fact. However, this is not the case because an AT1 holder's 'upside' is always capped by the original principal amount of their investment (unless and until such time that an AT1 instrument is converted into equity). As we know, conversion into equity may not be possible for many banks who would like to issue AT1 and we feel it is absolutely necessary that principal loss absorption be fair and equitable in all cases - permanent write-down, temporary write-down or conversion into shares. The EBA should try to balance the speed of the recovery of a temporary write-up AT1 structure (capped), on the one hand, with the recovery of an equity conversion (uncapped) on the other hand. We don't view either option, so long as they are equitable between each other, as hindering recapitalisation of a bank.

PROPOSAL 2: There should be no restrictions once the bank has recapitalised and is outside of any capital conservation restrictions

In many cases, we would expect that a bank will seek to recapitalise itself with a one-time capital injection (either from existing shareholders or new shareholders). At that point, the bank may no longer be in breach of any capital conservation measures and should be able to operate under normal conditions. We firmly believe that if the bank is not subject to any capital conservation restrictions, the bank should have full discretion to apportion its current year profits as it sees fit, including using the same to write-up any AT1 instruments that may still be written-down in priority to making any dividend payments or coupon payments on AT1 instruments.

PROPOSAL 3: If the 5.125% CET1 trigger breach is generated by virtue of an increase in RWAs, allow the bank to write-up the AT1 instrument if it subsequently takes measures to reduce the RWA to restore capital ratios.

There is no distinction between a "loss" generated from an increase in Risk-Weighted Assets (RWAs) and a "loss" generated from an operating loss under the current proposed technical standards. We think that the 'denominator' in the CET1 ratio calculation is therefore not addressed adequately and would propose that provisions be made to permit a more symmetrical approach to write-up of AT1 instruments when RWAs have been reduced to restore capital ratios accordingly.

PROPOSAL 4: Provide clear guidance on 'Gone-Concern' principal loss absorption for AT1 and Tier 2 capital instruments.

As regards the additional loss absorbency provisions contemplated by the Basel Committee for Banking Supervision in January 2011 (the point of non-viability ("PoNV") additional trigger for the write down of AT1 and Tier 2 capital instruments), clarity on this is of vital importance to banks and their investors from the point of view of the pricing of risk.

We note the recent proposals in the recently released European Commission proposal on Resolution and Recovery, however in our view the issue requires addressing under the transitional provisions of the Regulatory Technical Standards on Own Funds, to the effect that that if an institution is in all other respects in compliance with the EU Capital Requirements Regulation for AT1, the instrument will still be treated as own funds.

PROPOSAL 5: The Temporary Write-down/write-up mechanisms included in the EBA RTS should only apply to instruments where that principal loss-absorption trigger point is 5.125% CET1.

We make reference to Article 51 of the CRR that states, in part, that a trigger event can be set at "a level higher than 5.125% when determined by the institution and specified in the provisions of the governing instrument." We would propose that the EBA make clear in their RTS that the mechanics that they propose for the write-up of AT1 solely apply to instruments that include a CET1 trigger point of 5.125%. This is based on the view that if the trigger point is set higher than 5.125%, it will absorb losses at an earlier point in time and, as such, the EBA should not have to be as proscriptive about the nature or manner of any write up of the principle amount of such instrument.

Arguments to support our proposals

1. *Writing-up AT1 benefits the overall recovery of a bank, allowing CET1 to be used more efficiently*

Before a bank can satisfy its combined capital buffer requirements, it must first satisfy its total minimum capital requirements under the CRR. This means that if a bank's AT1 instruments are not written up, CET1 must be used to satisfy total minimum Tier 1 capital before CET1 can be used to satisfy the combined capital buffers. In the short to medium term as a bank rebuilds its capital, this would mean that the bank would need more equity to satisfy its minimum requirements than would otherwise be necessary had an earlier write-up of the AT1 instruments been allowed, which would be more dilutive to its shareholders and, generally, an inefficient use of CET1 based on the cost of capital for a bank.

2. *Subordinating AT1 to CET1 during the recovery will make the instrument 'un-investable' by a large proportion of the market-at-large.*

RBS' Markets Division conducted a comprehensive study with more than 50 of the largest and most active investors in the Tier 1 market globally during the first half of 2012. Nearly all of them confirmed that an AT1 instrument that is effectively subordinated to equity during the recovery of the bank will make the AT1 instrument unattractive as an investment proposal, especially if coupons are not paid on an AT1 instrument while written down (whereas dividends could, in theory, be paid).

3. *An AT1 instrument that absorbs losses at any time means that if the instrument is written back up, it can always be written back down.*

We do not support the argument that writing up an AT1 instrument in priority to allotting future profits to retained earnings 'hinders recapitalisation' of a bank. We have observed a number of bank recapitalisations during the recent finance crisis through the public markets via private sector investors where dividends have not been paid (yet coupons on legacy hybrid Tier 1 instruments were still paid). We can therefore deduce that dividend income was not the fundamental driver for these investments. Equally, cash that is not used to pay dividends or coupons but used to write-up an AT1 instrument are effectively being retained (and can be used to further absorb losses in the future). Equity investors, in our view, would prefer the retention of earnings for this purpose.