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Re: Consultation Paper on Draft Regulatory Technical Standards on Own Funds – Part one (EBA/CP/2012/02)

Dear Sir/Madam,

UBS would like to thank EBA for the opportunity to comment on the Consultation Paper on Draft Regulatory Technical Standards on Own Funds. Please find attached our response to the paper.

We would be happy to discuss with you, in further detail, any comments you may have. Please do not hesitate to contact Gabriele Holstein on +41 44 234 4486.

Yours sincerely,
UBS AG

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UBS Response to EBA Consultation Paper on Draft Regulatory Technical Standards on Own Funds – Part One (EBA/CP/2012/02)

INTRODUCTION

UBS would like to thank EBA for the opportunity to comment on the discussion paper on Draft Regulatory Technical Standards (RTS) on Own Funds. Please find below our response to the overall content, as well as the specific questions set out in the Paper.

Write-down and write-up of the principal amount

We would like to emphasise that UBS is in favour of the proposal for a write-down/write-up mechanism and in general of mechanisms that allow for a participation of bank creditors in a possible economic recovery of the institution following a trigger event.

As the rules[1] with respect to resolution, going-concern, bail-inable debt and the role of Additional Tier 1 (AT1) and Tier 2 (T2) instruments in this context are, or will be, defined more clearly in future, the write-up is necessary to address shortcomings, voiced by investors, which currently hinder the development of a larger market in those instruments.

In particular, as Additional Tier 1 (and Tier 2) instruments technically should rank senior to equity, it will important for investors that they are not fully subordinated to equity holders when the issuer faces distress. Furthermore, as the holders of write-down instruments in a crisis situation might otherwise suffer losses before the equity holders, wrong incentives can be created. These issues can be addressed through a participation in a possible recovery, as rightly proposed by EBA. We would, however, encourage that more flexibility be allowed as to the specific nature of the write-up.

[1] E.g., see European Commission Draft Crisis Management Directive, June 12 2012.

Deduction of capital instruments of financial institutions

Our understanding of the draft RTS proposal is that all capital instruments must be deducted from Common Equity Tier 1 (CET1), unless the issuer of the instrument is subject to capital requirements equivalent to the Capital Requirements Regulation (CRR). In practice, depending on how 'equivalence' is determined, this may mean a deduction from CET1 is very frequently required.

We disagree with this approach and believe that a full CET1 deduction of less subordinated instruments would not be proportionate with the risk exposure inherent in holding those instruments. We therefore propose that the corresponding deduction approach should apply to all holdings of capital instruments issued by financial institutions, regardless of whether the issuer is subject to the CRR or equivalent capital regulation. This would also achieve consistency with the Basel III requirement.

Please find below our response to the specific questions outlined in the Consultation Paper.

TITLE II - ELEMENTS OF OWN FUNDS

Chapter 1, Common Equity Tier 1 Capital

Section 2, Common Equity Tier 1 items and instruments

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?

We believe that the provisions are sufficiently clear in general. We would, however, appreciate further clarification with regards to:

(i) **Disclosure of the dividend policy**: specifically, confirmation that the management body should not be required to disclose its dividend policy to the public as this may inadvertently set market expectations for the institution's payment of dividends going forward;

(ii) **The calculation methodology of foreseeable dividends:** specifically, confirmation that the impact of future regulatory requirements, or actions taken by competent authorities, that may restrict the amount of dividends available for distribution should be factored into the calculation of foreseeable dividends.

Finally we have a general comment regarding the *period for determining the dividend payout ratio*. In our view it is not appropriate to base the dividend payout ratio on the average of the dividend payout ratio in the three years prior to the year under consideration, as proposed in Article 2, 4. (b). This is because dividend payouts are closely linked to market conditions and a ratio based on a three year period may for example overstate the foreseeable dividend if market conditions in the year under consideration were materially worse than in the earlier years of the period on which the calculation was based.

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?

We believe that the provisions on the applicable forms of indirect funding of capital instruments are too broad and require further clarification.

First, we believe that *indirect funding should only refer to the case where funding has been made with the intention that the borrower finances the institution's own capital instruments*. As such, if a bank lends money to a counterparty in the normal course of business, and the counterparty uses some of the loan to invest in capital instruments issued by the bank, this should not be considered indirect funding, unless the granting of the loan is contingent on the counterparty subscribing for the lender's capital instruments. In our view, a broader interpretation of indirect funding would be very difficult to comply with in practice as it would require ongoing monitoring of the borrower's use of the funding.

Second, *intra-group transactions,* for example, where a subsidiary directs excess cash to its parent company in the normal course of business and the parent separately purchases capital instruments issued by the subsidiary, should be considered outside of the scope of the provisions.

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?

We consider that Article 6, 1. (d) goes beyond the EBA's mandate to develop draft regulatory standards to specify "the applicable forms and nature of indirect funding of capital instruments" as it refers to loans to related third parties for purposes other than purchasing an institution's own capital instruments. We therefore propose that it is deleted.

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

We have no comments to provide.

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

We have no comments to provide.

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).

We have no comments to provide.

Section 3: Deduction from Common Equity Tier 1 items

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?

We offer the following comments:

Immediate access: Article 13 states that the competent authority shall only grant the prior consent in Article 38 (1) (b) when the unrestricted ability to use the assets entails immediate and unfettered access to the assets. However, given that board sign-off may be required to access assets in a pension fund, there may in practice be a delay in getting access to use the assets and this should be reflected in the

provision. We therefore propose that the text "unrestricted ability to use the assets entails immediate and unfettered access to the assets" is removed and replaced with "when the use of the assets is not barred (…)".

Nature of losses to be deducted: It is not clear in Article 11 (1) whether calculated losses at full year or at 6 months must be audited. We do not consider that audited figures should be necessary.

Section 4: Other Deductions

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?

Please see our response to the related question 9.

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

Suspension of the corresponding deduction approach: Our understanding of the proposal in Article 15, 3. (a) is that all capital instruments must be deducted from CET1, unless the issuer of the instrument is subject to capital requirements equivalent to the CRR. In practice, depending on how 'equivalence' is determined, this may mean a deduction from CET1 is very frequently required.

We disagree with this approach and believe that it is inconsistent with the CRR text and Basel III. A full CET1 deduction of less subordinated instruments would also not be proportionate with the risk exposure inherent in holding those instruments. We therefore propose to adopt the corresponding deduction approach (in which the deduction is applied to the same component of capital for which the capital would qualify if issued by the institution itself) for all holdings of capital instruments issued

by financial institutions, regardless of whether the issuer is subject to the CRR or equivalent capital regulation. This is consistent with the Basel III requirement[2]. The corresponding Tier of capital for deduction should be determined based on subordination and which Tier of capital the instrument's features are closest to (e.g. deduction of dated instruments from T2, of undated instruments from AT1 and of equity from CET1).

Should the EBA choose not to widen the scope of the corresponding deduction approach, we note that in cases where countries do not implement Basel III (and II and 2.5) on a co-ordinated timescale, specifically where some are late in implementation, there appears to be limited potential for equivalence to CRR to be achieved. Consequently, institutions will likely face a particularly large value of deduction and this should be mitigated by a phasing of the implementation timetable. The same comment equally applies to Article 16 (2)(c) and (3) and Article 17 (2)(c) and (3). But again, our strong preference is that equivalence to the CRR is not required in order for the corresponding deduction approach to apply.

Deduction of holdings of instruments included in a financial institution's own funds: Article 15, 2. (c) requires the deduction of holdings of instruments included in a financial institution's own funds pursuant to the relevant applicable prudential framework. We would like to bring to EBA's attention that it will be very difficult to determine at a detailed level what other instruments are part of a financial institution's capital base where we have no credit relationship with that institution. We consider that Pillar 3 disclosures are unlikely to be sufficient to enable this analysis to be conducted.

Section 5: Exemption from deduction where coordination is applied

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

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[2] Basel III requires that "Reciprocal cross holdings of capital that are designed to artificially inflate the capital position of banks will be deducted in full. Banks must apply a "corresponding deduction approach" to such investments in the capital of other banks, other financial institutions and insurance entities. This means the deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself".

We have no comments to provide.

Chapter 2, Additional Tier 1 Capital

Section 1, Form and nature of incentives to redeem

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?

Whilst we agree on the types of incentives to redeem as described in paragraph 2 of article 19, we would appreciate clarification that the following case is not considered an incentive to redeem:

Article 19, 2 (b) states that an incentive to redeem includes "a call option combined with a requirement or an investor option to convert the instrument into a Common Equity Tier 1 instrument if the call is not exercised". We understand that the intention of this provision is to preclude incentives to redeem arising from so called "principal stock settlement" mechanisms utilised in the past, where the only investor option to convert to shares during the life of the instrument arose as a consequence of the issuer not calling the instrument, with the number of shares determined by the then current share price.

We would urge a clarification in this respect in the final BTS, in order not to unintentionally impact the feasibility of structuring and marketing convertible capital instruments, where the investor has the option to convert into ordinary shares during a pre-specified time period, at a pre-specified share price. The specified time period for the investor's conversion right may straddle an issuer call option, in which case it is unclear whether Article 19, 2. (b) would be violated.

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?

Please refer to our response to the related Q13.

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

Nature of the write-up mechanism

While UBS is very supportive of mechanisms that allow for a participation of bank creditors in a possible economic recovery of the institution following a trigger event, we question the intent of EBA to only allow for one specific possibility in the form of a concretely defined write-up instrument. In order for capital instruments to be most effective, they must on the one hand fully absorb losses, but on the other hand, deep and liquid markets need to develop. As many issues with contingent capital remain open, and the developments of a large market remains at this stage uncertain, it might be more appropriate for EBA to set-up the framework and a list of specific criteria that capital instruments must fulfil. Within this concrete framework, banks would be free to choose the exact features of the instruments, also based on investors' demand). Other forms of participation in a recovery could for example take the form of warrants or of an interest rate linked to the bank's profits. In addition, too specific a definition and unnecessary focus on a single concept/instrument could limit the flexibility of EU banks in the issuance of such instruments and might ultimately disadvantage them compared to international competitors.

Scope of instruments subject to write-down/write-up

It is not evident why the write-up is confined to AT1 instruments only, as within a proposed recovery framework, other subordinated instruments can be used to absorb losses while the institution could still remain a going concern. In a scenario whereby the various classes of capital instruments have been used to maintain going concern status, it is thus not evident that only AT1 instruments would have to be protected for investor hierarchy purposes. We therefore propose to expand the scope of instruments eligible for write-up to include T2 instruments.

Maintaining the creditor hierarchy

Whilst we welcome the write-up guidelines contained in the draft RTS and the potential upside recovery for AT1 holders, the provisions still leave AT1 holders

subordinated relative to equity holders. This is important, as, in order to maximise the bank capital investor base and to not hinder recapitalisation, we believe that the creditor hierarchy needs to be appropriately reflected. We have received feedback from a number of institutional investors that they either cannot buy AT1 instruments with a permanent write-down, or would demand a significant premium over an instrument which includes potential future upside participation.

Proposed changes to the EBA model

In order to address these issues, we believe the following adjustments to the proposal should be considered:

(i) While there is a suggestion for a mandatory requirement to cancel coupons during the write-down period, there is no restriction on equity dividends, other than those arising from the MDA. If the rationale for coupon cancellation during the write-down period is retention of cash within the company, then a similar restriction should also apply to equity dividends. From a prudential perspective, a write-up of AT1 principal should be preferable to the payment of an equity dividend, since cash and capital are preserved within the bank and remain available to absorb further losses should another trigger event occur in the future.

(ii) Removal of a prescribed formula for limiting AT1 write-up and prohibition on coupon payments on the non written-down amount, at least post the bank meeting the combined capital buffer requirements. In such situations, use of distributable profits should be at the discretion of the bank, since financial health would have been restored – in the event where the institution chooses to prioritise AT1 write-up from then on, the equity-holders also stand to gain, through (i) lower cost of funding and capital (earnings positive) given the positive messaging that creditor hierarchy is being adhered to and (ii) the sustained ability for the institution to raise non-equity capital to meet total capital requirements, instead of raising further equity which would be earnings dilutive.

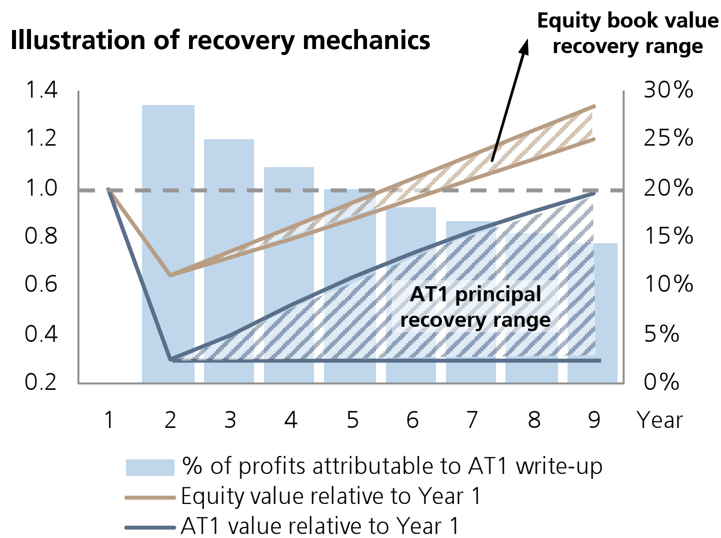
(iii) Alignment of decision making in relation to equity dividend payment and write-up of AT1 principal (i.e. the decision to write-up AT1 principal should be taken at the same time as the decision to pay an equity dividend) – this keeps the discretionary decision process for remuneration of capital providers consistent while also facilitating such determination given their combined reliance upon the MDA.

(iv) If a prescribed formula for AT1 write-up is utilised during the period when combined capital buffers are not met, it should be based on the relationship of AT1 to CET1 immediately prior to the write-down event – this provides for a fairer allocation of the upside participation to the capital providers, given it would be based on how they would have shared in the losses of the bank. In addition, instead of the proposed calculation which is based on accounting, a more market based approach (e.g. based on share price) for determining the share of the capital instrument holder and the share of the shareholder could be introduced.

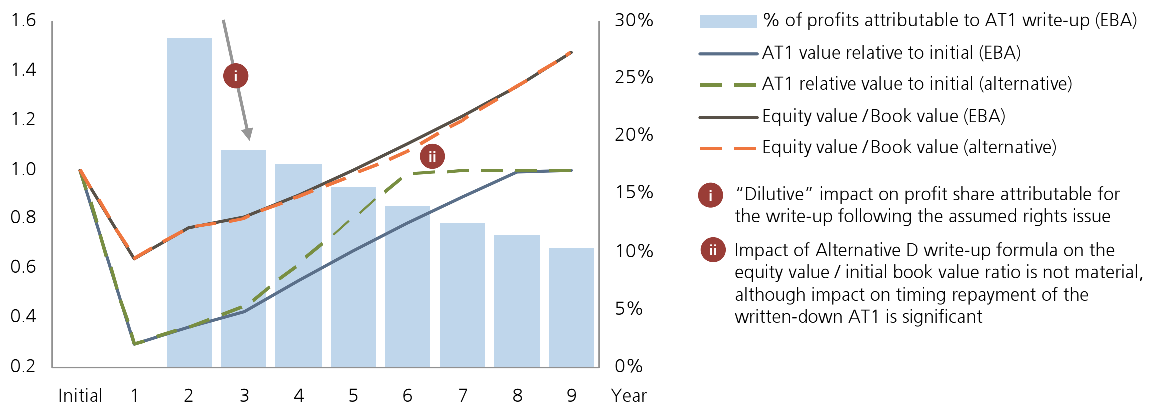
These changes would mean that the write-down period could be shortened, which would be crucial for the write-up feature to have a meaningful impact on both the marketability of the instrument to investors and its sustainability as an asset class even if a trigger event should occur, while not unduly impacting the recovery of equity-holders, thus not hindering equity recapitalisation. The ability to shorten the write-down period is particularly important when coupon payments are not permitted until the principal is fully restored.

Graphical representation

The subordination of AT1 holders compared to legacy equity-holders under the current proposal can be demonstrated graphically. Based on the example included in the Annex of the RTS draft, in the best case scenario, principal recovery for AT1 holders would take twice as long as for equity-holders, as illustrated below:



Graphical representation with a shortened write-up period (formula as described in (iv) above):



Calculation of the write-up

We would appreciate clarification on the following point:

In relation to Article 21 (a) on the determination of the occurrence of the trigger event, how such AT1 instruments (e.g. containing loss absorption triggers at 5.125% CET1 ratio) shall interact with other loss absorbing capital, with similar capital-ratio-based triggers, when absorbing losses through either conversion or

write-down. As banks should have flexibility to select a higher trigger ratio than the proposed 5.125 % CET ratio, we suggest to include a clear description of the sequencing of events in the case in which an institution has issued instruments with different trigger levels.

For example, it should be specified that in determining whether the "*Common Equity Tier 1 ratio has fallen below the level that activates conversion or write-down of the instrument*" (Article 21 (a)), the institution should consider pro-forma Common Equity Tier 1 after the conversion or write-down of instruments with higher / earlier loss absorption triggers, if any are outstanding at the time (e.g. an instrument with a 7% CET1 ratio trigger).

We also consider that the following amendment is necessary:

In relation to Article 20, 1(b), the requirement for a write-down to "*lead to an increase in equity, under the relevant accounting standards*" should be amended to the written down portion of the instrument being required to be accounted for as equity. This is the case because an AT1 instrument compliant with CRR is likely to be accounted for as equity upfront under IFRS and certain local GAAP, which means a write-down of any form would not lead to an increase in equity, rather a reclassification within equity.

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

We would appreciate clarification with regards to the following points:

Defining the "concept of index": we would welcome clarification of how the *"concept of index"* in Article 25, 1. is to be defined, specifically, if it only refers to indices which are publicly disclosed.

Deduction based on the nature of the index: We consider that the reference in Article 25 , 5. that "*Depending on the nature of the index (equity index or bond index), the dedcution should be applied on a corresponding deduction approach*" is

unclear. In our view, it would not be necessary to apply a different deduction approach based on the nature of the index and it is also not clear what the proposed alternative deduction method would be. We therefore propose that the text "*Depending on the nature of the index (equity index or bond index)*" is deleted.

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

Operationally burdensome is, in our view, quite a subjective concept. We believe, however, that the drafting fairly captures the cost benefit of decomposing indexes that have many names.

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 have no comments to provide.

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)?

We have no comments to provide.

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

We consider the 3 month period to be acceptable.

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)?

We have no comments to provide.

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 have no comments to provide.

TITLE III
Minority interest and Additional Tier 1 and Tier 2 instruments issued by subsidiaries

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?

We are not in agreement with just having the limit on the amount of other assets of a SPE set at 0.5% (or lower) of the average total assets of the SPE. We would advocate an aggregate limit on the total of SPE additional T1 and T2 capital contributed, e.g. 10% or 20%. This is because, otherwise, it would be possible to have several SPEs falling below the 0.5% individual limit which were used to contribute a disproportionate amount of an entity's capital in aggregate.

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

We believe that just having Article 34(a) would make the assessment easier.