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INVESTMENT

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To the Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

30 September 2010

Dear Sirs

Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability

Insight welcomes changes to the bank regulatory environment and is pleased to have the opportunity to provide comments to the committee on its consultative document. By way of background, Insight manages just over £100bn of largely fixed income assets, which includes a significant proportion of corporate bonds. Our clients are predominantly UK and European institutional pension funds and we manage their portfolios on an 'active' basis.

While we believe it is in the interests of our clients and of the banking sector for a hybrid capital market to continue to exist, we expect our participation in this market going forward to be less than our historical involvement. Having reviewed how existing instruments have behaved over the last few years, some of our clients have decided to explicitly exclude them from their fixed income guidelines. For other clients, our interpretation of their guidelines is likely to mean that we will not be investing in new securities, e.g. clients' restrictions on convertible bonds.

We believe our clients' appetite for hybrid instruments will be diminished further if the bulk of the proposals outlined in the consultative document are enacted. The priority for fixed income investors is for a fixed coupon (or fixed margin) over the life of the security, and a strong preference for a fixed maturity date. The prospect of a permanent write-off based on a potentially arbitrary regulatory decision and/or conversion into some form of equity will not be palatable to many of our clients.

First, the full write-off scenario effectively means that holders of hybrid instruments are subordinated to equity shareholders, begging the question why they should accept anything less than equity-like returns. The argument that if a bank issues a 'write-off instrument', its common shareholders will suffer the consequence of increased risk-taking through higher coupon rates on hybrid securities, is not a compelling one in our view.

Second, we believe that any trigger event must be based upon a measurable, transparent and consistent methodology. Any ambiguity around how the trigger might work in practice will make such securities extremely difficult to value with any accuracy. Furthermore, the trigger must also be linked to a capital event, not a liquidity event. Over the last few months we have seen a number of EU banks struggle to raise funding because of sovereign risk related issues. It would be unacceptable for a write-off in these circumstances based on a regulatory decision.

We can envisage securities that include a number of different trigger thresholds, linked for example to the tier 1 ratio. At the first threshold, bonus payments and dividends could be suspended forcing the suspension of coupons on hybrid securities (which would be non-cumulative). At the second, tighter threshold, management would be forced to execute an emergency plan to restore the capital position within a short cure period. We believe this would lead to closer monitoring by debt and equity holders, as well as encourage a 'self-help' approach before hybrid investors faced impairment. However, an overriding factor is that our clients may only contemplate some form of partial or full write-off if there is the ability to be written-up at a later date as the bank recovers, subject again to an appropriate transparent and consistent methodology.

Though we acknowledge your comments on the problems with formula-based triggers, we again reiterate our view that placing the decision-making in the hands of an individual country's banking regulator is too arbitrary and would add greatly to uncertainty and therefore, cost. As a quid pro quo, the threshold levels and write-down/write-up mechanisms would be pre-agreed by the regulator, though the actual measurement would need to be mechanistic. The inclusion of different threshold levels may also be a way to distinguish clearly between tier 1 and tier 2 hybrid capital.

Finally, we would also highlight the fact that many clients' guidelines either exclude or restrict non-investment grade and unrated issues. Aside from the question as to whether ratings agencies should actually opine on securities with equity-like characteristics, we would highlight the fact that at present Lloyds' ECNs are non-investment grade and Rabobanks' SCNs are unrated.

In summary, though we believe hybrid capital still has a role to play in bank capital structures, we do not agree that holders of this capital should be forced to bear losses equal to or greater than ordinary shareholders. Overall, we believe our clients and the wider investment community will have far greater appetite for hybrid capital if these securities have clearly defined and measurable trigger thresholds, greater uniformity of structure, including fixed lifetime coupons and fixed maturity dates, and investment grade ratings.

Yours faithfully,

David Averre
Head of Credit Analysis

For and on behalf of
Insight Investment Management (Global) Limited