1 October 2010

Mt Stefan Walter
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbankplatz 2
CH-4002 Basel, Switzerland

Dear Mr Walter,

BCBS CP 174: Consultation on Loss Absorbency of Regulatory Capital at the Point of Non-Viability

I am pleased to submit The Royal Bank of Scotland's ("RBS") response to the above consultation (the "Proposal"). We summarise below our principal observations on the Proposal; the attachment to this letter expands on these and provides more detailed comments on specific aspects.

RBS welcomes the Basel Committee's proposals and the opportunity to comment on them. Let me preface by saying that RBS fully supports the principle of enhancing entry criteria of regulatory capital to ensure they are able to absorb losses. We are supportive of a system that achieves a fair and predictable distribution of losses and eliminates the need for future government support.

Turning to the specific Proposal in the consultation, we do however have several recommendations that further fine tune the mechanics of the Proposal to ensure that the new features of capital achieve their intended objectives. We believe that the following matters should be an area of focus for the Basel Committee:

A. Trigger determination: further refinement of the trigger is suggested, to reduce subjectivity and increase uniformity of application, while at the same time encompassing as broad a range of stress scenarios as possible. A more clearly defined trigger will also minimise perceived differences in regulators' willingness to declare a trigger event and enhance the likelihood rating agencies will be able to rate such instruments.

B. Compensation of loan stock holders: we recommend the form of compensation takes into account the capital structure by adjusting the conversion ratios for Tier 1 and Tier 2 investors. In addition, write-up can be reintroduced if it is made conditional on any government support being repaid in full and the institution being restored to full financial health by a set of objective standards.

We would gladly welcome the opportunity to meet with the Basel Committee, its Secretariat or individual regulators to explain our views in more detail.

Yours sincerely

John Cummins
Group Treasurer
The Royal Bank of Scotland Group plc

Direct tel: +44 20 7085 6606
Email: John.Cummins2@rbs.com

Attachment: RBS Response to BCBS 174

A. Applicability, trigger determination and ratings

1. Applicability

Uniform application

We are of the view that loss absorbing features should be incorporated into capital securities of all financial institutions and not be limited to the capital securities of internationally active firms. Creating a systemic divide in the market can significantly distort the competitive landscape. An ambiguous line will add to the uncertainty that investors have to face. If domestic, non-systemically important banks can be allowed to be rescued by their own loan stock holders, then this is a positive for the economy. A trigger event does not guarantee any government support so non-systemically important banks can fail after the event, which has simply given them one last lifeline. The cost of capital for such institutions is unlikely to be considerably higher as the government support assumption has never been present.

A uniformly applicable trigger adds an element of certainty and removes the possibility of circumventing rules. All institutions have the right to benefit from this last minute measure to rebuild their capital.

2. Trigger determination

Predictable triggers

Triggers based on a regulator's determination of the viability of an institution do not provide an independent and measurable test. This uncertainty is likely to affect the ability to issue loss absorbing capital and obtain ratings required to satisfy fixed income investor mandates. We consider that a certain level of predictability and transparency of the criteria used for triggering write-off and compensation is necessary. We recommend capital be made to absorb losses prior to any government assistance if any of the following triggers are reached:

- (i) the institution no longer fulfilling, or being likely to fail to fulfil, its licensing obligations;
- (ii) the institution no longer possessing, or being likely to fail to possess, sufficient own funds (including Pillar 2 requirements);
- (iii) the institution approaching a Central Bank or other Government Agency for the explicit purpose of resolution and/or bankruptcy avoidance.; or
- (iv) a regulator requiring a bank to seek external support through public sector funds.

An element of regulatory discretion remains under the triggers listed above and we acknowledge such discretion is important, but at least the framework within which regulators can intervene is more clearly observable. Jurisdictions that have a defined legal process to be followed before a bank is declared unviable will find the process of finding an appropriate set of triggers easier.

No implicit or explicit government support

Government assistance can be used to make up a shortfall following write-down and compensation if regulators view this to be the best course of action. It may also be the case that the write-down and conversion triggered by any of the events above provides sufficient assistance so that the institution does not require any public funds.

Solving cross-border differences

The flexibility given to national regulators could give rise to varying degrees of interpretation and application and ensuing pricing differentials between jurisdictions may become more pronounced than is currently the case. The cost of capital could be substantially higher for institutions where loan stock holders face a higher perceived risk of write-down and compensation. The pool of investors for such securities is likely to be significantly reduced and this is likely to have a

measurable impact on the economy in terms of cost and availability of credit. Setting predictable triggers can contribute to reducing cross-border differences.

3. Ratings

Rating agencies have over time expressed concerns about rating instruments where conversion is discretionary. Moody's have confirmed they will not rate loss absorbing capital incorporating a discretionary trigger following the release of the Proposal. It is therefore, in our view, paramount to focus on the definition of more observable triggers as the capital securities in question rely on the universe of fixed income investors who in turn rely on ratings. Linking the trigger to a measurable failure scenario will be essential in ensuring the capital securities are not viewed as convertible debt.

B. Compensation of loan stock holders

<u>Write-down only removed</u>
We strongly recommend the removal of a write-down only option. Unanimous feedback from investors has been that a write-down only feature would not be marketable to either equity or fixed income investors. This is primarily because under such a scenario, loan stock holders receive all the risks of equity and their upside is limited to the coupon, effectively subordinating them to equity. Efforts can instead be focussed on developing an adequate form of compensation of loan stock holders that takes into consideration their relative position in the capital structure.

<u>Conversion considerations</u>
If a write-down is to be accompanied by conversion, consideration should be given to the mechanism by which the conversion rate is determined. The conversion rate will most probably need to be capped to take into account authorised share capital and the dilutive impact on existing shareholders, whilst at the same time allowing for sufficient compensation of loan stock holders, which may be proportionate to the current share price. RBS recommends preserving the capital structure by ensuring Tier 2 capital converts into more shares than Tier 1 capital. We do not see the conversion of Tier 2 capital into Tier 1 capital as suitable as it would leave investors holding a very illiquid instrument in a time of stress.

The Basel Committee is already familiar with other issues concerning conversion, including mandate restrictions of fixed income investors on holdings of equity, potentially resulting in further share sales in a downward trending market and limits on pre-emptive rights. Despite suggestions for coping with such issues made in the Proposal, we would like to highlight that conversion remains a key concern for investors.

<u>Introduce modified write-up</u>
RBS proposes introducing a write-up mechanism to circumvent issues with conversion into equity. The contingent claim would be structured to be payable only once any public sector funds have been repaid in full and the institution has been restored to full financial health, by a set of objective measures. This would ensure the contingent claim of loan stock holders remains subordinated to the government at all times whilst at the same time offering an alternative to conversion. Such a write-down, although temporary, will have to be recognised as being capital generative by regulators.

<u>Optional enhancement feature</u>
Existing shareholders could also be granted an out-of-the money option to buy out loan stock holders once a trigger event occurs, thereby mitigating dilution. The loan stock holders would effectively underwrite a rights issue. This measure will help limit the effect of the write-down and compensation on the share price in a time of stress.

C. Other considerations

1. Economic impact

The size and nature of the pool of investors in loss absorbing capital will be linked to the loss absorbing features, in particular the nature of the trigger. A less subjective trigger will allow broader participation, ensuring that a market for capital securities continues to exist at a price that makes economic sense for the issuing institution. A significant re-pricing could have substantial economic consequences and implications for the capital structure of banks at a time when a significant amount of new capital will need to be raised.

The Proposal does not fully counteract market confidence issues associated with failing financial institutions and could create more price volatility and possibly take the bank into an early downward spiral. Mark-to-markets on capital securities could potentially be very large, linked to rumours on any particular name. Once again, a clear definition of the trigger will help reduce the uncertainty.

2. Group treatment

Group treatment gives rise to complications: to count in consolidated capital, a security issued by a subsidiary will need triggers in the subsidiary and in the parent jurisdictions. The subsidiary regulator could however preclude the issuance of capital instruments with trigger events based outside its jurisdiction, or which would convert into shares of a foreign bank. Subsidiary capital without a trigger in the parent jurisdiction will not count as consolidated capital. The cost impact of the Proposal will be amplified where several triggers exist and is likely to lead to a centralised model of capital issuance.

3. Legal considerations

The potential acceleration of financial contracts must be examined and avoided. It will be necessary to explore measures to establish that the exercise of a write-down and compensation would not be considered an event of default amongst counterparties of the firm in question and in respect of credit derivative contracts referencing the firm.

4. Clarifications

Clarification is sought as to how the Proposal fits in with prior proposals (e.g. contingent capital) given that they achieve similar outcomes but may have different trigger levels making the pricing of the options even more complex.

Likewise, grandfathering provisions need to be specified as no existing instruments would comply. Such clarification will also help encourage issuance of capital securities and avoid a rush once regulations come into effect.

D. Conclusion

If significant disincentives to issue loss absorbing capital exist, the benefits of the mechanism will be reduced. The more such capital can be issued, the higher the protection given to depositors and the lower the reliance on the government.

RBS agrees that developing national and international resolution frameworks that allow losses to be allocated to all capital instruments at the point of non-viability is important and that the Proposal is an important step in the right direction. We understand that developing effective resolution schemes on an international scale is a challenge and we are pleased to work with policy makers to achieve this medium term goal.