Relevance & Applicability of Basel II/III to Asian Banks

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Basel I, II, III – History & Evolution

Background to the Basel Agreements

Basel I

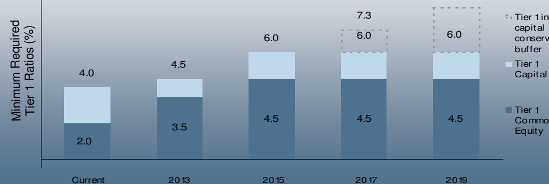
- Basel I has been the bank regulatory regime for credit risk since 1988. It established basic capitalization requirements (e.g., a minimum tier 1 ratio of 4% for adequately capitalized banks) and simple risk weightings by asset classes
- Basel I is widely considered inadequate in its ability to reflect true credit loss characteristics of different asset classes. As a result, the capital requirements do not sufficiently discriminate between credit quality, tenor, nature of collateral, etc.

Basel II

- Basel II strengthens international capital standards by:
  - Refining the assessment of credit risk
  - Introducing operational risk and market risk
  - Strengthening supervisory reach
  - Enhancing disclosure of bank's risk information
- Basel II was published in 2004. While Europe implemented Basel II in 2008, US implementation was delayed until 2011

Basel III

- Basel III seeks to address shortcomings in the capital, leverage, and liquidity rules exposed by the financial crisis
- Agreement was reached on Sept. 12, 2010 on the calibration and gradual phase-in of new capital standards:
  - Increase in Tier 1 ratios requirements
  - A 2.5% *capital conservation buffer* (must be met with common equity) to be phased-in during 2016-2019 and a discretionary 0-2.5% *counter-cyclical capital buffer*



- Other new standards include:
  - Higher "loss absorbing capacity" requirements for Systemically Important Financial Institutions
  - More stringent definition of Tier 1 Capital requiring a preponderance of common equity in the capital structure
  - A minimum Tier 1 leverage ratio of 3%
  - Counterparty risk measures including credit charges on corporate derivatives transactions
  - Minimum liquidity ratios

Basel III – no shortage of strong opinions

Recent commentary has probably generated more heat than light on the effects of Basel 3 - as well as country-specific initiatives

"In 2019, you'll have overly liquid, overly capitalized banks…We cannot generate global growth with shrinking banks, please believe me…" (Oswald Gruebel, CEO of UBS)

"India, China, Australia, Canada...countries that have strong banking systems need to ally themselves and push back on some of these proposals" (Mike Smith, CEO of ANZ)

"I'm very close to thinking the United States shouldn't be in Basel any more. I would not have agreed to rules that are blatantly anti-American…Our regulators should go there and say: 'If it's not in the interests of the United States, we're not doing it'." (Jamie Dimon, CEO of JP Morgan)

"It's literally unthinkable that the US Treasury would ever dream of doing to JP Morgan what the UK Treasury, here, seems to want to do to the likes of Barclays and RBS. This is a Volcker Rule on steroids…" (Felix Salmon, Reuters Blog)

"Our estimate of optimal bank capital (by which we mean equity) is that it should be around 20% of risk weighted assets…At the risk of stating the obvious, equity is a form of financing; other things equal a bank that raises more equity has more money to lend – not less" (David Miles, UK MPC Member)

Basel III Implications

Basel III Explained: Fixing Weakness

The Basel Committee set out to address specific weaknesses identified in the crisis, step-by-step, with the December 2009 "Basel 3" proposals. This lead to five "chapters" of rules and two more to fit the whole together.

Shortcomings of the Old Regulatory Framework

Most banks that failed, or nearly failed, were typically '*well-capitalized'* at the time

A — Systemic events needed write-down rather than revaluation – or "going concern" capital

B — 'Lower-risk' weightings came under suspicion

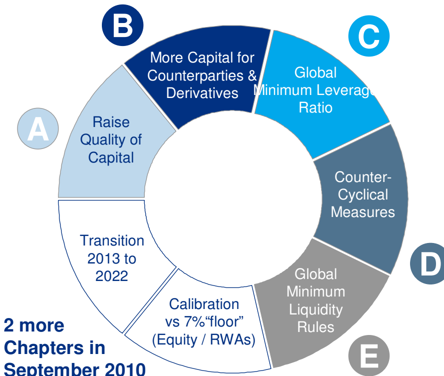
C — Global capital standards needed to be harmonized

D — Hybrid gearing occurred right before the crisis

E — Lehman and AIG showed systemic interconnections and the need for liquidity buffers

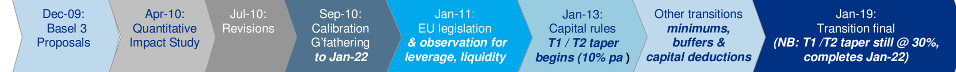
In combination, the proposals will improve quantity and quality of capital

5 Chapters from December 2009



2 more Chapters in September 2010

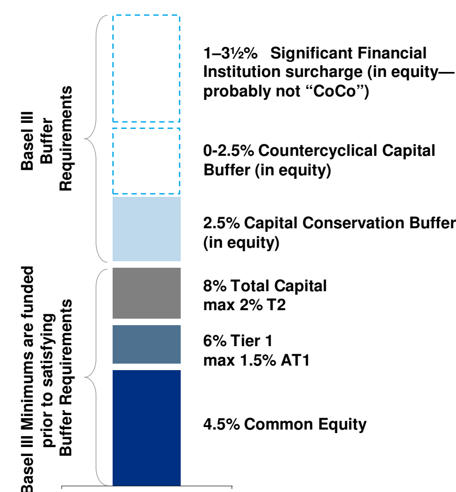
An extended timeline – or "long runway" for reform



Source: Basel Committee on Banking Supervision

What We'll Find Out in Implementation…

New Capital Structure under Basel III



- SIFI requirements vs. degrees of "SIFI-ness" (scale, complexity, connectedness and ability to substitute?)
- EU and US implementation could still differ (capital definitions, Dodd-Frank, etc.)
- Markets for new Hybrid (or "CoCo")?
- Harmonisation?

For Example:

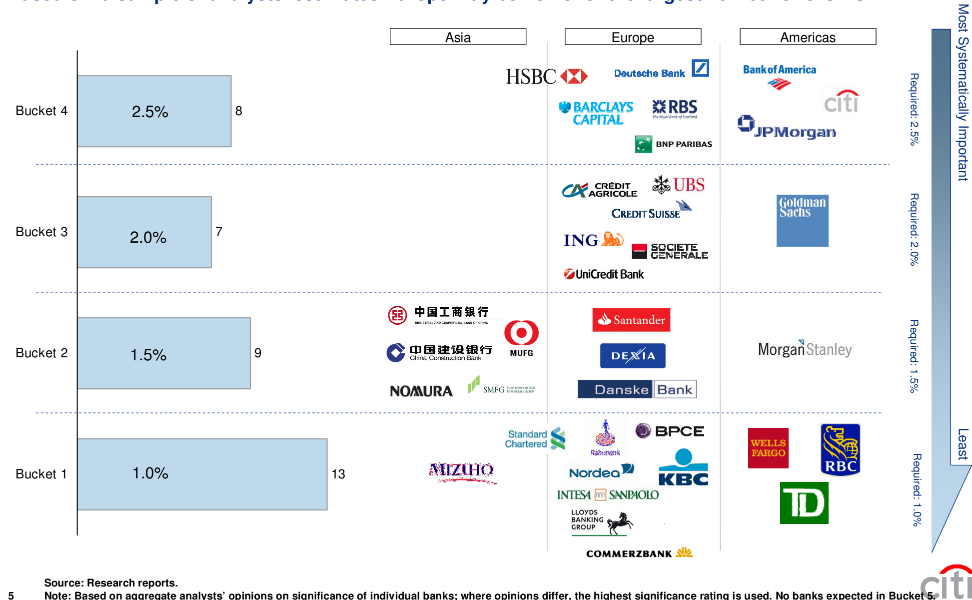
	Retail	Wholesale
Spain	8%?	10%?
UK (ICB)	10%?	8%?

And in Asia…

	CET1	Add T1 (max)	T2 (max)	Total Cap
Singapore	6.5%	1.5%	2.0%	10.0%
China	5.0%	1.0%	2.0%	8.0%

Predicting The G-SIB Universe

Based on a sample of analysts' estimates Europe may be home for the largest number of G-SIBs

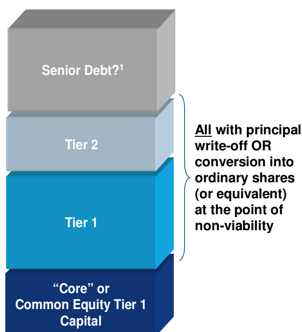


Source: Research reports.
Note: Based on aggregate analysts' opinions on significance of individual banks; where opinions differ, the highest significance rating is used. No banks expected in Bucket 5.

"Gone Concern" Loss Absorption and "Bail-In" senior debt?

In January 2011, the Basel Committee issued a press release detailing the minimum requirements to ensure loss absorbency at the point of non-viability; meanwhile, debate continues on the potential role of 'bail-in' senior debt

Potential Capital Structure:



All with principal write-off OR conversion into ordinary shares (or equivalent) at the point of non-viability

Gone Concern Loss Absorption Feature in Tier 1 and Tier 2

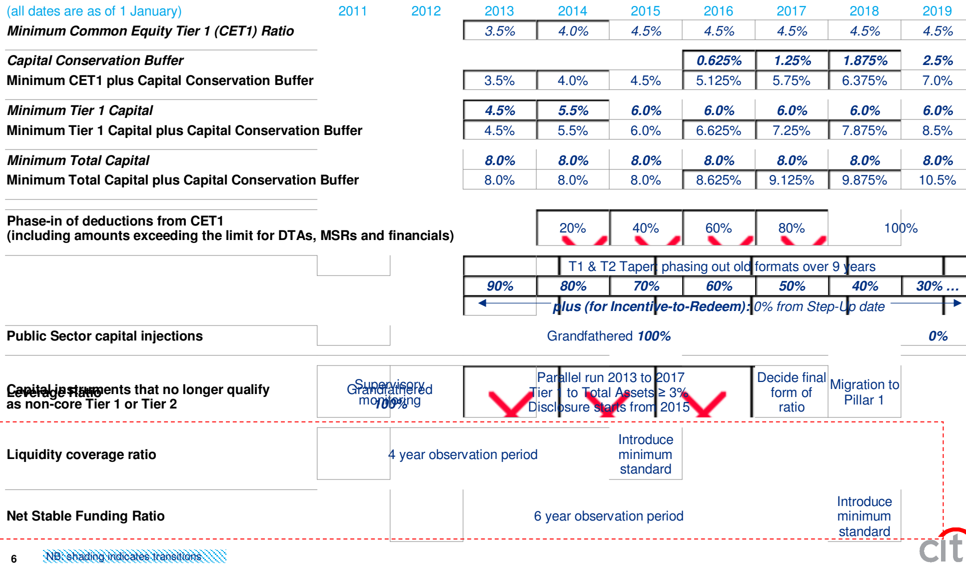
- **Scope and Requirement: All Additional Tier 1 and Tier 2 instruments issued by an internationally active bank must provide for permanent write down or conversion into common equity at the point of non-viability (can be contractual or statutory)**
- **Non-Viability is the earlier of:**
  - **a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority, and**
  - **the decision to make a public sector injection of capital, without which the firm would become non-viable, as determined by the relevant authority**
- **Issuance of any new shares must occur immediately and prior to any public sector injection (to avoid dilution)**
- **The bank must maintain at all times sufficient authorised but unissued capital to cover any conversion**
- **Transitional Arrangements: Must be included from 1 January 2013.**

Senior debt as part of a potential capital resolution structure

- **Debate continues over bank resolution / bail-ins of senior unsecured debt and is intensifying, with the adoption of various national resolution regimes and EU Recovery/Resolution proposals**

Basel III Phase-In Timeline

On 12 September the Basel Committee calibrated the Basel III proposals, setting out the compromises reached between member authorities, and established a timetable to 2022 for transition and further work.



(all dates are as of 1 January)	2011	2012	2013	2014	2015	2016	2017	2018	2019
Minimum Common Equity Tier 1 (CET1) Ratio			*3.5%*	*4.0%*	*4.5%*	*4.5%*	*4.5%*	*4.5%*	*4.5%*
Capital Conservation Buffer						*0.625%*	*1.25%*	*1.875%*	*2.5%*
Minimum CET1 plus Capital Conservation Buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Minimum Tier 1 Capital			*4.5%*	*5.5%*	*6.0%*	*6.0%*	*6.0%*	*6.0%*	*6.0%*
Minimum Tier 1 Capital plus Capital Conservation Buffer			4.5%	5.5%	6.0%	6.625%	7.25%	7.875%	8.5%
Minimum Total Capital			*8.0%*	*8.0%*	*8.0%*	*8.0%*	*8.0%*	*8.0%*	*8.0%*
Minimum Total Capital plus Capital Conservation Buffer			8.0%	8.0%	8.0%	8.625%	9.125%	9.875%	10.5%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	
Capital instruments that no longer qualify as non-core Tier 1 or Tier 2		Grandfathered *100%*	T1 & T2 Taper, phasing out old formats over 9 years: *90%*	*80%*	*70%*	*60%*	*50%*	*40%*	*30% …*
			plus (for Incentive-to-Redeem): 0% from Step-Up date						
Public Sector capital injections			Grandfathered *100%*						*0%*
Leverage Ratio		Supervisory monitoring	Parallel run 2013 to 2017. Tier 1 to Total Assets ≥ 3%. Disclosure starts from 2015				Decide final form of ratio	Migration to Pillar 1	
Liquidity coverage ratio		4 year observation period			Introduce minimum standard				
Net Stable Funding Ratio			6 year observation period					Introduce minimum standard	

NB: shading indicates transitions

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Regional Adoption of Basel Standards

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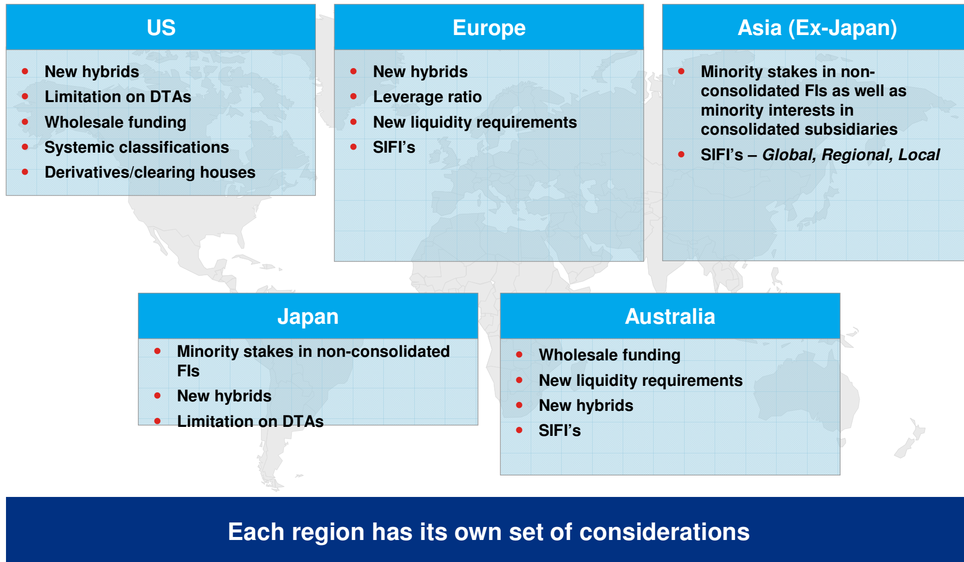

Many of the Concerns are Regional
US
New hybrids
Limitation on DTAs
Wholesale funding
Systemic classifications
Derivatives/clearing houses
Europe
New hybrids
Leverage ratio
New liquidity requirements
SIFI's
Asia (Ex-Japan)
Minority stakes in non-consolidated FIs as well as minority interests in consolidated subsidiaries
SIFI's – Global, Regional, Local
Japan
Minority stakes in non-consolidated FIs
New hybrids
Limitation on DTAs
Australia
Wholesale funding
New liquidity requirements
New hybrids
SIFI's
Each region has its own set of considerations
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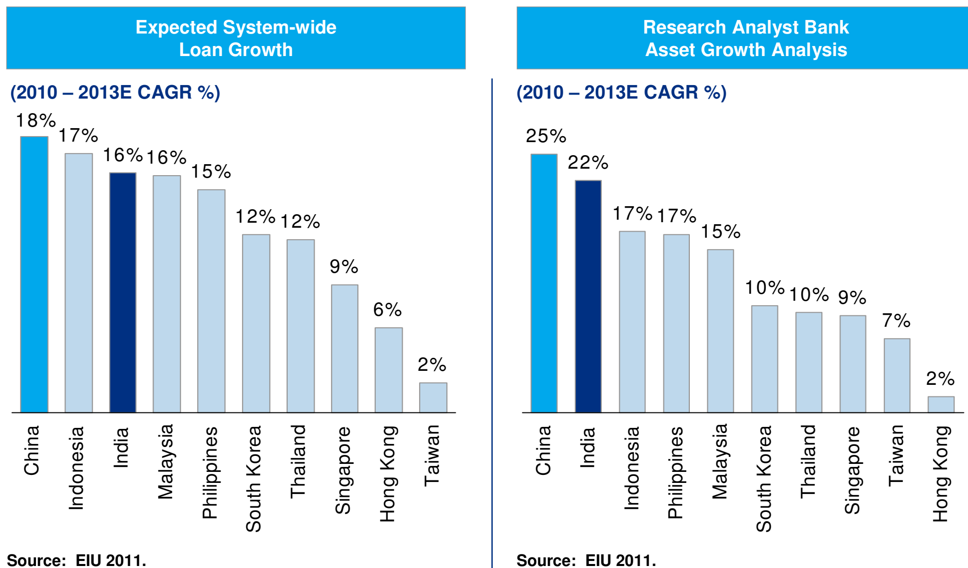

Managing High Growth Here in Asia
Expected System-wide Loan Growth
(2010 – 2013E CAGR %)
18% 17% 16% 16% 15% 12% 12% 9% 6% 2%
China Indonesia India Malaysia Philippines South Korea Thailand Singapore Hong Kong Taiwan
Source: EIU 2011.
Research Analyst Bank Asset Growth Analysis
(2010 – 2013E CAGR %)
25% 22% 17% 17% 15% 10% 10% 9% 7% 2%
China India Indonesia Philippines Malaysia South Korea Thailand Singapore Taiwan Hong Kong
Source: EIU 2011.
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Asia-Pacific Bank Capital Update

Key focus across Asia is on refinancing Tier 2 with "old-style" Tier 2 with no step-ups during the window prior to 2013. All key regulators have confirmed Basel 3 transition / grandfathering will be followed, allowing portfolio tapering for old-style instruments with no step-ups.

- Emerging themes across Asia Pacific include USD capital issues to solve USD liquidity requirements and systemic domestic risk for loss-absorbing instruments

HK	• Consultation paper on Definition of Capital expected to be released in 3Q 2011. Other consultation papers will follow in due course • Unlikely to "gold-plate" higher requirements like MAS but will seek to utilise Pillar 2 supervisory powers • HKMA keen to encourage accelerated adoption of "new-style" Tier 2 products • Old-style Tier 2 still allowed, but based on wholistic capital plan – do not want to see deliberate "abitraging" of old-style window • Timetable for transition / grandfathering will follow Basel 3 • Callable structures allowed, fixed rate reset allowed • Happy to receive term sheets and sign-off on new-style products • Bail-in / resolution regime unlikely, though expanded HKMA powers are being sought through legislative change • Expected to work with tax authorities to ensure tax deductibility
China	• Recently also set higher than Basel 3 standards on capital, including 1% SIFI buffer • Have outlined detailed consultation paper on August 15 for Definition of Capital • Tier 1 products now allowed, but though have been explicit that cannot be bought by commercial banks or affiliates • Tier 2 products have followed Basel 3 • No detailed discussion of Basel 3 transition / grandfather, but expected to allow similar transition period • Focus on regulatory approvals for offshore issuance of capital over the next 6-18 months – CBRC recognises system risk of domestic capital issuance • Considerable focus on RMB sub debt
Singapore	• Higher standards than Basel announced by 2%, core equity of 9% (6.5% + 2.5% capital buffer), Tier 1 of 10.5%, Total CAR of 12.5% • Transition also harsher, 4.5% in 2013 (3.5% B3), 5.5% in 2014 (4.0% B3), 6.5% 2015 onwards (4.5% B3) • However, capital instrument transition / grandfathering arrangements will follow Basel 3 • Old-style Tier 2 Have allowed fixed-rate-resets in old-style Tier 2 (UOB)

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Asia-Pacific Bank Capital Update (cont.)

The region is likely to follow Basel 3 very closely, with minor deviations for country specific views.

Australia	• 6 September 2011 released draft definition of capital rules – key focus on deductions • Viewed as "middle" case outcome – investment in consolidated subsidiaries is a full deduction (no threshold), but APRA no longer requires expected dividends to be a deduction • Tier 1 stapled structures continue to be allowed, hence preserving tax deductibility for Australian banks • Basel 3 transition / grandfather arrangements will be followed – portfolio amortisation and allowance of old-style instruments with no step-ups until Jan 2013 • Major banks have significant Tier 1 refinancings in early 2012
Korea	• FSS will follow Basel 3 • Very supportive of continued relevance of Tier 1 and Tier 2 • Basel 3 transition rules will be followed, old-style instruments allowed • Currently considering fixed-rate-reset mechanisms • Will work with tax authorities to ensure tax deductibility
Malaysia	• BNM will follow Basel 3 • Very supportive of innovative products to help reduce the cost of capital for banks • Will work with authorities to ensure tax deductibility will be allowed • Basel 3 transition rules will be followed, old-style instruments allowed • "Old-style" Tier 2 Have allowed fixed-rate-resets in old-style Tier 2 (Maybank, Hong Leong)
India	• Likely to follow Basel 3, including transition and grandfathering • Consultation paper due at end of 2011 • Likely to maintain overall capital ratio at 9%, but may vary the composition
Others	• Thailand, Indonesia, Philippines and others are all likely to follow Basel 3, though there are some signs of setting higher standards than Basel 3 in consultation papers

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Asia-Pacific Bank Capital Update – G3 Issuance

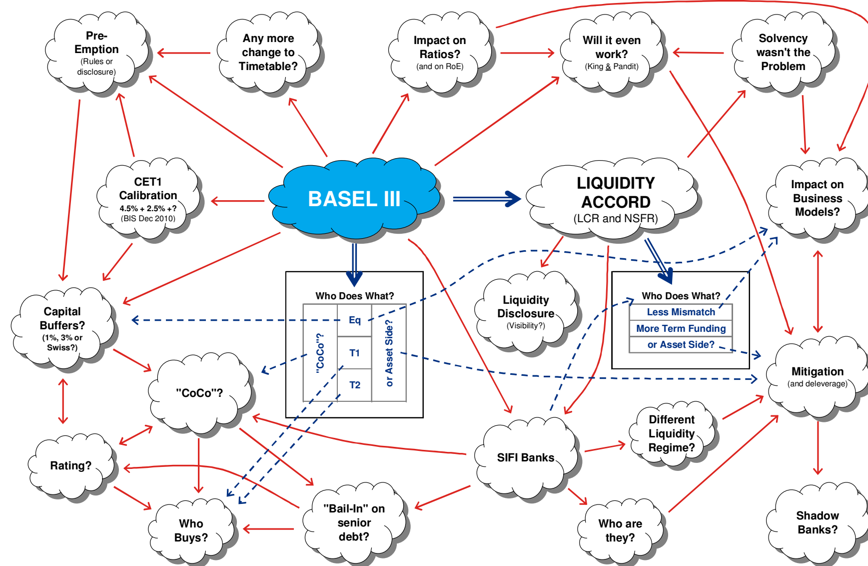
Date	Issuer	Volume (mm)	Product	Issue Rating	Pricing	Comment
May 2011	QBE Insurance Group	GBP325	30NC10	Baa1/BBB+/NR	7.5% (G + 425)	• Callable at par at Year 10 and Year 20
May 2011	QBE Insurance Group	USD1,000	30NC10	Baa1/BBB+/NR	7.25% (T + 412)	• Callable at par at Year 10 and Year 20 • Coupon then resets at MS + 405 bps
Apr 2011	Woori Bank	USD500	10NCL	A2/BBB+	5.875%	• Tax call
Mar 2011	Macquarie Bank	USD1,000	10NCL	A2/A-	6.625%	• Tax call
Nov 2010	Macquarie Bank	USD400	PerpNC5	Baa3/BBB/BBB	8.375%	• Tier 1 instrument, non-cum, no step-up, exchangeable into non-cum preferreds
Nov 2010	Fubon Bank	USD200	10NCL step-down	NR/BBB/NR	6.125% (T + 334)	• Issuer option to exchange into senior with 50 bps step-down after Jan 2013 if regulatory treatment lost
Nov 2010	ICBC	USD500	10NCL	A3/NR/BBB+	5.125%	• No regulatory call
Nov 2010	ICICI Bank	USD150	10NCL step-down	Baa3/NR/NR	7.00%	• Issuer option to exchange into senior with 50 bps step-down after Jan 2013 if regulatory treatment lost
Nov 2010	OCBC	USD500	12NC7	Aa2/A	3.75% (T + 275)	• Callable at par at Year 7
Oct 2010	Chong Hing Bank	USD225	10NCL step-down	Baa3/NR/BBB	6.00% (T + 338)	• Issuer option to exchange into senior with 50 bps step-down after Jan 2013 if regulatory treatment lost
Sept 2010	HSBC	USD750	10NCL	A2/A+	5.00%	• One-time reg call in Sept 2015 at 101% • Interest may be deferred until maturity (cumulative) or when ordinary dividends are paid and principal can be deferred for up to 6 months after maturity
Sept 2010	Macquarie	€600	10NCL	A1 / A / NR	M/S + 340	• Received Tier 2 approval prior to Sept 12 Basel release
Aug 2010	HSBC Bank USA	USD1,250	10NCL	A1/AA-/AA-	4.875% (T + 225)	• NA
July 2010	Bank of East Asia	USD600	10NCL	A3/BBB+	6.125% (T + 320)	• Regulatory call at par

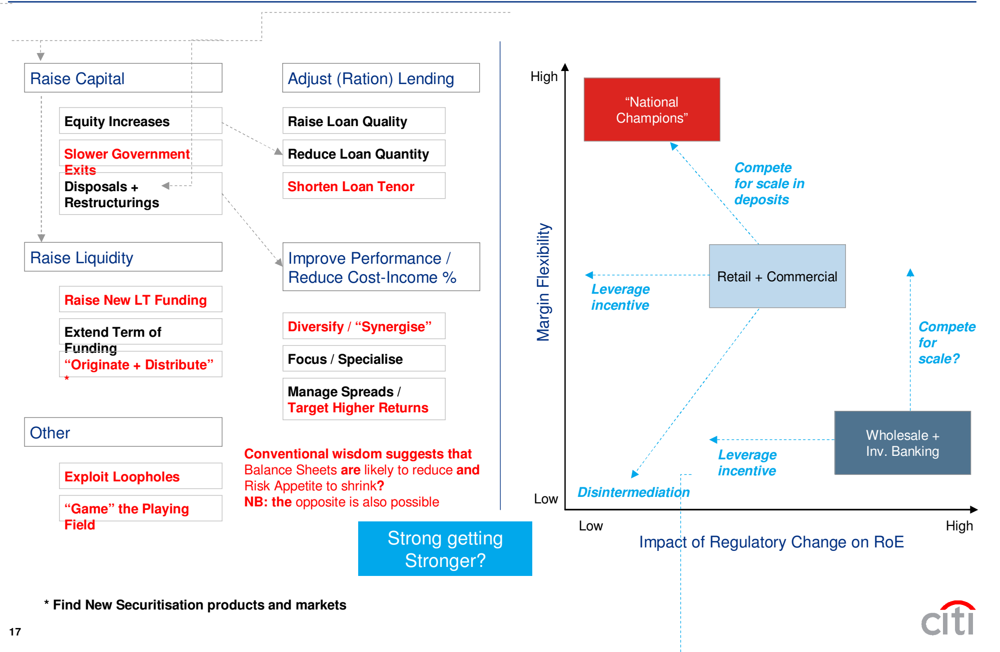
Asia-Pacific Bank Capital Update – Local Currency Issues

Date	Issuer	Volume (mm)	Product	Issue Rating	Pricing	Comment
Aug 2011	Taipei Fubon Commercial	TWD2,450	7NCL	NR	1.70%	• Fixed for life
Jul 2011	CIMB Bank	MYR1,350	10NC5	NR	4.15%	• Fixed for life
		MYR150	10NC5	NR	4.70%	• Fixed for life
Jul 2011	Public Bank	MYR3,000	11NC6	NR	4.28%	• Fixed for life
Jul 2011	CIMB Thai Bank	THB3,000	10NC5	NR	5.35%	• Callable at par from Year 5 semi-annually
Jun 2011	Zhejiang Tailong	CNY3,500	10NC5	NR	7.30%	• Callable at par at Year 5
Jun 2011	ICBC	CNY38,000	20NC15	NR	5.56%	• Callable at par at Year 15
Jun 2011	Guangdong Dev't. Bank	CNY3,000	10NC5	NR	5.79%	• Callable at par at Year 5
Jun 2011	Industrial Bank	CNY10,000	15NC10	NR	5.75%	• Callable at par at Year 10
Jun 2011	Cathay United Bank	TWD3,900	7NCL	NR	1.65%	• Fixed for life
		TWD2,500	10NCL	NR	1.72%	• Fixed for life
Jun 2011	Punjab & Sind Bank	INR3,000	10NC6	NR	9.73%	• Callable at par at Year 6
Jun 2011	Union Bank of Taiwan	TWD2,000	7NCL	NR	2.78%	• Fixed for life
Jun 2011	Banco de Oro Unibank	PHP8,500	10NCL	NR	6.5%	• Fixed for life
Jun 2011	Philippine Nat'l. Bank	PHP6,500	10NCL	NR	6.5%	• Fixed for life
Jun 2011	Agricultural Bank of China	CNY50bn	15NC10	NR	5.3%	• Callable at par at Year 10
May 2011	Bank of Chengdu	CNY2,400mm	10NC5	NR	7.0%	• Callable at par at Year 5
May 2011	E Sun Commercial Bank	TWD2,100mm	7 year bullet	NR	1.73%	• Fixed for life
May 2011	Bank of Queensland	AUD200mm	10NC5	A3/BBB/--	3m BBSW + 375	• Callable at par from Year 5 quarterly
May 2011	Hong Leong Bank	MYR1,400mm	60NC5	NR	5.05%	• Callable at par at Year 5
May 2011	Hong Leong Bank	MYR1,000mm	10NC5	NR	4.35%	• Callable at par at Year 5
Apr 2011	CIMB Islamic Bank	MYR250mm	10NC5	NR	4.2%	• Callable at par from Year 5 semi-annually
Apr 2011	Maybank	SGD1,000mm	10NC5	--/BBB+/BBB+	3.80%	• 5-year reset to 5-year SOR + 1.93%
Apr 2011	UOB	SGD1,000mm	10NCL	Aa2/--/A	3.45%	• 5-year reset to 5-year SOR + 1.475%

Strategic Implications For Banks

Basel III is Complicated





How Will Banks Adjust?
Raise Capital
Equity Increases
Slower Government Exits
Disposals + Restructurings
Raise Liquidity
Raise New LT Funding
Extend Term of Funding
"Originate + Distribute"*
Other
Exploit Loopholes
"Game" the Playing Field
Adjust (Ration) Lending
Raise Loan Quality
Reduce Loan Quantity
Shorten Loan Tenor
Improve Performance / Reduce Cost-Income %
Diversify / "Synergise"
Focus / Specialise
Manage Spreads / Target Higher Returns
Conventional wisdom suggests that Balance Sheets are likely to reduce and Risk Appetite to shrink?
NB: the opposite is also possible
Strong getting Stronger?
High
Low
Margin Flexibility
"National Champions"
Compete for scale in deposits
Retail + Commercial
Leverage incentive
Compete for scale?
Wholesale + Inv. Banking
Leverage incentive
Disintermediation
Low
High
Impact of Regulatory Change on RoE
* Find New Securitisation products and markets
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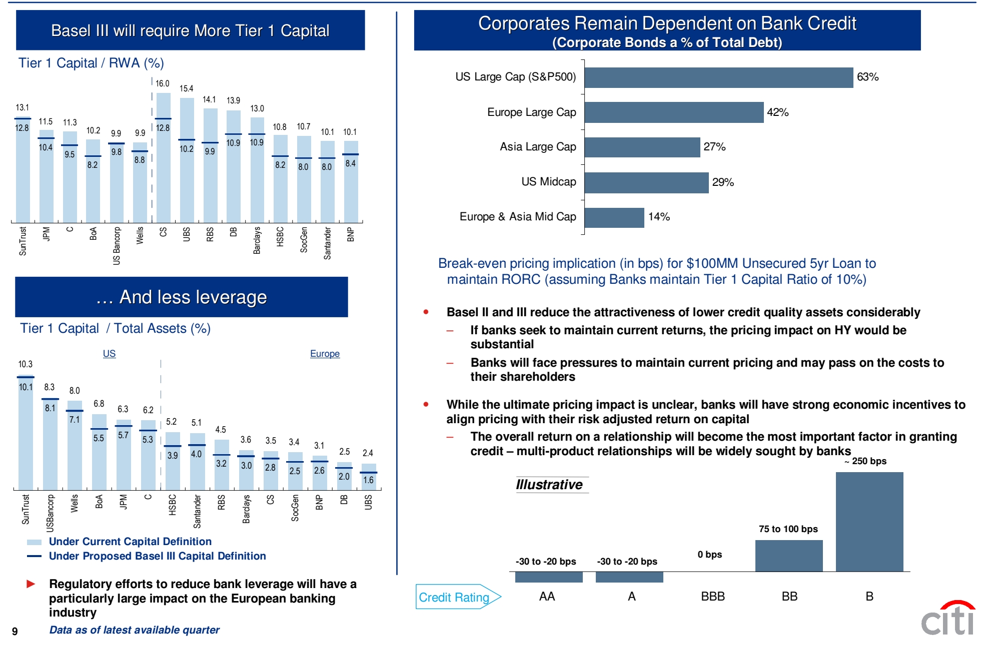

Required Price Adjustment for Banks to Maintain Current RORC
Basel III will require More Tier 1 Capital
Tier 1 Capital / RWA (%)
… And less leverage
Tier 1 Capital / Total Assets (%)
US
Europe
Under Current Capital Definition
Under Proposed Basel III Capital Definition
Regulatory efforts to reduce bank leverage will have a particularly large impact on the European banking industry
Data as of latest available quarter
Corporates Remain Dependent on Bank Credit
(Corporate Bonds a % of Total Debt)
US Large Cap (S&P500) 63%
Europe Large Cap 42%
Asia Large Cap 27%
US Midcap 29%
Europe & Asia Mid Cap 14%
Break-even pricing implication (in bps) for $100MM Unsecured 5yr Loan to maintain RORC (assuming Banks maintain Tier 1 Capital Ratio of 10%)
Basel II and III reduce the attractiveness of lower credit quality assets considerably
If banks seek to maintain current returns, the pricing impact on HY would be substantial
Banks will face pressures to maintain current pricing and may pass on the costs to their shareholders
While the ultimate pricing impact is unclear, banks will have strong economic incentives to align pricing with their risk adjusted return on capital
The overall return on a relationship will become the most important factor in granting credit – multi-product relationships will be widely sought by banks
Illustrative
-30 to -20 bps
-30 to -20 bps
0 bps
75 to 100 bps
~ 250 bps
Credit Rating
AA
A
BBB
BB
B
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1 Jan 13 is the key date under the transitional rules

After 1 January 2013 new capital instruments must comply fully with the new framework's requirements including the PONV loss-absorption feature, and existing T2 will be run off on a portfolio basis

Rationale for being proactive prior to 1 Jan 13

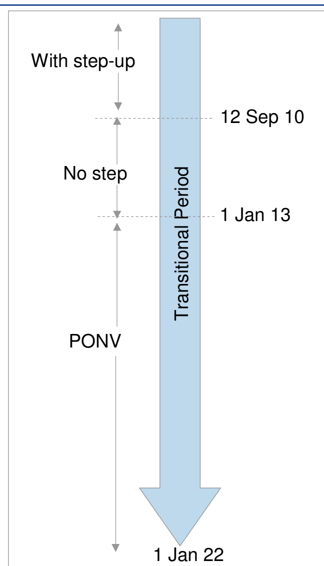
• Basel 3 transition rules require amortization of ineligible instruments on a portfolio basis from 1 Jan 13

• This would include running off of all 'old-style' T2 instruments (generally those with step-ups) issued before 12 Sep 10

• It would also include T2 instruments that comply in all respects with the new Basel 3 proposals except for the PONV (point of non-viability) write-down, if issued prior to 1 Jan 13

• Estimates of the additional cost of the PONV feature range up to ~ 50bps versus 'old-style' Tier 2

• There exists therefore an incentive to optimize the total T2 portfolio base as at 1 Jan 13



Basel 3 "New-Style" Tier 2 – Structural and Market Considerations

There remains a number of regulatory and structural concerns around "new-style" Tier 2 with non-viability loss absorption mechanism. The investor base is likely to shrink, adding significant premium to "old-style" products.

Structure	• **Will banks have the ability to choose between write-down or conversion? Will write-up be allowed?** • **Will the guidelines for loss absorption be principle-based or prescriptive?** • **Conversion may be more marketable for some accounts. Private Bank investors prefer conversion** • **10-year bullets may be preferable given higher yield – maximizes Private Bank interest** • **Some investors would actually prefer "new-style" Tier 1, rather than Tier 2 due to the yield pick-up**
Tax Deductibility	• **There is a risk that tax authority does not agree (as in some jurisdictions like Australia)** • **Even if the tax authority agrees, there may be significant delay in obtaining official clarity**
Investor Base	• **Some investors interested in yield pick-up, while others dislike "new-style" loss absorption products – so it is likely the investor base will shrink, but at the same time, many investors who don't like it will probably still be forced to buy due to lack of alternative supply** • **Lack of ratings or significant notching below investment grade will be a key negative to investment**
Pricing	• **With no precedents, investors are likely to reference pricing against existing contingent capital deals (e.g. Credit Suisse) and also old style perpetual Tier 1 (with no loss absorption)** • **There is a strong argument that old-style Tier 1 is potentially more senior than new-style Tier 2** • **Based on this, we would expect the upper limit to be the existing spreads for these old-style Tier 1 products – roughly 1.5x the spread of the existing Tier 2: around 50-175 bps depending on the credit** • **However, we think that the market will slowly gravitate towards 1.2x the existing old-style Tier 2 spreads given scarcity of supply of bank paper** • **Smaller banks are likely to be punished more for the new-style product than larger banks**
Regulatory Confirmation	• **Concerns about whether the regulators would sign-off on a new structure and whether that it would not change its mind about the key features and loss-absorbing mechanisms (e.g. Australian Tier 1)**
Ability to Rate	• **Fitch remains the only agency that has given clear guidance on the ability to rate new-style Basel 3 loss absorbing products** • **S&P notching likely to be at least 1 further notch** • **Moody's still unable to rate "contingent" loss-absorbing products**

Basel 3 "New-Style" Tier 2 – Detailed Investor Feedback

Citi has recently undertaken detailed investor soundings on "new-style" Tier 2 loss absorbing instruments. The key message continues to be that "new-style" Tier 2 will attract a significant premium and the investor base will be smaller.

Institutional Investor A	*No*	• Does not like loss-absorbing products • Prefers "new-style" Tier 1 and does not believe there will be a large buyer base • Unclear as to ranking of products vs "old-style" Tier 1s? Would "new-style" be more junior? • Prefers conversion over write-down
Institutional Investor B	*Unlikely, unless strong yield pick-up*	• Does not like these securities • Will view similarly to CS continent capital deal (even if CS trigger significantly earlier) • Will price off the European contingent capital trades (Rabo, Lloyds, CS)
Institutional Investor C	*Yes, if strong yield pick-up*	• Interested in these products and will invest regardless of rating due to higher yield • Will price against European financials, particularly contingent capital deals
Institutional Investor D	*Yes, if strong yield pick-up*	• Interested in Asian contingent capital deals • Would buy due to yield pick-up, so "new-style" Tier 2 would have to incorporate significant premium
Institutional Investor E	*No, unless certain features and strong yield pick-up*	• Not interested unless there is a write-back or if there is a significant yield pick-up. Ratings required • Should price around "old-style" Tier 1s, but believe is structurally more junior • Unsure about conversion – wishes to participate on upside, but may be forced to sell equity at worst time. Therefore may prefer temporary write-down structure • Would like to get strong language / comfort that common equity holders would be first-loss • Prefers lower trigger levels, not high triggers like existing CoCos
Institutional Investor F	*Yes, if investment grade + yield pick-up*	• Can only invest if the product is rated and is investment grade; yet is yield sensitive • Prefer "old-style" Tier 1s to "new-style" Tier 2
Institutional Investor G	*Yes, if significant yield pick-up*	• Focused on yield and name – must be a well-known bank • Only comparable to European contingent capital deals, even though much worse product • 10-year bullets may be better from a yield perspective

Given Uncertainty, What Do Banks Do?

Some uncertainty for a few months more – most banks await clarity on "SIFIs", Counter-Cyclical buffer components and implementation (CRD IV). Evolution of structures continues – this might take several market iterations.

Equity Capital	• **European banks raised a lot of Equity since March 2008 (€ 230bn)** • **Basel 3 requires even more** • **Earnings should take care of most of this** • **SIFI surcharge still uncertain** • **EBA Stress Tests imminent**	Q. How much more is enough?
Non-Equity Capital	• **€ 236bn of old Tier 1 – lot's of "wood to chop" if all or most of this is to be replaced in capital** • **How to optimise?** ➢ **Which components fit which buffers?** ➢ **Will senior CoCo or T1 (or both) fit the Counter-Cyclical buffer?** • **Non-Viability instruments now embedded in Basel 3 – but Basel wording allows for wide jurisdictional difference and perhaps the level playing field tilts from here on …** • **CRD IV is still work-in-progress**	Q. How much more Tier 1? (tough to know if we're not yet clear on Equity) Q. Product design & scale? Q. What's the role of Tier 2? (Does this depend on senior bail-in?)
Liquidity	• **Rules revised and long observation periods for both NSFR and LCR** • **But QIS data released in December showed European banks' LCR at 67% - the** biggest impact point for Basel 3 • **LCR, NSFR and Leverage Ratio form a "Bermudan Triangle" …to manage a future crisis, banks need to be super-equivalent to at least one of the three**	Q. Final form of rules? Q. Leverage Ratio exemption for Highly Liquid Assets?

Greater structural clarity allows issuers to move ahead with hybrids if they want to

 Source: Capital Management Strategy Group.

Strategic Considerations and Concluding Remarks

(1) CAPITAL MANAGEMENT

- **The benefits of dividends / buybacks proved ephemeral**
- **Longer term view required**
- **Composition AND rate of capital formation matter now more than ever**
- **We live in a "fat-tailed" world with asymmetric payoffs**

(2) REGULATORY IMPACTS ON STRATEGY

- **Banks are redefining what are "core" businesses**
- **More capital necessary**
- **Rate of internal capital generation will slow**
- **Risk aversion reflected in composition of assets**
- **Retained funding capital**

(3) CAPITAL MARKETS PERSPECTIVE

- **Valuation drivers have shifted**
- **Financial engineering out of favor**
- **Potential flood of issuers to come to market**
- **Markets becoming more selective with regards to investment alternatives**
- **Value proposition of banks not fully brought into focus at present**

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