



Mr. Andrew Bailey
Director, UK Banks and Building Societies Division
Financial Services Authority
25 The North Colonnade
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Thursday, 14 June 2012

Dear Mr. Bailey,

I read with interest the Financial Times article on Saturday 9 June, stating that the FSA was requiring Royal Bank of Scotland to replace its £8bn of contingent capital debt securities with new securities with a higher strike level or with equity. The argument was made in the article that the existing securities have such a low strike price that they are unlikely to be converted to equity and so do not serve as primary loss-absorbing capital.

I am writing to first of all say that I fully agree with the position of the FSA stated in this article. I have been making the point for several years to the FSA that UK banks are undercapitalised and should be made to hold much more common equity to avoid repeating the crisis of 2008. The UK Banking Commission process and Basel 3 regulations are clearly moving in this direction but the delays in clarification and implementation are not helpful to ensuring stability.

Secondly, I would like to point out there is a bigger issue on contingent capital securities than those at RBS. Lloyds Banking Group has a similar security, Equity Capital Notes, which are designed to become loss absorbing in the event that the bank gets into difficulty. There are over £10bn of principal of these notes outstanding and they represent a significant part of the Lloyds capital base. While the concept behind their issuance was good at the time, the trigger level was set at 5pc under Basel 2 rules in order to incentivise bondholders to accept the exchange offer which created them. The prospectus for the notes does not allow for the trigger level to be 5pc under Basel 3 guidelines or any new regulatory

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regime. Given the tighter definitions of capital and calculations of risk-weighted assets under Basel 3, Lloyds Bank estimates there is around 3pc difference in their core equity calculation between Basel 3 and Basel 2. In other words, the 5pc trigger under Basel 2 becomes only 2pc under Basel 3. This is such a low trigger level that it would need Lloyds to suffer over a £20bn post-tax loss before the FSA could force the company to issue equity. The low likelihood of such an event decreases every year that the bank's capital increases, as it continues to successfully deleverage.

The ECN's of Lloyds have a further disadvantage in that they are extremely expensive funding. On average, they yield a massive interest rate at over 12pc to maturity – a cost of over £1bn pa which encourages the bank to continue to aggressively deleverage and shrink lending to the economy. No lending can be economic if the bank is funding a massive part of its capital at a cost of 12pc pa.

The failure of the FSA to clarify to Lloyds Bank exactly the capital treatment of these instruments and if they will be included in core capital has, in my opinion, resulted in Lloyds not knowing what they can do to eliminate these expensive and uneconomic securities which actually serve no effective value as equity capital. Given their low strike price, it is patently impossible for the FSA to view these as core equity and I would argue they serve as no credible loss-absorbing capital whatsoever, given their low probability of ever being exercised.

Just as the FSA is doing with RBS, I urge the FSA to clarify as soon as possible that the Lloyds ECN's do not constitute core equity capital nor effective loss-absorbing capital additional to common equity. The UK Banking Commission has recommended that banks bring their total capital (core equity plus contingent capital) up to 17pc of risk-weighted assets under Basel 3. The effective loss-absorbing capital of Lloyds Bank is currently only at 7% of core equity capital, as measured by Basel 3 rules, versus the 10% required.

The solution to the Lloyds situation is clear. If the ECN's are no longer deemed to be valid capital for UK regulatory purposes, then Lloyds will need to find other sources of capital to get to the 10pc core equity level under Basel 3 and the total capital up to 17pc if the UK Banking Commission recommendations are implemented.

Clearly, the most effective option for raising the capital ratios of Lloyds from their currently inadequate levels is for Lloyds to offer an exchange offer of these ECN securities into common equity.

Alternatively, an exchange offer at a much higher strike such as 7pc under Basel 3 could be offered, as is being apparently proposed by the FSA to RBS. However, the market will likely require a punitive cost of

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interest for such an instrument. Legally, these securities cannot be coerced into such an exchange offer, so it must be done on commercially appropriate terms.

If Lloyds executed such a debt to equity exchange offer, it would benefit from a much higher earnings base (at least 1bn pounds a year more profit). The economy would benefit from a better capitalised bank with less pressure to aggressively shrink lending to the economy. Shareholders would benefit because the new bank would have a much higher equity capital base of £10bn and hence be a safer bank. Its equity trading multiple would expand, offsetting any dilution from the issuing of shares.

The main obstacle to such an exchange offer would be the position of the UK Government holding 42pc of the common shares of Lloyds. They will be concerned with the politics of selling equity, although they will like the fact that the more capitalised Lloyds is, the closer it becomes to being able to grow rather than shrink its asset base. This is likely to lead to the government to preferring to keep the status quo, to maximise its possible equity value by keeping leverage high at the expense of the right regulatory decision.

So, in other words, the UK government, as both effective regulator and controlling shareholder, is conflicted in this issue. What is needed is for the FSA to act independently of the government and force much more common equity capital into Lloyds, by disallowing the ECN's as valid capital and insisting that the government replaces them with common equity. Further delays in this action can only continue to damage the FSA's reputation and the economy, by continuing to allow an undercapitalised UK banking system to remain unchallenged and uncorrected.

In the interests of transparency, I would encourage the FSA to make public its position on these instruments as urgently as possible.

Yours sincerely,

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