July 2, 2012

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

Introduction

Citigroup welcomes the opportunity to provide comments on the EBA's Draft Regulatory Technical Standards on Own Funds. We have addressed only the questions where we have specific comments.

Most of our comments relate to the temporary writedown mechanism for Additional Tier 1. Having engaged extensively with investors, we feel that the creation of a workable temporary writedown mechanism is essential for the development of a meaningful market that can supply anywhere near the amount of AT1 capital required by the European banking sector.

There is little appetite from investors for going concern permanent writedown structures, which invert the hierarchy of the capital structure and leave investors with no potential for recovery. Similarly, many institutional fixed income investors still have mandate restrictions that prevent them from owning instruments that can convert into shares and/or that force them to sell shares immediately upon conversion.

A Citi survey of 77 major institutional investors illustrated that market capacity for temporary writedown instruments would be 2x that for instruments that convert into shares and 4x that for permanent writedown structures (and this would be concentrated among a very small number of the highest quality issuers). In addition, a significant proportion of banks would not be able to issue instruments that are convertible into shares (e.g. mutuals).

The proposal for a temporary writedown mechanism is therefore very welcome. However, it has one key flaw – the automatic prohibition of partial AT1 coupons during a writedown. If not corrected, this is a very significant concern for investors and could very substantially reduce their appetite to invest, as they could end up in a worse position than holders of Common Equity Tier 1 for an extended period.

We believe that our proposals below address this in a way that fully meets regulatory objectives while ensuring the marketability of the instrument.

Comment on RTS Article 7 (as it applies to CRR Article 49(1)(l)(i))

In many European jurisdictions, Additional Tier 1 instruments will have the legal form of debt under national law. In many of these cases, it is factually incorrect to say that payments on a legal-form debt instrument are "paid out of distributable items" (distributable items relate only to distributions on legal-form equity instruments; payments of interest are an "above the line" item).

We believe that this inconsistency could easily be addressed without changing the regulatory/commercial intent of the CRR by phrasing CRR Article 49(1)(l)(i) as:

"they should not exceed the amount of distributable items"

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 think this is sufficiently clear.

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).*

Any addition to the restrictions on redeeming instruments will potentially have a negative impact on their cost in the primary and secondary markets (to the extent there is a secondary market for such mutual instruments). However, the magnitude of this impact will vary significantly according to the nature of the holders – potentially from very little impact to a few percentage points of yield.

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?

We would agree with those types of incentives to redeem. In relation to points 2(c) and (e) it is important that an institution should have full commercial flexibility to periodically reset the reference rate, provided that the credit spread itself does not exceed the credit spread at the point of issuance.

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?

The procedures for writedown are sufficiently clear. In terms of timing, it is also sufficiently clear with respect to what is proposed. The one month period seems realistic from a market perspective, although we would defer to issuing banks' treasury/capital teams in terms of the practicalities for issuers.

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

In the recent Public Hearing, the EBA representatives helpfully outlined some key principles for a temporary writedown:

1. AT1 should function similarly to equity during a writedown (but not worse)
2. Write-ups should be discretionary
3. The proportion of profits used for writing up should be limited to AT1's "fair share" of overall Tier 1

4. A general preference to retain capital on balance sheet over paying out distributions

We would add to these some complementary market principles:

1. There should always be at least an equal level of discretion to pay common dividends and/or AT1 coupons (i.e. discretion to pay one/both, or no discretion to pay either) within the constraints of the Capital Conservation Buffer. There should not, however, be any situations where there is discretion to pay common dividends but no discretion to pay AT1 coupons – this is a fundamental inversion of the hierarchy of the capital structure
2. The discretion to write up AT1 should be applied fairly – and if it is not appropriate to write up the AT1 (e.g. because the bank feels it needs to retain a greater proportion of earnings), it should not be appropriate to pay out distributions either

Although we have some concerns with the current proposals, we think it is possible to reconcile these EBA and market principles in a way that fully meets the regulatory objectives while also ensuring the creation of an AT1 security that respects the hierarchy of the capital structure and hence is broadly marketable to investors for the widest possible range of banks.

In relation to RTS Article 20(3) we have the following comments:

(a) Cancellation of AT1 payments while a write-down is in effect

We think that there is a significant problem with this requirement ("AT1 coupon stopper"), when considered together with (i) the prohibition on CET1 stoppers (CRR Article 50(b)) and (ii) the limitation on AT1 write-up to its proportionate share of total Tier 1 capital (RTS Article 20(3)(e)). These issues are further exacerbated if write-ups are discretionary, which in theory could lead to a situation where an AT1 instrument is never written back up and never makes any further coupon payments, even though CET1 payments have resumed.

Taken together, these three restrictions structurally put AT1 holders in an automatically worse position than CET1 holders (or AT1 with permanent writedown), thus distorting the hierarchy of the capital structure. Our extensive discussions with investors confirm that this would be likely to significantly reduce investor appetite for AT1, both in terms of overall market capacity and the number of issuers that would have market access.

To give an example of a scenario where such a problem might arise, consider a bank that has recovered such that it is now within the 4th (i.e. highest) quartile of the Capital Conservation Buffer (CCB). In this situation, the Maximum Distributable Amount (MDA) would be 60% of current period profits. However, the "proportionate share of total Tier 1 capital" limitation may be considerably lower (say, 20%). In this situation, the write-up of the AT1 would be limited to a maximum of 20% of current profits, leaving at least 40% of "spare" MDA. With an AT1 coupon stopper, but no CET1 stopper, the bank would be free to use some/all of this spare MDA to pay a CET1 distribution, but would automatically be prohibited from paying a partial coupon on the written down amount of the AT1. Given the other restrictions on the pace of the writeback, this situation could exist for an extended period of time, including when the bank is again well above the CCB. By contrast, for AT1 that converted into shares, investors who could hold the shares would by that point be able to receive dividends, and for permanent writedown AT1, investors would be able to receive partial coupons.

In the Appendix we include a chart that shows the rebuilding of CET1 and AT1 following a writedown using the EBA's proposed mechanism and worked example (but adjusted for how we understand the CCB mechanics should work – see comment below). We introduce the concept of the Profit Writeup Ratio (PWR) – which is the cumulative amount of profit generated by the bank since a writedown, divided by the original writedown amount of the AT1. The PWR when the bank reaches the 2^{nd} quartile of the CCB (where it might first have the ability to resume dividend payments) is 91%. The PWR when the bank moves out of the CCB (where dividend payments are unconstrained) is 258%. However, the PWR where the AT1 is fully written back (and hence AT1 coupons could resume under the EBA's proposals) is 613% - i.e. 6.7x the cumulative profit when dividends might have resumed and 2.4x the cumulative profit when dividends became unconstrained. Another way of looking at the output from our analysis is that the CET1 ratio would have reached 10.9% at the point that the bank would be able to resume AT1 coupon payments – clearly way past the point where the bank is recapitalised. Whichever way we look at this, we conclude that the automatic AT1 coupon stopper creates a situation where the AT1 is substantially disadvantaged relative to CET1.

We think that there are two important (but separate) structural elements to reconcile these conflicts:

1. Most importantly, do not apply an AT1 coupon stopper except in the context of point 2 below. This would mean that the bank would have discretion either to retain any "spare" profit (either excess MDA or general profit outside the CCB) or to make (partial) distributions on CET1 and/or AT1, subject to normal discretion and limitations. This would simply put AT1 and CET1 back on an equal footing with regard to distributions.

In practice, it may well still be the case that no distributions (either AT1 coupons or CET1 distributions) are paid for a considerable period and that even when AT1 payments do resume, they are based off the written down amount for an even longer period. We think investors understand this risk. The key point is that they should not be placed automatically in a worse position than CET1 holders in this regard.

2. Prioritise the writing up of AT1 over any type of Tier 1 distributions (CET1 or AT1), to the extent permitted by other regulatory constraints (e.g. the proportionate share of total Tier 1 capital). This would mean that if a bank exercised its discretion not to write up its AT1 to the fullest extent possible (i.e. because it wanted to conserve even more CET1), it would also be appropriate not to make any Tier 1 distributions. In this way, AT1 holders are not treated any worse than CET1 in relation to distributions (although shareholders may benefit from a disproportionate share of retained profits). The bank is retaining loss absorbing Tier 1 capital on its

balance sheet rather than paying out distributions, which is presumably desirable from a prudential standpoint.

We would not consider point (2) above to be a form of CET1 stopper (we note that from a purely technical perspective, CRR Article 50(b) only prohibits CET1 stoppers as a consequence of not making distributions on AT1, rather than as a consequence of a principal writedown), nor would we consider this to hinder recapitalisation since all profits are being kept within Tier 1 capital and common shareholders are benefitting from the increased book value arising from the substantial retention of earnings that is occurring in parallel with the write back of the AT1.

Equally importantly, once AT1 has been written down, it is necessary to refill this amount with CET1 and/or AT1 to once again meet the minimum 6% Tier 1 requirement before CET1 can be counted toward the combined buffer requirements. In this respect, using profits to write back AT1 is as effective as retaining earnings. Since the CCB imposes constraints on paying both CET1 distributions and AT1 coupons, writing back AT1 in this context is as helpful to the bank's future ability to pay common dividends as retaining all profits. It is therefore equally supportive to recapitalisation (the exact opposite of hindering recapitalisation).

(b) we agree with this

(c) Whether write-ups should only be discretionary?

We do not agree that write-ups should necessarily be fully discretionary, although we respect the EBA's views on this. In our view, this could be a commercial choice for banks as to whether they prefer full discretion or a more quantitative approach. Write-ups would in either case be subject to the restrictions of the CCB/MDA and the proportionate share of total Tier 1 capital.

Furthermore, if a regulator felt uncomfortable with the amount/usage of the MDA for any purposes (write-up, dividends or AT1 coupons) they already have the power to limit it under CRD IV 132(4)(b).

Beyond that, however, the decision as to how to allocate the MDA/profit could be mainly a commercial one.

However, if the EBA retains a discretionary approach, it becomes even more important to address the concerns around AT1 stoppers (as highlighted in (a) above) and also to prioritise the retention of capital as CET1 and/or AT1 over the payment of CET1/AT1 distributions.

(d) we agree with this

(e) we agree with this, subject to the comments in (a) and (c) above concerning the interplay between this condition and the other limitations. We would note, however, that given the natural bias towards earnings retention in the lower quartiles of the CCB, it would be more equitable to apply this limitation based on the aggregate cumulative profit since the writedown, thereby allowing AT1 to "catch up on" (but never exceed) its proportionate share of total Tier 1 capital in the higher quartiles of the CCB.

We would also suggest that it would be a useful clarification to define the calculation as "…the profit multiplied by the sum of the original nominal amount of all Additional Tier 1 instruments before write-down…".

(f) we agree with this. However, we would note that the testing of the bank's position within the CCB (and hence the available MDA) should be done on a "continuous" basis, rather than just at the beginning of the relevant reporting period. In other words, a large profit may be sufficient to lift a bank through one or more quartiles of the CCB and the different MDAs should apply to the relevant portion of profit for each quartile of the CCB, even if within a single reporting period.

As an example, if a bank's profit in one period were sufficient to move it from the 1st quartile of the CCB to the 3rd, the portion of profit needed to move it to the top of the 1st quartile would have an MDA of 0%, the portion of profit needed to move it to the top of the 2nd quartile would have an MDA of 20% and the portion of profit within the 3rd quartile would have an MDA of 40%.

Finally, we would note that we believe that the EBA example of a write-up mechanism provided in the Annex needs to be amended to accurately capture the way the CCB restrictions work. Our understanding is that CET1 can only count towards the CCB once all of a bank's minimum capital requirements (including total Tier 1 capital) are met. Writing down an AT1 instrument will increase CET1 but the amount of AT1 will correspondingly go down. Therefore, future profits will first need to refill the total Tier 1 requirement before surplus profits can count towards the CCB. For example, if a bank had 1.5% of AT1 and had a temporary writedown of 0.5% of this, the bank would need to make profits equal to this 0.5% plus 0.625% to fill the 1st quartile of the CCB before any write-up of the AT1 could occur.

Overall, we would therefore propose the following amendments to RTS Article 20 (3):

"3. For the write-down to be considered temporary, all of the following conditions shall be met:

(a) all payments shall be based on the current written-down amount while the write-down is in effect, and subject to points (f) and (g);

(b) write-ups shall be based on profits after the institution has taken a formal decision confirming the final profits;

(c) any write-up of the instrument shall be operated at the full discretion of the institution subject to the constraints arising from points (d) to (g) and there shall be no obligation for the institution to operate or accelerate a write-up under specific circumstances;

(d) a write-up shall be operated on a pro rata basis among similar Additional Tier 1 instruments that have been subject to a write-down;

(e) the maximum amount to be attributed to the write-up of the instrument shall be based on the profit multiplied by the sum of the original nominal of all Additional Tier 1 instruments before write-down that have been subject to a write-down divided by the total Tier 1 capital of the institution. This calculation shall be made at the moment when the write-up is operated;

(f) the sum of any write-up amounts shall be treated as a payment that results in a reduction of Common Equity Tier 1 and shall be subject, together with other distributions on Common Equity Tier 1 and Additional Tier 1 instruments, to the restrictions relating to the Maximum Distributable Amount as laid down in Article 131 of the CRD, as transposed in national law or regulation.

(g) if the institution decides not to write up all written down Additional Tier 1 instruments by the lower of the maximum amount permitted under Section 20(3)(e) and the Maximum Distributable Amount (if applicable), then no distributions will be permitted on either CET1 or AT1 for that period."

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

Additional Tier 1 and Tier 2 instruments will typically have an investor notification period of at least one month. When added to the proposed three month regulatory notification period, this could result in an application needing to be made at least four months in advance of an actual redemption date, which is quite a lengthy period, especially in volatile markets. We would instead propose a regulatory notification period of one month, thus giving a total period from regulatory application to potential redemption of two months.

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)?

These would seem to offer some useful flexibility in terms of dealing with small holders of capital instruments.

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?

In such a situation, maximum flexibility may be helpful for all involved parties and hence we would support the 5 year maximum period.

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?

The primary form of other assets held in a special purpose entity is likely to be cash, but it may be helpful to allow some other additional assets. We would propose a level of 1.0% of average total assets over the last three years.

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

See answer to Q21

Please let us know if you have any questions or require any clarification in relation to the points raised above.

Yours sincerely

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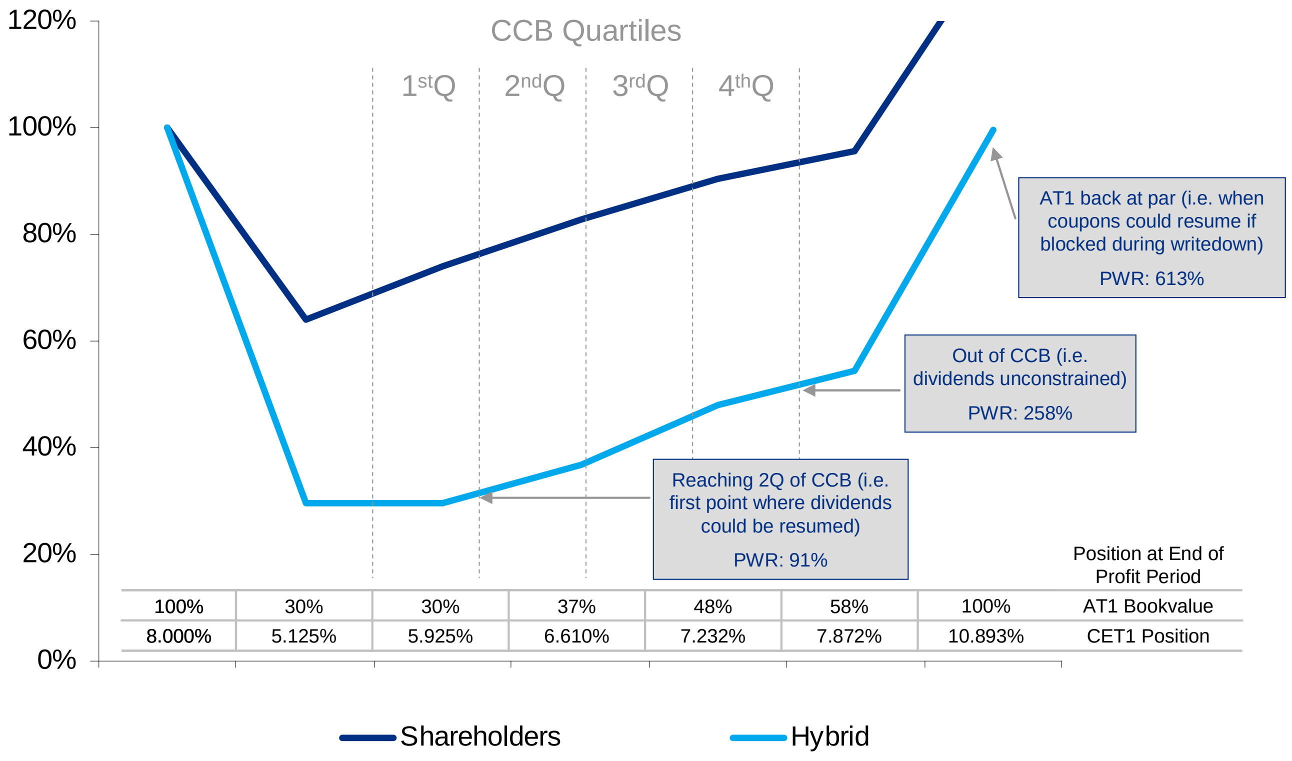
Appendix – Impact of applying AT1 coupon stopper until AT1 is fully written up

Principal / Book Value vs. Starting Point (%)



							Position at End of Profit Period
100%	30%	30%	37%	48%	58%	100%	AT1 Bookvalue
8.000%	5.125%	5.925%	6.610%	7.232%	7.872%	10.893%	CET1 Position

Profit Writeup Ratio (PWR): the cumulative amount of profit generated by the bank since a writedown, divided by the original writedown amount of the AT1.