Committee of European Banking Supervisors

3 April 2008

Feedback to the consultation on CP17

1. CEBS published its consultation paper on a proposal for a common EU definition of Tier 1 hybrids on 6 December 2007 (CP 17). The consultation period ended on 22 February 2007. 32 responses were received, all but 2 of which were published on the CEBS website.

2. This paper presents a summary of the key points arising from the consultation on the paper, CEBS's views on the public comments and the changes made to address them.

3. For the purpose of assessing the comments received, CEBS has distinguished between;

- general comments on key issues relating to the concept and content of CP17; and

- specific comments relating to single paragraphs of CP 17.

Outcome of public consultation - Overview

4. Most respondents generally supported the need for greater convergence in the area of hybrid capital instruments and the creation of consistent eligibility criteria and limits for the recognition of hybrids as Tier 1 capital across the EU. A number of respondents emphasized the role of hybrids as an integral part of banks' own funds and stressed the necessity for a full harmonization of the applicable rules in order to avoid competitive distortions and to reduce the cost of capital for banks. CP 17 was welcomed as a significant step in the right direction and a valuable basis for further discussion.

5. But the respondents also provided suggestions for further improvements to the proposal and raised a number of concerns, notably regarding level playing field issues and the degree of detail. The following paragraphs provide a short overview of the issues raised. A detailed summary of the responses to CP 17 and CEBS's feedback can be found in the annex to this note.

6. A number of general comments questioned the **necessity and usefulness of an EU approach on Tier 1 hybrids at this point in time**, i.e. ahead of future discussions on capital at the Basel Committee. Respondents also noted that **some proposals go beyond the requirements set out in the Sydney Press Release**

and cautioned that this could cause **competitive disadvantages for EU banks** compared to banks in non-EU member countries of the Basel Committee.

7. A number of respondents warn that the current **degree of prescriptiveness** could create further divergences between national rules across the EU as the Member States have to adapt the proposals to the framework and boundaries of their existing company and insolvency law and their tax regimes. A **more principles based approach** would be more flexible in this respect and better suited to achieve greater convergence.

8. On the content, the main comments related to the proposals on loss absorbency, instruments with Alternative Coupon Satisfaction Mechanisms (ACSM), limits and grandfathering. The proposal for an explicit trigger for **loss absorption mechanisms** and a limited list of possible mechanisms was considered to be too prescriptive. The conditions set out for the eligibility of **instruments with ACSM** features were perceived to be too strict, as was the inclusion of these instruments in the 15% basket.

9. Regarding the proposal on limits, the respondents **expressed a unanimous preference for an overall limit of 50% of Tier 1 capital without any further conditions**. Respondents had concerns regarding the cliff effect of Option 1.

10. Some respondents suggested **abandoning the differentiation between innovative and non-innovative instruments** in particular with respect to limits and grandfathering.

CEBS's response

11. The consultation paper has been revised on the basis of the feedback on CP 17 and the outcome of the impact assessment analysis.

12. It was decided to respond to the industry's concerns that prescriptive rules may collide with their national legal frameworks and could cause unintended distortions and competitive disadvantages and to adopt a more principles based approach.

13. Some of the major amendments concern the section on loss absorption (see proposal 2). The explicit trigger and the list of loss absorption mechanisms has been dropped and replaced with the principles an instrument has to meet in order to be considered loss absorbent in liquidation and in going concern (in particular in stress)situations. In order to give guidance, the general principle has been elaborated further in the proposal with some examples illustrating the general principle:

14. On an ongoing basis, the instrument must absorb losses to help the institution to continue operations as a going concern which means:

1) that it should help to prevent its insolvency (deep subordination will not help to prevent insolvency and only absorbs losses in a winding up); and

2) that it would make the recapitalisation of the issuer more likely.

CEBS advises that, in order to prevent insolvency, the following conditions must be met:

- the instrument is permanent;
- the issuer has the flexibility to cancel coupon/dividend payments;
- the instrument would not be taken into account for the purposes of determining whether the institution is insolvent; and
- the holder of the instrument cannot be in a position to petition for insolvency.

15. When the issuer has incurred losses, notably when these losses cause a breach of capital requirements, it is likely that it will need to be recapitalised. The new capital provided to recapitalise the institution should not be used to benefit existing hybrid holders. Hence, the hybrid must also include a meaningful mechanism that will make the recapitalisation more likely, by reducing the potential future outflows to the hybrid's holders.

16. The mechanism must be disclosed and transparent to the market and in the case of a principal write-down must be on the issuer's balance sheet (assuming this is possible from an accounting perspective). In addition, the mechanism must be legally certain.

17. Regarding instruments with ACSM features, the restriction that these instruments are only eligible if the ACSM is needed solely for tax reasons was dropped as was their inclusion in the 15% basket (see proposal 4).

18. CEBS believes that there is no reason to give up the distinction between innovative and non-innovative instruments. Innovative instruments are marked by an incentive to redeem which potentially makes them less permanent than instruments without such a feature. CEBS decided therefore to maintain the 15% limit for innovative instruments as set out in the SPR but to drop the particular grandfathering rule for these instruments (see proposal 6).

Annex to CEBS 2008 33 rev

Feedback to the consultation on CP17 – detailed summary

A. General comments

Level playing field issues and timeline

1. A large number of respondents point out that the proposals in CP 17 may create competitive distortions which will disadvantage EU banks with respect to the following issues:

   - The proposal goes beyond the requirements set out in the Sydney Press Release (SPR) by the Basel Committee on Banking Supervision (BCBS) and their implementation prior to the impending review of the capital definition by the Basel Committee on Banking Supervision could cause competitive disadvantages for EU banks compared to non EU-banks. EU banks could also be obliged to adapt twice to a new regulatory environment within a relatively short timeframe.

   - The harmonisation of the regulatory approach will not diminish other impediments to common rules for hybrids, such as national tax and accounting regimes and company and insolvency laws. On the contrary, a prescriptive regime for hybrids might even create a more unlevel playing field.

2. A large number of respondents therefore question whether this is the right time for an EU approach on the definition of Tier 1 hybrids. They highlight that there is no evidence that current Tier 1 rules have failed and that any hybrid instrument did not perform in the manner in which it was supposed to. At a time when market access is already very restricted, changing well-established structures once or even twice can only cause confusion in the market and impede vital access to capital. At least all proposals that go beyond the SPR should be discussed in Basel first.

3. Some respondents suggest a phased approach and, for example, to adopt the proposals on permanence, limits and grandfathering in a first step towards harmonisation without creating significant market distortions, whereas the proposals on loss absorption and flexibility of payments should be harmonized in a second step in the context of Basel's recommendations.

4. Other respondents suggest that the EU's priority should be limited to resolving only those differences amongst Member States which truly matter from a competitive point of view, while Basel Committee is reviewing its definition of eligible capital in the years to come. The central issues named by these respondents are that all EU banks should be authorized as a matter of principle to issue hybrids to strengthen their capital base and that the total limit for the inclusion of hybrids into Tier 1 capital should be harmonised.

5. A third proposal highlights that the Core Tier 1 composition is currently not harmonised throughout Europe and that this also creates an uneven playing field. The respondent suggests harmonizing Core Tier 1 calculation at an EU level in connection with the first phase mentioned above, based on IFRS accounts and on strictly harmonised filters without national discretion possibilities.

CEBS response

CEBS's proposal follows to a large extent the requirements set out in the SPR. However, the SPR is rather vague and CEBS felt that in order to create a common definition of Tier 1 hybrids further explanations and, in some cases, different or stricter rules were required (for further information please refer to the detailed feedback table in the annex of this document).

The timeline of the exercise is determined by the European Commission as the proposal responds to a letter by the European Commission of April 2007.

Degree of detail – prescriptiveness (loss absorption mechanisms)

6. Most respondents consider the proposals as being too prescriptive. In their view, they do not take into account the different national tax regimes and company and insolvency laws across the EU. Against this background the implementation of the proposal would most likely create more divergence than convergence. Some respondents also caution that the proposals might lead to a shift back from direct issuances to SPV structures to preserve tax deductibility.

7. The respondents therefore advocate a more principles based approach which could be interpreted by the individual European regulators in a way that accommodates their particular jurisdiction.

8. In the opinion of some respondents, a principles-based regulation should also enable the market to evolve and provide a sound capital base for regulated institutions. Policy should be flexible enough to apply to newly-developed instruments. A rules based approach would lead to an unintended outcome of: (1) new instruments being developed in the market (in order to work around existing legislation) without such legislation matching its pace, (2) continuing structural divergence rather than convergence across Member States resulting in the risk of an unlevel playing field being created.

9. In general, detailed rules should only be included if their impact is clear in advance and if the details are essential to harmonisation. This holds in particular for the rules on limits. Other areas, on the contrary, should be kept as flexible as possible so that the rules can be implemented at national level in an appropriate and flexible manner. This is especially the case for the three criteria loss absorption, flexibility of payments and permanence.

CEBS response

CEBS agrees with the concerns raised and has revised in particular the section on loss absorbency in order to provide more principles-based guidelines.

Equity as benchmark, consequences for market

10. A number of respondents point out that following the principle “equity as the benchmark” may have an immediate impact on the Tier 1 investor base because fixed income investors have become a very important component of a bank’s capital structure. Features such as the write-down requirements and conversion provisions run contrary to the investment restrictions of these investors, therefore preventing them from investing in the instruments and limiting the bank’s investor base. Given that similar provisions have not been stipulated for US issuances, EU issuers accessing the US market are likely to be viewed less favourably than their US counterparts.

11. One respondent points out that hybrid instruments may increase financial stability and should be more readily accepted as Tier 1 as they provide for an additional cushion protecting depositors and senior bondholders and diversify and broaden the investor base. While equity tends to be highly volatile, fixed income instruments are much more stable. The respondent believes that investors will start to treat instruments that would be required to be issued under the proposed regime as equity and will price them accordingly. This will increase the cost of capital issuance and may reduce the availability of capital. In times of stress this enhances the chances to raise significant amounts of hybrids when the equity markets are closed, and can be an important part of any solvency restoration plan.

CEBS response

CEBS considers equity to be Tier 1 capital of the highest quality and believes that hybrid capital instruments in order to be eligible for Tier 1 should be compared to equity. CEBS, however, acknowledges the concerns raised. In the course of the revision of the section on loss absorbency the former exhaustive list of possible loss absorbency mechanism has been transformed into a list of examples illustrating the principles set out in this section. Provided fixed-income instruments contain a loss absorbency mechanism in line with the revised proposal they will be eligible for Tier 1.

Interconnection of key criteria

12. A number of respondents stressed that the three key economic features of Tier 1 capital instruments (permanence, flexibility of payments and loss absorbency), are clearly inter-related and should not be taken and analysed in isolation from each other with loss absorbency being the central criterion. In the opinion of these respondents the proposals only insufficiently take into account the overlaps between the key criterion of loss absorption and the other two principles.

CEBS response

CEBS agrees that the three key criteria are closely connected. However, it was decided to follow the structure set out in the letter of the European Commission and for the sake of clarity to discuss each criterion and its particular requirements in a separate section and to highlight the interconnection with other criteria where necessary.

Loss absorption in going concern criteria

A number of respondents underline that the loss absorption in going concern means that the instrument shall help to prevent insolvency and does not hinder recapitalisation but they stressed that the permanency and the flexibility of payment are sufficient to achieve this objective. Some other respondents point out that the ability of a hybrid instrument to facilitate the recapitalisation goes beyond the SPR principles.

CEBS response

CEBS considers that the simple fact that the principal is available to the institution and the hybrid provides the flexibility to stop the payment of coupons may not be sufficient to attract new shareholders. It is easier to attract new shareholders if they will benefit fully from the return of their investment after the firm becomes again profitable due to their intervention. The new capital provided to recapitalise the institution should not be used directly to benefit existing hybrid holders. Hence, the hybrid must contain a meaningful mechanism that will make the recapitalisation more likely, in reducing the potential future outflows to the hybrids holders.

CEBS agrees that different mechanisms may achieve this objective and proposes a more principle based approach and some guiding examples of meaningful mechanisms.

Harmonization with insurance sector

13. A number of respondents refer to the joint CEBS/CEIOPS work on the sectoral rules on the definition of eligible capital for banks and insurance companies and would welcome a cross-sectoral harmonization of these definitions. They point out, however, that in many European jurisdictions rules for insurance Tier 1 hybrids have not yet been promulgated and that too detailed proposals for bank Tier 1 hybrids may create obstacles with regard of a future harmonization of the sectoral rules. One respondent also suggests that the insurance sector should be involved in the finalization of the proposal.

CEBS response

CP 17 was open to all market participants.

Some insurance regulators are very restrictive regarding the eligibility of hybrid instruments. A new approach is currently being discussed in the context of Solvency II. these discussions will not be completed until after the CEBS proposal is submitted to the Commission. CEBS's and CEIOPS's experts have informed each other about their respective work. Regarding the European Commission's Call for Advice to address the differences in cross-sectoral rules, the IWCFC recommends to harmonise the treatment of hybrids based on the CEBS Advice.

CEBS role in implementation

14. Some respondents touch upon the implementation of the new provisions. One respondent explicitly asks that an authorisation by supervisory authority should only be necessary in cases of doubt.

15. One respondent requests that national supervisory authorities, when addressed, should be able to assess and deliver a decision regarding the eligibility of newly created hybrids in a short time frame (e.g. 8 weeks). In cases national supervisors do not feel in a position to take a well-founded decision, they should be able to address CEBS and ask for assessment and decision, provided the CEBS decision would have some kind of binding character. A CEBS involvement resulting in a mere non-binding recommendation is not considered as useful.

16. Some respondents suggest that in case a hybrid instrument has gained the approval of a national supervisory authority or CEBS, it has to be accepted in the EU (EU- passport)

CEBS response

CEBS's main purpose is to improve the convergence in the supervisory practices and application of the EU Directives. In publishing this Advice, CEBS defines common principles which may be used by the supervisor in order to define the local regulations in relation to the assessment of eligibility of hybrid instruments in Tier 1 capital. This, in principle, will promote convergence between Member States.

Disclosure

17. In order to guarantee a level playing field, transparency requirements should be introduced, e.g. by way of supervisory disclosure.

CEBS response

In its Advice, CEBS has proposed that the main characteristics of hybrids must be disclosed. Disclosing these features is similar to making public the practical criteria which are applied in practice by the supervisor.

Specific comments

18. One respondent highlighted that the proposals do not take into account the unique capital structure of mutual organisations like building societies and that, as a result, it would be difficult for societies to comply with them. Building societies are unable to raise common equity.

19. The respondent refers to permanent interest bearing shares ("PIBS") which were introduced in the UK as the first and only form of external instrument to count as Tier 1 capital for building societies under the terms of the Own Funds Directive and suggests that PIBS are allowed to continue to qualify outside the innovative Tier 1 limit when including a step-up in the interest rate and/or an alternative coupon settlement mechanism.

CEBS response

According to paragraph 16 of the proposal CEBS members will endeavour to apply the prudential requirements set out in the proposal independently of the legal form of the institution[1].

[1] Institutions are incorporated in various legal forms and alternative but equivalent solutions may be necessary.

B. Specific comments on CP17

Draft text CP17	Comments received	CEBS' analysis	Amended text
Comments on specific paragraphs			
Background			
Para 7	One respondent found that the targets of "convergence in the area of hybrid capital" and "improving the quality of capital" must be separated. The first task will improve a level playing field and is in the interest of all parties involved. The latter will create unlevel playing fields with institutions outside the EU by increasing the cost of capital of hybrid instruments in the EU which can not easily be passed on to customers. This creates incentives for EU banks to have lower capital ratios than outside the EU. CEBS should restrict itself to harmonisation and not to disrupt international competitiveness of the European banking industry.	The aims of the CEBS's advice is to define the minimum criteria hybrids instruments must fulfil to be included in tier I and so, to increase convergence in the EU market. The criteria proposed by CEBS may be different than those that currently apply, at least in some countries, meaning that for these countries, the quality of hybrids may be affected.	
Terminology			
Para 16	It is stated in the paper that the term 'hybrids' is used to encompass three broad categories of instruments, one of which is non-cumulative perpetual preference shares. This is contrary to Irish legislation which defines equity capital as paid up ordinary share capital and perpetual non-cumulative preference shares/preferred stock. Irish Companies legislation permits the redemption of these instruments only out distributable reserves or out of the proceeds of a new issue of shares made for the purpose of the redemption. While the volume of preference shares issued by Irish institutions is not significant, it is our view that such instruments should not in fact be considered as hybrid instruments. At a very minimum, preference shares issued prior to the introduction of the revised definition should continue to qualify as core	As required in the call for advice of the EU Commission, the CEBS's advice aims at defining criteria applicable to all Tier 1 instruments without regard to their legal status and the legal form of the issuer. Hence, CEBS has used a broad definition of hybrids that includes also preference shares without making a distinction between different categories of non- cumulative preference shares. CEBS recognises that hybrids may include many different	No change.

Draft text CP17	Comments received	CEBS' analysis	Amended text
	Tier 1 capital in Ireland. Non-cumulative preference shares and similar instruments are extremely equity-like, especially those ranking pari passu with ordinary shares in case of liquidation. Therefore, they should not be seen as hybrid capital but treated as common equity. As such capital fulfils the objectives of Tier 1 capital there is no economic reason to limit its eligibility as Tier 1 capital. The definition of non-innovative instruments provides no differentiation to common equity. Therefore, the subsequent considerations lack clarity or tend to become too strict. Instruments are benchmarked versus common equity and under the targets of CEBS have similar features. Under customary legal principles it will then be difficult to differentiate between the treatment of common equity and such instruments when calculating Tier 1 capital. It will not be possible to maintain a clear "common equity" concept anyhow, as long as cooperative banks and public law entities or other specific forms of financial institutions exist.	instruments, some of them being extremely equity like. To acknowledge the different quality of hybrids, one solution could be to set different sub limits as proposed in option 2 of part 4 of the final Advice. However, some members were concerned that this solution could entail other disadvantages. With regard to cooperative banks and public law entities, or other specific legal form of institutions, the supervisor must apply the principle of the CEBS's proposal mutatis mutandis, taking into account its legal framework.	
Para 17	The Clarification on minority interest is welcomed as an important step towards converging capital regulation. Recognition of the underlying consolidated instrument is a consistent concept. Minority interest provided via instruments regarded as hybrid capital under the Sydney Press Release should, as a general rule, fall under the suggested limitations on hybrid capital instruments, whereas common equity will remain common equity also at consolidated level.	CEBS's proposal focus only on hybrids instruments and not to the treatment of minority interests which are not hybrid instruments. The limits proposed by CEBS apply to minority interests provided the underlying instruments are regarded as hybrid instruments.	No change.
Methodology / Scope			
Para 18	CEBS proposal should require national supervisory authorities to accept subordinated debt instruments as hybrid Tier 1 capital provided that such instruments fulfil the requirements for Tier 1 capital at an EU level.	The aim of the CEBS's advice is to reach convergence in EU in order to avoid unlevel playing field and also to avoid that a hybrid	No change.

Draft text CP17	Comments received	CEBS' analysis	Amended text
	In other words, there should be no super-equivalence at a local level.	instrument recognised at local level is not recognised at consolidated level, and vice-versa. Under the CRD, the definition of own funds is nevertheless always the responsibility of the supervisor of the individual entity.	
Executive Summary			
Para 31	It is necessary to clarify the requirement that all the conditions put forward in the paper must be fulfilled at the same time as some of these characteristics (for example: step-ups cases) may not be accumulative, either alternative.	The paper is clear on the fact that the requirements must be fulfilled by all hybrids and that some features are acceptable (e.g. step up, dividend pusher and stopper).	No change.
Para 33	Please clarify the proposal on disclosure: Must banks disclose the full terms of the instrument, the component of their capital, as well as the Tier 1 requirements met on an ongoing basis? One respondent agreed with the notions of public disclosure and easy understanding of the mechanisms of the instrument, which we believe is strongly in the interest of investors and will ensure that the mechanisms of the instrument are well-known by market participants. However, based on the evolution of the capital requirement under Basel 2's Pillar 2, they are not certain that the publication of "*the proportion of Tier 1 it accounts for and the Tier 1 requirements it effectively meets*" will provide the necessary element of regulatory discretion. We believe that the mechanism under which the instrument will work will need to be detailed, yet it may not be "easily understood". We have observed	The bank must disclose the terms of the instruments and the amount and importance of hybrids in their capital structure. There's no intention to require the disclosure of capital requirements under pillar 2. The text has been amended.	See new para. 29.

Draft text CP17	Comments received	CEBS' analysis	Amended text
	that qualified investors were often turning to investment banks to explain the mechanisms of certain detailed clauses. In any case, Tier 1 hybrid instruments falling in either of the category of with or without incentive to redeem could state so on the first page of their prospectus.		
Part 1: Permanence			
Para 66	We understand that CEBS sees it of little relevance whether or not the hybrid Tier 1 instrument is directly-issued or issued via a financing vehicle. Currently, in the capital regulations of Member States there is a difference between 'solo' and 'group/consolidated' capital with indirectly-issued hybrid issues qualifying as consolidated capital only. We would appreciate clarification as to whether a change in the regulations is anticipated in this area. CEBS is not making a distinction between direct and SPV issues. In order to ensure a level-playing-field we think this is a fair approach for all the banks operating in a jurisdiction where SPVs are necessary to obtain e.g. tax deductibility.	The criteria defined by CEBS apply to direct and indirect issues. To recognise an indirect issue in tier 1, the supervisor must assess carefully if the funds are available to support losses of the institution. The possible recognition on solo basis will depend on the different characteristics of the issue notably the mechanism that will make the funds available to cover losses on a solo basis.	Change in the text to make clear that, in case of indirect issue, the funds must also be available to support losses.
Para 89	Mandatory Convertible Securities are short-dated, and due to mandatory conversion will provide Core Tier 1 capital upon the maturity date. CEBS rightly mentions that such products allow investors to receive shares solely. Given the strong equity content of such instruments, mandatory convertible securities should be eligible as Tier 1 capital and be treated similar to Tier 1 hybrids with no incentive to redeem for as long as they are not converted. This may be subject to complementary rules.	As mentioned before, CEBS's advice does not take into account the legal form of the instrument and uses a broad definition of hybrid instruments.	

Draft text CP17	Comments received	CEBS' analysis	Amended text
Proposal 1st para (=para 35): Undated Hybrid instruments are considered as permanent if they are contractually undated.	There was broad agreement that hybrids must be available at all times. Some respondents also agreed with the proposal that Tier 1 hybrids must also be fully paid-up, whereas no respondent challenged that proposal. On that grounds, some respondents agreed on the CEBS proposal that an instrument must be undated, which they found consistent with the SPR, or, at least, had no objection, recognising that the requirement for hybrid Tier 1 to have a perpetual maturity reflects the existing status quo. Although agreeing on the requirement that hybrids must be available at all times, Many respondents rejected the CEBS proposal to require all Tier 1 hybrid instruments to be undated in order to qualify as Tier 1 capital for various reasons: 1) Permanent does not necessarily mean undated. It can be argued that a contractually undated maturity may not necessarily be required if the capital instrument has strong enough features to ensure that the capital is fully paid up and available when needed. Instruments with a long maturity are also permanently available to the issuing bank. 2) Equity, the task of which is to absorb unexpected losses before all other forms of Tier 1 capital, can be redeemed with the approval of a court and listed entities can repurchase ordinary shares in the open market at any time. 3) This goes beyond the "permanence" stated in the Sydney Press Release. In the US, for example, instruments with a 30-year maturity are recognized as Tier 1 capital. This can prove a strategic advantage	CEBS does not find it appropriate to accept dated instruments with "lock-in" features at this point of time as this would not be covered by the minimum requirements set out in the SPR. Whether or not this kind of instruments could be permitted or not in the future should be discussed at the level of the Basel Committee first. CEBS believes that it is by nature the case that instruments end with the life of the issuer. Therefore, also instruments whose maturity is linked to the life of the issuer fulfil the criterion to be undated.	No change.

Draft text CP17	Comments received	CEBS' analysis	Amended text
	when market conditions deteriorate markedly. With this in mind, we do not consider it advisable to decide at this stage that permanence presupposes an undated maturity without awaiting the results of the Basel Committee's discussions. In consequence, many respondents suggested that dated instrument with a "lock-in" feature that would allow the hybrid to be repaid at maturity only a) with the permission of the supervisory authority or b) above a predetermined point of stress in relation to the issuer's regulatory capital resources, e.g. a breach of capital requirements, should also be eligible as Tier 1 (hybrid) capital, at least when they have a long maturity. Some respondents suggested in addition, that dated instruments might not be recognised as Tier 1 capital any more in the final period of their life (e.g. the last ten years). This would in their view ensure that capital is permanently available to institutions during the period of regulatory recognition. Furthermore, one respondent proposed that shorter dated instruments callable at any time at the discretion of the bank should be recognised as <u>innovative</u> Tier 1 capital, subject to the same repayment constraints. It was agued that under this proposal hybrids would still have the same quality and that in a number of jurisdictions globally, these features are already permitted for existing dated Tier 1 instruments. In addition, such a flexible approach would mean that the terms and conditions of a bank's hybrid capital instruments can more easily be adapted to regulatory changes or changes in the legal structure or the risk profile of the institution. This would not automatically		

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	mean that institutions would issue significant amounts of short-term instruments as this would lead to higher than normal transaction costs. The call option would remain solely at the initiative of the issuer and hybrid investors never have enforceable claim to the repayment of the principal and therefore are not in a position to force bankruptcy. Hybrid capital then remains available in time of financial stress. A second issue raised by some respondents in relation to undatedness was that the permanence of a hybrid Tier 1 instrument should not only be recognised if it is contractually undated, but also if its maturity equals the life of the issuing entity or indeed its dissolution, winding up, liquidation or bankruptcy. Without materially change the substance of the instruments, such alternative wording is aimed to avoid any discrepancy with local legal frameworks under which undated instrument are not regulated. In addition, by the adoption of such proposed wording, substantially permanent instruments (such as "Mandatory Convertibles") will be qualified as "hybrids instrument" even though formally dated.		
Proposal 2nd & 3rd para: call options 2 Hybrids may be callable but only at the initiative of the issuer, always subject to prior supervisory approval and under	Some respondents supported that call options are acceptable under conditions and subject to supervisory approval. One respondent believed that the "call option" conditions set out in the Sydney Press Release are sufficiently clear and do not need significant amendment. One respondent pointed out that the possibility to include a call option in all types of hybrid instruments including preference shares has to be recognized by		

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the condition that they will be replaced with capital of the same or better quality unless the supervisor determines that the bank has capital that is more than adequate for its risks. 3 Hybrids may be callable after a minimum of 5 years if they contain a pure call option, or after a minimum of 10 years if the call option is associated with an incentive to redeem.	CEBS since it is an important feature that is required to attract fixed income investors which are the usual investors in hybrid instruments. *Eligible call dates* Two respondents were of the opinion that the Basel II framework makes it necessary for banks to manage their capital more flexibly and adjust their use of cost-intensive regulatory capital to a changing risk environment. Therefore, they believed that it would be too restrictive to permit issuers to call their hybrids only after five or ten years. They see no need for mandatory minimum periods as the supervisory approval requirement offers sufficient protection against untimely capital outflows. They acknowledged, however, that these minimum periods are determined by the SPR. They would therefore welcome if the Basel Committee addressed the issue. One respondent raised a more technical issue: According to his account several banks have employed calls without incentives to redeem at year 5 (i.e. par calls) within their otherwise standard instruments that have step-up features beginning in year 10. They propose that the wording should be clarified as that structure would (unintentionally) not be allowed under the current proposal. *Supervisory approval of redemption* One respondent highlighted that not all institutions are joint stock companies but have the legal nature of private foundations, so they do not have equity (they do not have "capital", strictu sensu). For that reason it	*Eligible call dates* The thresholds of 5 and 10 years are minimum requirements set up by the SPR. CEBS does not see a reason for deviating from them at this point in time (maintaining a level playing field). *Possibility to have a call after 5 years and a call with step up after 10 years for the same instrument* This interpretation of the requirement is indeed possible, but was unintended. CEBS believes that there is no reason why an instrument having a call option without incentives to redeem after 5 years and a step-up after 10 years should not qualify as Tier 1 capital. Clarify by splitting the sentence in two. *Call Subject to Prior Supervisory Approval* This requirement is also contained in the SPR. In addition, CEBS believes that supervisors need to have the possibility to assess the financial condition of the issuer	No change. "Hybrids may be callable after a minimum of 5 years if they contain a pure call option. If a call option is associated with an incentive to redeem, it is only permitted after a minimum of 10 years."

Draft text CP17	Comments received	CEBS' analysis	Amended text
	could be understood that this kind of institutions would not be able to replace hybrids. Therefore, they suggested replacing the expression of the Draft Proposal as follows: "under the condition that it will be replaced with ***instruments*** of the same or better quality". One respondent supported regulatory oversight on call provisions, but found this may not be necessary if the instruments are replaced with similar instruments. In contrast, another respondent suggested that, in accordance with Basel II guidelines, the early redemption of the instruments should not be subject to the issuance of new instruments. Some respondents regretted that there is no proposal to promote convergence concerning the supervisory discretion to approve redemptions. Hence, in order to provide for a level playing field following the implementation of these rules, two respondents asked CEBS to establish a common standardised approval process for repayment and a list of criteria, including capital limits. The standardised approval process should determine how supervisory approval is to be sought and how much time supervisors will have to consider the request (a reasonable period would be two weeks, or four weeks at most). The list of criteria should establish which criteria will result in supervisors approving repayment, which criteria will result in closer scrutiny of the request and which criteria can be expected to result in rejection. Two respondents proposed that redemption should automatically be allowed if, after redemption, the same amount of capital of the same quality or better is raised and/or the bank maintains a Tier 1 capital of at	before redemption. *redemption of instruments subject to the issuance of new instruments* CEBS believes that this is a general principle that is important to maintain the amount of capital an institution has. The condition can be waived if the supervisor determines that the bank has capital that is more than adequate for its risks. The point that not all institutions are stock companies is valid. Therefore, the wording should be clarified by using the term "capital instruments" instead of "capital". *Common supervisory approval procedure* CEBS believes that this issue must be decided on a case by case basis. A one-size-fits-all approach would be too prescriptive and inappropriate in many cases.	No change. No change. 2 "…the condition that they will be replaced with capital ***instruments*** of the same or better quality…". No change.

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	least 125 % of the regulatory minimum capital. *Replacement condition* As regards the verification that "capital of the same of better quality", one respondent thought that supervisory approval is not required. In order to make the procedures less "bureaucratic", banks should be allowed to settle these questions with their auditors. *Other* One respondent held the view that, due to the ICAAP processes, which determine the bank's plan on shorter and longer run and allow to compare such plans with the finally resulting ratios, supervisors have already much information at hand. In particular, when there are hybrid programs, the replacement of some hybrids with others within the course of the program will ensure permanence.		
Proposal para 4 -7 (6 = para 41): Incentives to redeem 4 Step ups and principal stock settlements in conjunction with a call option are considered as incentives to redeem. Step ups are permitted, in conjunction with a	Overall, some respondents found the CEBS proposal in that area acceptable, with one recognising in particular that in this area the CEBS proposals raises very few contradictions with existing regulation in Europe, and indeed among existing regulation there is little discrepancy from country to country. *step ups* Some respondents proposed that the provisions on the maximum step up should be changed in such a way that institutions would have the choice between accept the greater of 100bps or half of the new issue spread. Rationale for this proposal is that this would reflect both benign and volatile market conditions, giving	*Drop distinction between innovative and non-innovative* This distinction with the corresponding 15%-limit for innovative hybrid instruments is a minimum requirement set up by the SPR. CEBS does not see a reason for deviating from the SPR at this point in time (maintaining a level playing field). *No supervisory discretion for*	No change.

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call option only if they are considered moderate, i.e. if they result in an increase over the initial rate that is no greater than, at national supervisory discretion, either; - 100 basis points, less the swap spread between the initial index basis and the stepped up index basis; or - 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped up index basis. 6 The terms of the instrument should provide for no more than one rate step up over the life of the instrument. The swap spread should be fixed at the pricing date and reflect the difference in pricing on that date between the initial reference security	particular attention to recent market conditions which saw a widening of secondary market spreads for Tier 1 securities in a matter of weeks. The flexibility to chose the 50% of initial spread would also be important for lower rated financial institutions within Member States. One respondent suggested that not only a one time step-up should be permitted, but instead that CEBS should focus on the aggregate step-up amount over the call period being no larger than (i) or (ii) above. *Cap on principal stock settlement mechanisms* Some respondents agreed that principal stock settlement mechanisms create an incentive to redeem and that there is strong economic background to the concerns about dilution these may cause. Nevertheless, they did not find it necessary to specify a cap, for various reasons: Two respondents had the view that supervisors will be in a position to limit dilution on a case by case basis, so supervisors should decide about a cap on a case by case basis together with issuers based on their specific circumstances. One of them stressed in addition that in current market conditions, this may be supportive of capital transactions. One respondent saw no need to impose a cap on the conversion ratio for principal stock settlement mechanisms that involve the conversion into preference shares, which would not dilute ordinary shareholders. Further they think that the extent of any dilution is a governance matter for the shareholders to agree in the appropriate meeting of the company and should not be prescribed by the regulator. In addition, two respondents observed that principal stock settlements are not covered by the SPR and	*step-up conditions* CEBS believes that, in order to avoid competitive disadvantages, the choice about the threshold should be left to the bank. Delete "at national supervisory discretion". *Cap on principal stock settlement* CEBS believes that principal stock settlement is an incentive to redeem. Therefore, it has to be capped as for the step up. *More than one step-up* CEBS believes that it should not disqualify a hybrid instrument as Tier 1 capital if it has more than one step-up, provided that all step-ups cumulatively fulfil the conditions for a moderate step up. The first step-up cannot occur before year 10.	"…over the initial rate that is no greater than either;…". No change. No change.

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or rate and the stepped up reference security or rate, in line with the guidance given in the Sydney Press Release. 7 Principal stock settlement mechanisms must contain a cap on the conversion ratio in order to limit the potential dilution.	therefore feared any regulation in this area could lead to competitive distortions. *Incentive to redeem* Some respondents did not think that an incentive to redeem automatically weakens the permanence of an instrument, but that it rather enhances the financial flexibility and improves investor diversification. Int herir view, an instrument would not be called if the issuer were not able to refinance more efficient or when the capital were redundant. Therefore, they drew the conclusion that the approach to differentiate between hybrid and innovative instruments is outdated and should be dropped, although acknowledging that the SPR guidelines include this distinction.		
Proposal 8th para: Early redemption triggered by an event such as a change in regulatory recognition of hybrids or a change in the tax treatment of these instruments, subject to prior consent of the supervisory authority, is not considered to be an incentive to	*Early redemption subject to prior consent of the supervisory authority* One respondent believed that early redemption (subject to replacement with qualifying capital) should be permitted at *all* times, including within the first 5 years, in particular for in case of a change in the tax treatment of the instruments, as not to permit such redemption would increase the cost of the capital issue and reduce the capital resources available to the organisation. *Catalogue of eligible early redemption events* Some/ many respondents observed that early redemption is generally accepted by most CEBS members under conditions of changes in tax leading to a lost benefit from the instrument or changes in the regulatory recognition of the instrument. Therefore,	*Early redemption subject to prior consent of the supervisory authority* CEBS believes that supervisors must retain the option to restrict early redemption. In order to preserve the principle of permanency, CEBS believes that early redemption before 5 years may only be permitted in exceptional circumstances. Examples may include a change in the tax treatment or a change in the regulatory treatment. Hence, only in case of exceptional circumstances, the early redemption before 5 years seems justified.	"...these instruments, subject to prior consent of the supervisory authority, ***is permitted, before 5 years***."

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redeem.	they believe that CEBS acknowledges the necessity for banks to manage their Tier 1 capital instruments in relation to their economic value. There are a number of other important triggers, especially the loss of a particular accounting treatment (debt/equity) or rating agency treatment which should also be included in the (non-exhaustive) list of examples. Otherwise, they fear, the text of the CEBS proposal may be interpreted too narrowly and therefore early redemption could be limited to only the two mentioned cases. They reckon issuing banks should be granted flexibility to manage their capital base for any set of adverse circumstances. *Change in regulatory treatment* One respondent was unhappy that CEBS have used a change in Regulatory Recognition as a reason for redemption at all. They argue that significant costs are incurred in the issue of capital and they believe that once an instrument has been granted a regulatory status on issue (for example Tier 1 qualification) it should not lose that status through a change in the regulatory recognition rules. Therefore, once approved as a Tier 1 instrument, an instrument should always qualify as Tier 1. Consequently there would not be any need to have a clause for early redemption for a change in regulatory recognition. Another respondent found it somewhat strange that, if the regulator finds an instrument no longer eligible for as Tier 1 capital, redemption still needs the prior consent of the regulator.	*Catalogue of eligible early redemption events* The two events mentioned reflect current market practice, are clearly marked as examples and are not an exhaustive list. Nevertheless, as mentioned above, the possibility to redeem before 5 years must be limited in order to preserve the principle of permanency. Therefore, CEBS does not believe that the catalogue of events should be expanded. *Change in regulatory treatment* Changes in regulatory treatment are not exceptional and the CEBS proposal may change the regulatory treatment in some EU countries. As proposed by CEBS, the current issues will be grandfathered and the length of grandfathering must be sufficient but not necessary an unlimited period.	No change.
Part 2: Loss Absorption			
Para 107	Two respondents found that the 3rd scenario (stressed situation) goes beyond the SPR and deemed this	See below	

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	neither necessary nor justified.		
Para 108	Two respondents commented on the options mentioned in para 108. With respect to **permanent write down of coupon** one respondent remarked that from an economic perspective, this reduces the present value of the undated instrument to zero, even if it might be redeemed at par when the institution recovers, at the option of the issuer. This would limit the financial flexibility given to the issuer that can decide when to stop and when to resume those payments. The fact that coupons can be cancelled on a temporary basis is enough to allow the bank to pursue its activity and to avoid hindering a future recapitalisation (in comparison to coupon deferral for instance). Furthermore, in terms of comparison to equity, this would discriminate hybrid instruments as dividends cannot be stopped on a permanent basis. With respect to **permanent write down of principal** on a mandatory basis it remarked that this would be inconsistent with the ranking of hybrid instruments which are senior to ordinary shares. Another respondent strongly opposed a permanent write-down as it would fundamentally expropriate hybrid holders while equity holders still have exposure to all potential upside. Any permanent write-down may hurt hybrid capital raising significantly.	See below	
Para 109 109. Permanent coupon write-down permanently reduces part of the claims of investors. Permanent coupon write-down is not	One respondent pointed out that this would be pure accounting treatment creating no economic value for the company. They argued that the concept of capital write down is questionable and that instruments having such a feature are probably "more core Tier 1 than common equity".	See below	

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however as loss absorbent as permanent principal write-down. In the case of heavy losses, only the principal amount of the hybrid capital instrument may be sufficiently large to give the bank the opportunity to cover the losses			
Para 110 The temporary write-down of the principal of a Tier 1 hybrid allows reducing future expenses to the extent that future coupons are cancelled while the principal amount is written down and until the full principal amount is written up back up again. If the nominal amount of the principal is permanently written down then the holders of that instrument absorb losses. However, this seems to penalise hybrid holders compared to ordinary share holders who can benefit from potential future profits. Consequently, CEBS proposal is for a temporary write-down with a write-up of principal under certain conditions.	One respondent asked CEBS for clarification on its position between paragraph 110 and the final sentence of the conclusion on loss absorption: will CEBS accept that payment are made while the instrument is written down (at the lower principal amount for calculation of interest) or will CEBS prefer that no distribution is made for as long as the instrument is written down?	See below	
Proposal overall	Some respondents stressed their view that the financial industry's unanimous believe was that loss absorption, permanence and flexibility of payment are	CEBS agrees that a Tier 1 hybrid instrument, in order to cover losses in going concern, should	

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	closely interwoven with one another and that it is not possible, therefore, to make a clear distinction between those criteria as CEBS attempts to do. Rather, the permanence of an instrument and the issuer's discretion concerning payments play a major role in the ability of that instrument to absorb losses. Some respondents were concerned about the lack of a definition of loss and loss absorbance. They strongly suggested that CEBS should elaborate on what it understands by loss and loss absorbance. In terms of loss, in their view, loss appears to be considered mainly as an operational and accounting loss with a direct impact on the profit and loss account. It can also be an accumulation of past and current losses. From a prudential point of view, a loss could also be defined as a negative impact on own funds. It is particular not clear whether CEBS refers to the net loss for the year recorded in the profit and loss account, the accumulated loss reported in the balance sheet, loss in individual or in group accounts. 2. In terms of "loss absorbency" they expressed their expectation was that CEBS would use a precise definition of loss absorbance as a guiding principle when elaborating its more detailed requirements. In their view, CEBS did not make an attempt to do so, but merely provided a set of paraphrases which frequently result in overlaps and ambiguities. 3. <u>In their view, an instrument must meet the following conditions to fulfil the criterion of loss absorption:</u> a) the instrument must help to satisfy the claims of all non-subordinated creditors in the event of a bank's insolvency or liquidation.	help to prevent insolvency and should not hinder the recapitalisation in the case of a stress situation. CEBS believes that permanence and the ability to cancel payments are not sufficient to conclude that the instrument may facilitate the recapitalisation. It may be easier to attract new shareholders if they will benefit fully from the return of their investment after the firm becomes profitable again due to their intervention. Hence, the new capital provided to recapitalise the institution should not be used directly to benefit existing hybrid holders. A meaningful mechanism must be specified in the contract in order to achieve this objective of facilitating the recapitalisation. CEBS agrees that the mechanisms and trigger proposed in the CP 17 (written down and conversion at a trigger point of 2% of Tier 1) are too prescriptive and other mechanisms may be considered. Hence, CEBS has changed its proposal relating to loss absorbency in order to be more principle based (see after) and to enable the implementation of the criteria in each jurisdiction taking into account the local legal	

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	b) the instrument must help the bank to continue operations as a going concern – which means that (i) it should help preventing its insolvency and (ii) not hinder its recapitalisation, particularly in stress situations. _(a) To help a bank to continue its operations as a going concern, the instrument must firstly contribute to enabling the bank to meet its obligations and avoid that its liabilities exceed its assets. This implies that the instrument must make it possible that no payment leaves the bank. Instruments satisfy this requirement if: (1) coupons can be waived, (2) any repayment of a capital instrument can be prevented in certain circumstances (e.g. because repayment is permitted only with the approval of the banking regulator) and (3) if the holder of the hybrid instrument is not in a position to force bankruptcy (CEBS takes the view that such an interpretation would be too narrow and observes, more particularly, that a bank could loose the confidence of its creditors because of other circumstances to such an extent that it may not be able to continue or trade (see Paragraph 104). We do not grasp, however, the relevance of making such a comment within the framework of a discussion on hybrid instruments.). Instruments meeting those conditions as well as the deep subordination requirement constitute a class of capital which is well placed to ensure a bank's continuance as a going concern in stress situations. Their economic	framework (tax, accounting, corporate and bankruptcy law).	

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	characteristics do not, after all, distinguish these instruments from common shareholders' funds. Moreover, from a legal point of view, holders of hybrid instruments have fewer rights than common shareholders or holders of debt capital. Only accounting principles and legal classifications define them as hybrid capital. They acknowledged, that in extreme stress situations, however, the above mechanisms may not be sufficient to protect the bank from bankruptcy. One such situation would be if the bank's losses were so extensive that they completely eroded the equity on its balance sheet and result in its liabilities (debt capital, including hybrid capital instruments) exceeding its assets. However, this would bea highly unlikely scenario as the bank's regulator would have intervened long before this stage was reached because it would have been in breach of its regulatory capital requirements. Moreover, the bank would have long ago tried to access fresh capital. It might nevertheless be necessary in this highly improbable situation to reduce accounting liabilities in order to avoid over-indebtedness and thus insolvency. The customary market practice of solving this problem described below , namely management negotiating with hybrid issuers to waive a portion of their claims (see comments received on Proposal para 3 to 8) is in their view sufficient to achieve this objective. (b) To help a bank to continue its operations as a going concern, <u>the instrument should in addition not hinder recapitalisation, especially in stress situations (</u>See Paragraph 107 of the CEBS document.<u>)</u>.		

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	They found that the CEBS document fails to clarify precisely what needs to be achieved to make sure that hybrid instruments do not hinder recapitalisation. This in turn would make it unclear why it would be helpful to write down hybrids or convert them into ordinary shares. In their view, to attract fresh capital, investors need to be reassured that their investment will not be used to settle existing liabilities until the bank has completely recovered. This concern is addressed by means of the principles of permanence and flexibility of payment. 1. Hybrid instruments are perpetual. Because repayment is only permitted with the prior approval of the bank's regulators. Management will not consider repayment before the bank has recovered unless the funds are replaced with capital of at least the same value. What is more, regulators will not approve repayment until the bank has recovered. 2. Coupon payments can be suspended by the bank at any time, and will be at the latest when minimum capital requirements are breached. Hence no payments will be made until the bank has recovered. • One respondent believed that it would be helpful to provide a definition of loss; a common understanding of "loss" should be achieved before questioning about loss absorption and related issues. In its view "loss" can mean operating loss, i.e. the deficit recorded on		

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	the profit and loss account, but also balance sheet loss. The Proposal seems to suggest that CEBS considers as loss the breach of certain capital ratio thresholds.		
Proposal 1st para (= Para 43): Rank The instrument must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids are senior only to ordinary share capital.	Some respondents supported CEBS' contention that hybrid capital should always rank behind all other depositors, senior and "less deeply" subordinated creditors. However, they remarked that they should not only be permitted to be senior only to ordinary share capital but also to other more junior ranking Tier 1 instruments. One respondent sought clarification that this requirement merely says that *every* hybrid instrument is senior to ordinary share capital, in particular, that it is not meant to introduce an order of priority within the hybrid category. They argued that hybrid capital must be considered a homogenous category for prudential purposes and any internal ranking due to company law rules, for example, should not affect its eligibility as regulatory capital. A priority within the hybrid class would impose severe restrictions on the eligibility of hybrid instruments and cause international competitive distortions. For example a bank could not designate perpetual non-cumulative subordinated bonds as Tier 1 capital if it had already issued perpetual non-cumulative preference shares (because the latter would be senior to the bonds). Specifically, some respondent proposed that the word "only" will be ultimately removed from the document's wording, thus confirming that it should be sufficient for hybrid instrument to always rank junior to depositors, general creditors and subordinated debt of the institution and senior to ordinary share capital Two other respondents pointed out that in some jurisdictions equity includes also other types of shares	CEBS agrees that there can be different levels of subordination within Tier 1 hybrids. The current sentence does not prevent that. The term "hybrids" in the sentence refers to all hybrids collectively. Add "collectively" in the sentence and clarify in separate footnote.	"2.1 ... of the institution, meaning that hybrids ***collectively*** are senior only to ordinary share capital.<footnote>". Footnote:" This does not prevent that different levels of subordination exist between different types of hybrid instruments. The term "hybrids" in the sentence refers to hybrids altogether."

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	than ordinary shares. This should be reflected in the CEBS proposal by amending the text, saying that hybrid instruments should rank no higher than senior to share capital. One of these respondents specifically suggested to amend the text as follows: *"The instrument must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids are senior only to the share capital represented by the sum of (i) ordinary shares, (ii) any other category of shares such as saving shares as provided by the governing law effective in the Country of incorporation of the Company. Payment of dividends provided by saving shares treatment is directly linked to the earnings of the Company. Therefore, as far as seniority of hybrids instruments is concerned, saving shares should be considered at the same level of seniority of ordinary shares."*		
Proposal 2nd para (= para 44): Guarantee The instrument must neither be secured nor covered by a guarantee of the issuer or related entity or other arrangements that legally or economically enhance the seniority of the claim vis-à-vis the institution.	One respondent was of the opinion that this rule was unnecessary. In its jurisdiction many preference shares had the guarantee of the issuer, and this circumstance would not imply a lower quality of the instruments. Some respondents accepted this requirement but sought clarification from CEBS that subordinated guarantees of SPV-issued hybrid securities, where the subordinated guarantee offers no 'enhancement' over a directly issued hybrid Tier 1, are permitted, as this guarantee acts solely to protect the performance of the SPV and has been employed in all SPV structures across Europe. If this would not be allowed, at least grandfathering for existing guarantees should be granted. One respondent sought clarification as to whether this provision only relates to situations where a guarantee would change the subordination ranking of the	CEBS believes that the sentence is not controversial. Only a guarantee or other claim that enhances the seniority of the claims vis-à-vis the institution is not allowed. A subordinated guarantee granted by the institution to the issuing SPV is allowed if it does not increase the seniority of the instrument or accelerate repayment compared to a directly issued hybrid.	No change necessary.

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	instrument.		
Proposal para 3 – 8 (= para 45 – 50): Write down or conversion 3 In the case that the Tier 1 ratio falls below 2%, the instrument must be able to absorb losses either by ensuring that: (i) the principal of the instrument can be partially or fully written down in order to enable the institution to absorb losses. The principal of the instrument can be reinstated only out of future profits and pari passu with the shareholders; or (ii) the instrument can be converted into ordinary shares. 4 The mechanism must be disclosed and transparent to the market and in	Most comments focused on this part of the proposal, indicating that it is the area of primary concern of them. In summary, respondents observed that the CEBS proposal goes far beyond the SPR. They criticized the mechanism proposed by CEBS as unnecessary, too prescriptive, ineffective (would not achieve the desired outcome) and even detrimental (resulting in some undesirable consequences). In detail, they gave the following reasons for that conclusion: ***Unnecessary*** They were not aware of any cases since 1998 where the instrument has not met the SPR criteria, i.e. failed to meet the loss absorbance test. To ensure that hybrid instruments absorbs losses in liquidation, on a going-concern basis and in distressed situations It is sufficient that a. they are contractually undated, hence permanent, and only redeemable subject to prior supervisory approval. b. They provide the issuer with the ability to cancel payments at any time on a non-cumulative basis and for an unlimited period of time without triggering a default and give the issuer thereby full access to the waived payments, and that the supervisor can require the issuer to waive payments at their discretion based on the financial situation of the issuer.	• CEBS believes that the proposal on loss absorption should become more principles based along the lines of (but needs to go further than) the EBF proposal [3 a), b)] which should be used as general principle, replacing the explicit trigger for loss absorbency mechanisms. To give more guidance, this general principle is, however, to be elaborated further in the proposal with some examples fulfilling this general principle. The crucial point distinguishing a Tier 1 hybrid from a (lower) Tier 2 instruments is that it is loss absorbent also in going concern, and not only in liquidation. Further, to be distinguished from (upper) Tier 2 capital in terms of being loss absorbent in going concern CEBS deems it necessary that a Tier 1 hybrid instrument must from a certain point in time ("trigger point"), absorb more losses than upper Tier 2 capital. Hence, it must allow for more than deferral of the coupon (which is already a feature of	2.3. On an ongoing basis, the instrument must absorb losses to help the institution to continue operations as a going concern which means: - that it should help to prevent its insolvency (deep subordination will not help to prevent insolvency and only absorbs losses in a winding up), and - that it would make the recapitalisation of the issuer more likely. 2.4. The instrument prevents insolvency if the following conditions are met: - the instrument is permanent (see part 3); - the issuer has the flexibility to cancel coupon/dividend payment (see part 4); - the instrument would not be taken into account for the purposes of determining whether the institution is insolvent; and - the holder of the instrument cannot be in a position to

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the case of a principal write-down must be on the issuer's balance sheet (assuming this is possible from an accounting perspective). In addition, it must be legally certain that under the terms of the instrument the principal is written down on a going concern basis. 5 Future coupons are cancelled while the principal amount is written down. 6 If the bank goes into liquidation whilst the principal is written down then the hybrid holder will have a claim for the full principal amount. 7 If the bank wants to redeem the instrument whilst the principal is written down, it can only redeem it at the written down amount.	c. They rank subordinated to all general creditors and subordinated debt of the issuer, and that in case of liquidation, claims of hybrid instruments will be subordinated to the claims of all depositors, senior and subordinated debt holders. Therefore, no additional provisions were necessary, in particular no mandatory write-down mechanism or conversion into own shares. Management (and probably regulatory action) will already have been taken even before the Tier 1 ratio fell below 4%, so that the relevant regulator would be in position to decide what action would be preferable, crucially on a case by case basis resulting in a remedy that's appropriate for the institution's unique problem at the time. Moreover, they held the view that the write-down and conversion mechanisms proposed by CEBS would actually be less effective than the customary market practice in case of over-indebtedness, in which creditors holding hybrid instruments would agree to waive a portion of their claims (a permanent write-down) because, if the bank succeed in recovering and continuing as a going concern, they would obtain much more of their investment than if the bank would become insolvent (gone concern), where their claim would be deeply subordinated. On the principle that hybrid instruments should help prevent the issuer's insolvency, some respondents pointed out that it is mainly determined by Member State's bankruptcy laws (which are far from being harmonised) whether hybrid instruments are taken into account when determining whether an institution is insolvent or not (even if the legal or accounting form is debt). At least some in Member States (e.g. UK,	upper Tier 2 capital). • CEBS agrees that a Tier 1 hybrid instrument, in order to cover losses in going concern, should help to prevent insolvency and should not hinder the recapitalisation in case of stress situation. In order to help preventing insolvency the instrument must have the following features: 1) Permanence 2) Able to waive coupon payments 3) Must not be a liability in case of insolvency 4) Must not be able to trigger insolvency In order to help recapitalisation the instrument should have a meaningful mechanism that ensures that the new capital provided to recapitalise the institution may not be used to benefit existing hybrid holders. Meaningful mechanisms could for example be: 1) permanent write-down of principal 2) temporary write-down of principal without dividend	petition for insolvency. 2.5. When the issuer has incurred losses, notably when these losses cause a breach of capital requirements, it may need to be recapitalised. The new capital provided to recapitalise the institution should not be used directly to benefit existing hybrid holders. The hybrid must include a meaningful mechanism that will make the recapitalisation more likely by reducing potential future outflows to the hybrids holders. 2.6. Possible mechanisms are a write-down of the principal, a conversion into ordinary shares or other mechanisms, provided that the issuer can demonstrate to the satisfaction of the supervisor that the mechanism is capable of achieving the objective of facilitating a recapitalisation. 2.7. The mechanism must be disclosed and transparent to the market and in the case of a principal write-down must be on the issuer's balance sheet (assuming this is possible from an accounting perspective). In addition, the mechanism must be legally certain.

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Redemption at par will not be possible until the principal is completely written up. 8 The issuer must not pay any coupons until the principal is completely written up.	France) where the insolvency analysis is such that a hybrid Tier 1 instrument is not taken into account to determine whether an institution is insolvent, a write-down feature provides no tangible benefits. ***Ineffective & detrimental*** *i. General* - Tax concerns: A requirement for principal write-down and/or equity conversion might severely affect the tax deductibility of coupon payments (which is critical to issuers) in some Member States but not in others as tax law harmonisation is far from being achieved. This creates concerns in terms of a level playing field. - This may lead to an increase in SPV issuance, as issuers move towards jurisdictions where the tax implications are less severe. This would contradict the general move - which is supported by regulators, investors and issuers alike - towards direct issuance structures that avoid a number of undesirable consequences of indirect issuance such as: o significantly increased legal and operational risks, o increased cost of an issue o increased complexity of he issue and more complicated corporate structures, both leading to less transparency o extra day-to-day governance requirements. o making harmonisation even more difficult to	stopper 3) mandatory conversion into ordinary shares Other mechanisms may be accepted if they achieve the objective of facilitating the recapitalisation.	

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	achieve in practice o One respondent held the view that it will also lead to a lack of consistency between direct and indirect issuance across Europe (that had been harmonizing towards direct issuance via the non-cash cumulative (non-cash) Alternative Coupon Settlement Mechanism (ACSM), despite convergence being the goal of CEBS. o Some respondents pointed out that SPV issuance may also cause potential problems with respect to Article 70 of the CRD on solo-consolidation (for example, in some countries, there is no possibility to solo consolidate an SPV). One respondent held the view that even when a solo consolidation regime applies, as the write down happens at the SPV level, from an accounting perspective, the balance sheet of the bank (on a solo basis) would be unchanged. Accordingly, under an SPV offering structure, the write down mechanism is even more ineffective to assist the bank's recovery in financial distress. To effect a conversion of SPV securities into ordinary shares, the bank has potentially two choices, both of which can be cumbersome during financial distress: ♦ Redemption of SPV securities & repayment of the underlying on-loan in consideration for the issue of ordinary shares to the hybrid investors; in some member states redemption of SPV securities will itself need to be authorized by the Board. ♦ Purchase all the SPV tier 1 securities, in		

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	consideration for the issue of ordinary shares; sourcing the SPV security holders, in order to deliver ordinary shares can be a challenging process and will not be procedurally straight forward. Indeed, this process is akin to a liability management exercise which can be difficult even during a normal market environment. - Going beyond the SPR creates concerns about competitive disadvantages with non-EU institutions. - The situation at the proposed trigger point (2% Tier 1 capital ratio) is irrelevant in practice as management and regulatory action will already have been taken (see above) Management (and probably regulatory action). - The proposed mechanism would increase the risk for investors in Tier 1 hybrids. Therefore, if markets would accept the new instruments at all, the proposed features would increase the cost of hybrid capital for European institutions in the future, (creating competitive disadvantages with institutions outside the EU). In particular, The US institutional hybrid capital market would be particularly vulnerable if hybrid instruments were to include a write-down/up mechanism or an equity conversion feature because the it may result in equity classification by the National Association of Insurance Commissioners (NAIC) (which represents probably over 40% of the US buyer base for hybrid securities) for the purpose of determining the risk-based capital (RBC) charge for insurance company investors. Common equity designation implies an RBC charge of 30% of the principal amount of the investment, which is generally prohibitive for many		

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	insurance company investors. . European financial institutions will therefore be negatively impacted from raising cost-efficient regulatory Tier 1. - Legal concerns: Based on discussions with legal advisers, we believe that the currently contemplated loss absorption mechanism may not be compatible with Corporate Law in most jurisdictions. This would mean that what is currently the best form of issuing hybrid capital will have to be abandoned. - The proposal is not proportionate, as it will increase issuer's annual cost of (hybrid) capital (even) whilst they are a going concern for the potential but debatable benefit that in liquidation a failing bank may have an easier restructuring. - One respondent feared that Transfer and Stamp Duty may become applicable on transfer and conversion. *ii. specifically on write down* Specifically, with respect to the proposed mandatory write-down, respondents remarked the following: - As a result of the fact that from economic and legal point of view, hybrid holders never contractually waive their claim, the write-down accounting entry would not be possible (whether hybrid instruments are accounted for as equity or as debt). In particular from an IFRS perspective it would not achieve the desired outcome of creating "profit" if implemented as proposed by CEBS because the write-up is automatic. In that case, the effect of the write-down is simply ignored for accounting purposes because it is temporary and the write-up		

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	is beyond the issuer's control. - Even if it was possible, a write-down does neither improve the financial situation of the issuer nor does it change the amount of capital available to the issuer: o It would generate merely an accounting profit and not result in a cash flow. Secondly, as a hybrid Tier 1 instrument by definition already counts as Tier 1 - write-down (and indeed conversion, see below) would only increase one type of Tier 1 while decreasing another – adding nothing to the total. o On the contrary, it might even be that the accounting profit generated by a (temporary) write down may be a taxable item, resulting in a potential cash outflow and thus reducing the total amount of Tier 1, i.e. deteriorating the financial situation of the issuer. - It does not respect the principle that the relative ranking of subordination of different types of Tier 1 capital instruments should not be altered so that ordinary shareholders should suffer the first losses: If a situation arose where the value of a hybrid instrument was written down without an equivalent write down in the value of issued share capital, the subordination ranking is effectively reversed (If an issuer's capital ratio falls, distributable earnings will be affected and no dividends will be paid to equity holders, but the par value of the equity remains the same). Therefore, hybrid investors should only be at principal risk if ordinary shareholders have already lost their investment completely. - accounting concerns: about the impact that such a term would have on accounting for hybrid		

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	instruments. - The introduction of the write-down requirement would not benefit recapitalization: Any new investors to a company (particularly a troubled bank with a 2% Tier 1 ratio) will negotiate with the existing shareholders regarding dilution of their interest. The new investors will also, if they deem necessary, negotiate with existing bond holders both subordinated and senior. These negotiations will take place, in conjunction with the regulatory authorities, whether or not a write-down of the hybrid has taken place. It does not need to be documented in the instrument itself. In addition, a necessary write-up out of future profits is likely to severely hinder a potential recapitalisation: A potential investor would invest after the write-down (and would not have benefit from its "theoretical" positive impact) and before the write-up and therefore would suffer the reinstatement of the hybrid instrument principal. Thus, the write-on element, not the write-down would be the key aspect. Moreover one respondent anticipated that dividend stoppers would apply whilst the principal of a hybrid instrument was written down, which would not be palatable to anyone considering a re-capitalisation of the issuer. *iii. specifically on mandatory conversion into ordinary shares* Respondents argued that conversion into common shares would not deliver the desired outcome: - It would not improve the quality of the remaining capital of the bank to absorb future losses, as hybrid instruments are designed for this purpose,		

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	as explained before. - Further, a conversion into ordinary shares would in their view not improve the status of the general depositors and subordinated debt holders, neither on an ongoing basis nor in financial distress or in liquidation, as they are already senior to hybrid investors before conversion. At the same time, many respondents believed it would have a number of negative consequences: - The proposal ignores the different investor types to which hybrid capital and ordinary shares appeal. Hybrid capital is largely bought by fixed income investors who are typically prohibited by investment restrictions from holding equity securities. Therefore, any features that result in equity being held or delivered to fixed income investors would either result in these investors liquidating common shares immediately due to their inability to hold such instruments. This would not be desirable in times of stress as it would depress the market price of shares further, making a recapitalisation less likely, or could limit the investor base for hybrid Tier 1 issues in the first place hampering the diversification and broadening of the investor base of an issuer, which can be crucial to maintaining access to funding and capital in times of economic downturn. In addition, buyers of such an instrument may seek to hedge potential equity exposure by shortselling the underlying equity (or purchasing out-of-the-money put options), which may have an adverse impact on the share price.		

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	Another reason investors may be forced to sell is when the currency of the underlying hybrid is different to the currency of the equity being purchased, exposing the investors to foreign exchange risk, which they may not be willing to take at that time. - Accounting concerns: Auditors may conclude that an equity conversion should be presumed to have occurred for the purpose of calculating an issuer's fully-diluted earnings per share under IAS 33, potentially causing the Hybrid Instrument to be significantly dilutive from an EPS perspective. - Legal concerns: In many jurisdictions, the necessary corporate authorisations approving the issue of ordinary shares may be difficult, or even impossible, to procure (ordinary shareholders might refuse being extremely diluted as principal amount of hybrid instrument to be converted at a conversion ratio based on fair market value). Moreover, these authorisations are not perpetual, it will have to be repeated on a regular basis. One respondent explicitly argued that this mechanism cannot be applied in most Member States and thus would be unsuitable as a general proposal for absorbing loss. - If the conversion is into an unlimited number of shares, it may result in new controlling shareholders. Issuer Receptivity – Most companies would be loathe to issue a Hybrid Instrument with a mandatory equity conversion feature because, in a financial distress scenario, the provision could result in massive dilution that would undermine the company's ability to recover. Indeed, dilution is highlighted as a concern of CEBS in its comments		

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	on principal stock-settlement and ACSM. a conversion in a distress situation would create new shareholders with voting rights and interests which may well be incompatible with those of anyone seeking to re-capitalise the issuer. - Certain organisations like mutuals, savings banks and public banks may not have access to common equity as a result of their Articles of Association. Even if they have equivalent securities, these securities are not sold to institutional third party investors. As a result, the conversion would not work for them. For these reasons, some respondents held the view that conversion into common equity is unlikely to be utilized in practice by issuers. *Para 7* Specifically on para 7 of the proposal, one respondent believed this rule to be superfluous in light of the principle of permanence because (i) the bank has no obligation to redeem the instrument and (ii) the bank cannot be considered to have completely recovered until the instrument is written up to 100%. For this reason, the bank's management will not seek to redeem the instrument, nor would regulators be likely to approve redemption. Furthermore, market considerations would discourage a bank from redeeming an instrument at the written down amount as this would severely hamper its chances of attracting future investors. *Respondent's suggestions* *i. General* As a consequence, respondent's almost unanimous		

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	view was that these requirements should be removed. Instead, they promoted that institution failures are idiosyncratic and no two cases can really be considered the same. Therefore, they suggested that CEBS should outline broader principles and guidelines for European bank regulators to follow with sufficient discretion to allow optimal outcomes in individual situations. At least, one respondent advocated that, where national regulators continue to require principal write-down mechanisms, 'cure mechanisms' which would allow the issuing bank to address the situation with the possibility that the write-down may (subject to supervisory approval) be avoided if inappropriate. *ii. Specific comments* If CEBS should choose to maintain the requirements to include write-down or conversion, respondents had in addition specific comments: Two respondents found the CP does not answer adequately why a conversion into a higher form of Tier 1 capital (e.g. perpetual non-cumulative preference shares, profit sharing certificates) other than common equity, does not adequately cater for loss absorbance in a situation of financial distress, suggesting that conversion should be allowed not only into common equity but also into other forms of Tier 1 capital should be permitted. One of them recommended that CEBS offers the ability for issuers to use conversion into perpetual non-cumulative preference shares (or write-up/ write-down) as the sole accepted methods to achieve loss absorption, in order to preserve the fixed-income nature of hybrid instruments. As the conversion into ordinary shares will not work for		

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	mutual banks one respondent suggested redrafting the above mentioned paragraphs, in order to include other types of corporate governance structures (for example: cooperative banks and banking foundations). Some respondents advocated the Italian as well as the Danish and Swedish models for a write-down as potential solutions. Under the Danish and Swedish models, shareholders have the ability to write-down the principal only if the share capital and reserves have been reduced to zero, and either sufficient new capital is subscribed, or the issuer ceases to carry on its business without a loss for its non-subordinated creditors. The Italian direct issue Tier 1 template features a "suspension" clause following a breach of regulatory requirements. This provides for the suspension of: the principal amount, rights to any coupons and redemption, while a breach of regulatory requirements is occurring. One respondent noted further, that the practical application of a write-down needs further elaboration, as it remains unclear (a) How much of a write-down should be taken and (b) Do all hybrid instruments have to be written down on a "pari-passu" basis? Regarding the '**stress trigger**' of 2% of Tier 1, one respondent considered this to be too early because hybrid investors will be participating in losses prior to the level at which equity has been entirely written off. Another respondent suggested that a **write-up** of the instrument's value should occur in advance of a write up in equity value in order not to invalidate the fundamental principle of seniority of hybrid Tier 1 over common equity. Specifically on para 5 of the proposal one respondent		

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	found that unnecessarily prescriptive, and that the corporate law rules governing ordinary share capital do not 'prohibit' future dividends. Specifically on para 6 of the proposal, one respondent found it confusing, and that it contradicts para 1 of the proposal. It should be rewritten or removed. As hybrids are senior only to ordinary share capital, it seems difficult that if the bank goes into liquidation the hybrid holder will have a claim for the full principal amount (since that amount would have already been written down due to the financial crisis of the issuer). Another respondent, however, supported this suggestion, which reflected general market practice. Nevertheless, they believed this rule produced the same result as refraining from payments without a temporary write-down of the instrument. Specifically on the redemption at a potentially written-down amount (para 7 of the proposal), one respondent suggested that a floor should be included. If in a severely distressed scenario when the hybrids may have been written down to say 20% of initial nominal value then a potential new entrant into the bank may have an incentive to redeem the hybrid instruments to 'gain' from the temporarily low price. Therefore, they suggested that hybrid instruments cannot be redeemed at less than 50% of their initial nominal value or that hybrid investors should be allowed to reject a redemption below par. Another respondent noted on para 7, that this proposal would create tax problems in many European countries and it is therefore likely that the documentation of such hybrids would not allow for redemption when written down. Specifically on para 8 of the proposal, one respondent		

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	remarked that whilst this is the case currently in a few European countries for legally defined Tier 1 instruments (that are defined in law as tax deductible), in many European countries such cancellation of interest would lead to a loss of tax deductibility on direct issues of such instruments. It suggested that CEBS proposes that any interest accruing during such periods survive into liquidation, albeit in a subordinated form (perhaps pari passu with equity). Another respondent suggested that if the proposal was to be kept, it would have to be reworded as follows: *"In the case that the Tier 1 ratio falls below 2%, the instrument must be able to absorb losses either by ensuring that:* *(i) the obligations of the Issuer to make payments relating to the principal amount of the instruments will be suspended to the extent necessary to enable the Issuer to continue to carry on its activities in accordance with applicable regulatory requirements. Such obligations will be reinstated, as if they had not been suspended, in the event of winding up, dissolution, liquidation or bankruptcy, or in case of early redemption or finally to the extent that the stress situation is no longer continuing; or* *(ii) the principal of the instrument can be partially or fully written down in order to enable the Issuer to absorb losses. The principal of the instrument can be reinstated only out of future profits and pari passu with shareholders; or* *(iii) the instrument can be converted into ordinary shares* One respondent, however, aired preparedness to consider a clear and acceptable mechanism that would,		

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	in times of financial stress, makes compulsory the reduction in the capital base for interest calculations on hybrid instruments. Two respondents thought that financial instruments that have write-down features should qualify (without limitations) for core Tier 1 capital.		
Part 3: Flexibility of payment			
Proposal overall	Most respondents were supportive of the general approach of CEBS towards making payments flexible, pointing it out as the key provision to ensure that hybrids absorb losses. One respondent even fully supported CEBS' proposals with regards to flexibility of payments. One respondent added explicitly, that it would not only be necessary for hybrids to have flexible payments in order to make hybrids loss absorbing, but also sufficient to achieve this objective and that no additional requirements were needed: As long as the decision about making payments remains only with the issuer (and its regulator) and hybrid investors never have enforceable claims to the payment of the coupon (therefore, they are not in a position to force bankruptcy), the institution is able to keep, with undefined term, financial resources in time of stress.		
Proposal para 1 to 3 & 5 (= para 51 – 53 & 56): Waiving of payments 1 Issuers must be able to waive payments at any	*Para 1: At any time* One respondent explicitly agreed that issuers must be able to waive payments at any time on a non - cumulative basis and for an unlimited period. Some respondents, however, pointed out that the proposal would go beyond the respective wording of the Sydney Press Release ("the bank must have	*Para 1: At any time* CEBS recognises that tax authorities set different requirements for coupon payments to be tax deductible from one country to another. In order to preserve the quality of regulatory capital at the EU level	"4.1. Issuers must be able to waive payments on a non-cumulative basis and for an unlimited period of time ***whenever necessary***."

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time on a non-cumulative basis and for an unlimited period of time 2 If the institution is in breach of the minimum capital requirement (or another level defined by the supervisor), then it must waive payments. 3 In addition, supervisors can require institutions to waive payments at their discretion based on the financial situation of the institution. 5 Issuers must have full access to waived payments.	discretion over the amount and timing of distributions, subject only to prior waiver of distributions on the bank's common stock and banks must have full access to waived payments"). In particular, they contested the requirements "at any time" and "for an unlimited period" as unnecessary to enable hybrid instruments to absorb losses adequately. Rather, in their view it would only be necessary to waive payments in a crisis situation. The possibility to stop payments at an earlier stage (e.g. even if the bank is in profit) would in practice make these instruments more expensive and therefore more difficult to market. This is due to hybrids being generally marketed as bonds with a fixed coupon and investors expecting a corresponding margin to compensate for the higher risk of suspended payments and the deep subordination. *Para 2: Waiving when in breach of capital requirements* Most respondents commenting on this issue agreed that payments must be waived if the institution is in breach of the minimum capital requirements. One respondent suggested allowing banks to stipulate conditions/limits for the deferral of payments in the terms of the instruments, that would have to be in line with the intended supervisory purposes. The well-founded probability of a shortfall in prudential capital requirements could be such a limit. One respondent held the view that timely regulatory intervention can safely be assumed prior to a situation where minimum capital requirements are breached. Therefore CEBS should not be overly prescriptive (and limit flexibility) and stipulate a mandatory deferral	while providing the flexibility necessary to achieve a reasonable tax treatment of the instruments to avoid competitive disadvantages, the condition "at any time" should be replaced by "whenever necessary". This is sufficient to preserve the quality of capital, as a cancellation is not necessary e.g. when the financial situation of the institution is favourable. An additional paragraph in the main text will outline how to apply this provision. CEBS believes that the requirement "for an unlimited period of time" is indeed necessary to make an instrument adequately loss absorbent. Otherwise payments could be waived only temporarily which is not sufficient to absorb losses. *Para 2 & 3: mandatory trigger and supervisory waiver of payments* CEBS believes that a mandatory trigger and the possibility for supervisors to require the cancellation of payments is necessary on grounds that institutions are extremely	No change.

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	following a breach of capital requirements. Rather, it should leave sufficient flexibility on a national level to determine the most appropriate way, taking into account the specific situation in each jurisdiction. At the same time, however, in order to enhance harmonisation within the EU, no supervisor should be entitled to generally require waiving payments by a breach of higher triggers than the capital requirements. Therefore, the words "(or another level defined by supervisors" should be removed. Two respondents were worried that the proposal could jeopardize the seniority of hybrid holders with respect to the shareholders. One of them suggested rewording this proposal as follows: "The Issuer shall suspend payments of interest if both of the following events occur: I. the Issuer is in breach of the minimum capital requirements (or another level defined by the supervisor); and II. the Issuer has not paid dividends In addition, he advocated that the payment of dividends should be suspended in case the Tier 1 ratio falls below 2%. The other respondent encouraged CEBS not to include provisions that trigger an automatic cancellation (or deferral) of coupons at all. As regulators always had the ultimate authority to prohibit payments on hybrid Tier 1 (and ordinary equity) in times of financial distress, he argued, triggers for automatic cancellation were unnecessary.	reluctant to waive payments, because in their view this would damage their reputation in the market.	

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	Para 3: Supervisory waiver of payments Many respondents rejected the proposal to include a national supervisory discretion to waive payments, based on the financial situation of the institution. In their view this would undermine the key objective of harmonising the regulation on hybrids as it would eventually lead to different rules in the various Member States. One respondent acknowledged, however, that an issuer will, of course, make a cautious use of his leeway to defer or waive payments, as once payments are deferred, investor appetite for further capital issuance will be seriously negatively affected. As a consequence, the issuer's access to new capital will effectively be hampered and restoring investor confidence in the issuer will take a long time and require substantial measures to be taken.		
Proposal para 4 (para 54): Dividend pushers Dividend pushers are acceptable but must be waived when one of the supervisory events mentioned above occurs between the date the coupon is pushed and the date it is to be paid. Under those circumstances,	Many respondents feared that this proposal would invalidate the fundamental principle of seniority of hybrid Tier 1 investors over common equity holders, if following the occurrence of a "supervisory event" dividends are declared/paid or there is any other transfer of economic benefits to common equity shareholders (e.g. share buybacks), and the regulator cannot prevent this. This would deprive hybrid investors of one of the few possible ways to give issuers right incentives to service the debt by making sure that payments on hybrid capital are commensurate with the ranking of the instrument, i.e. that if payments are made on a more junior paper (e.g. dividends on ordinary shares), payments on hybrid capital become due as well. This might lead to difficulties selling hybrids with that	CEBS has recognised that there is a seniority of hybrid holders compared to shareholder, notably in accepting features like dividend pushers and stoppers. CEBS deems that the requirement to waive the dividend pusher is justified if a breach of capital requirements happens between the date of payment of the dividend to shareholder and the date of payment of coupon to hybrid holders. A breach of capital requirements may happen in case of sudden and unexpected losses. The financial situation of the firm may therefore be very different	No change of the proposal deemed necessary.

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payment of the coupons will be forfeited and no longer be due and payable by the issuer.	feature to potential investors, or at least more costly. Therefore, dividend pushers should be allowed at all times. Two respondents held the view that regulators in various Members State are entitled to stop dividend payments and, therefore, are always in a position to avoid dividend pushers being triggered. One suggestion was to require that any interest settled at such a time be settled only via ACSM. Another respondent suggested limiting the time period during which a dividend payment is able to "push" coupon payments, as currently hybrid instruments tend to provide that coupons will be paid if a dividend was paid in the previous year. For example, a proposal could be to provide that a coupon payment must be made to if a dividend was paid in the 6- month period prior to the coupon payment date (i.e. a reduction from the current standard period of one year). Some respondents agreed dividend pushers should be waived by the issuer in the event that it is in breach of its minimum capital requirement. But CEBS' proposals should also accommodate ***dividend stoppers*** with a regulatory "short-circuit" preventing the payment of coupons in a situation of financial stress (or in the event of a substantial change in ownership (such as an injection of new equity). This could enable dividend payments to the new shareholders while existing hybrids still fully support the institution. For one of them it would be acceptable that only junior (and not also pari passu) securities are included within the scope of a stopper. One respondent disagreed and argued that, for the above mentioned reasons, not only dividend pushers but also dividend stoppers should be allowed at all times.	from when dividends were paid; this problem may be worsened by the fact that dividends are generally paid annually.	

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	One respondent also claimed that the proposal has strong implications from a tax perspective for a number of jurisdictions.		
Proposal para 6 (= para 58): Distributions can only be paid out of distributable items; where distributions are pre-set they may not be reset based on the credit standing of the issuer.	Recognizing that this requirement is already included in the SPR, some respondents requested an explanation of the exact meaning of this statement. Interpretations offered were firstly that coupon payments on hybrids must not cause or increase a loss for the bank, and, secondly, that it would serve some kind of accounting issue. Anyway, the respondents doubted its necessity, believing that it should be sufficient to require that no cash is allowed to leave the company and that the deferral should not cause an equivalent amount of funds to be tied in any other way. One respondent explicitly asked to delete this requirement if it could not be explained in more detail. Another respondent asked for clarification that it does not imply that distributions can only be paid out of distributable profits.	This general principle means that the coupon/dividend can only be paid if the issuer has been sufficiently profitable. This requirement is already included in the SPR and CEBS see no argument to delete it.	
Proposal para 7 (= para 55): The instrument has to be non-cumulative in cash or kind: any coupon or distribution not paid by the issuer is forfeited and is no longer due and payable by the	No comments received		No change.

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issuer			
Proposal para 8 (= para 57): ACSM Alternative Coupon Satisfaction Mechanisms (ACSM) are acceptable solely if they are put in place for tax reasons and in cases where the issuer has full discretion over the payment of the coupons or dividends at all times. In addition they are only permitted if (i) they are made out of already authorized and unissued shares, (ii) subscribed by the hybrid holders and (iii) are exercised immediately to avoid the accumulation of debt. These instruments are limited to 15% of total Tier 1	*Overall* Broadly respondents welcomed the acceptance of ACSM for Tier 1 hybrids. One respondent acknowledged that ACSM needs to be subject to relevant conditions to ensure compliance with the principles of permanency, loss absorption and flexibility of payments. One respondent also agreed to the suggested discretionary, non-cumulative deferral provisions. Another respondent agreed with the notion that SPV based structures (until tested in a bankruptcy scenario) carry inherent cross-border legal risk. Respondents stressed that in the majority of cases, ACSM is included as a means to satisfy criteria for tax deductibility and/or to enhance marketability and that it would be essential to have a level playing field amongst EU Member States in this area. Many respondents raised concerns in relation to the CEBS proposals on ACSM. Mainly because it would restrict issuers' financial flexibility while ACSM in their view does not alter the equity like nature of a hybrid instrument. *Tax reasons* Whereas few respondents agreed that ACSM must be used and structured for tax reasons only and that they cannot, therefore, be eligible if used and structured for other purposes (such as an incentive to redeem when	*Overall* CEBS believes that the crucial point for eligibility of ACSM is that it has the same effect as a cancellation of coupon, i.e. that the core Tier 1 capital of the institution increases. Nevertheless, CEBS believes that it is not sufficient to only state this general principle, as this would entail requests from institutions as to how this principle may be fulfilled. Therefore, CEBS believes there is more merit in giving some further guidance on this subject in order to avoid differing interpretations by national supervisors. *Tax reasons* CEBS believes that the crucial point for eligibility of ACSM is that it has the same effect as a cancellation of coupon, i.e. that	"4.8. Alternative Coupon Satisfaction mechanisms are permitted only in cases where the issuer has full discretion over the payment of the coupons or dividends at all times, and only if the ACSM achieves the same result as a cancellation of coupon (i.e an immediate increase in the capital). To meet this condition: - The deferred coupons must be contributed without delay to the capital of the issuer in exchange for newly issued shares having an aggregate fair value equal to the amount of the coupon/dividend. - The obligation of the institution is limited to the issue of shares. Hence, the issuer must have already authorised and unissued shares. - The shares may be, afterwards, sold in the market but the institution must not be committed to find investors for these shares. If the sales proceeds are less than the coupon, the issuer must not be obliged to issue again new

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capital after deductions.	mandatory after first call date), the majority of the respondents commenting on the subject did not think that ACSM should only be permitted if they are used for tax reasons, for various reasons: - Regulatory capital treatments should not be tied to any particular tax, accounting or rating agency treatments. - It could create distortions under level-playing field aspects. - Incidentally, it is usually unhelpful for any tax analysis if a transaction includes elements solely for tax reasons. - Even if not required for tax purposes, ACSMs improve the financial flexibility of the issuer: they preserve the cash resources of the issuer and provide loss absorption, whilst improving the holders' chances of eventually receiving the payment which is settled through the ACSM, thereby improving the marketability of the instrument. - Limiting ACSM application only to optional interest deferral would undermine the tax deductibility of directly-issued hybrid Tier 1 instruments in those EU jurisdictions that require an instrument to be effectively cumulative (i.e. coupons are settled either via ACSM or are due in liquidation) to be tax deductible. That would force issuers into complex indirect issuance structures, which would be inefficient for all parties concerned, unless CEBS mitigates this by requiring assessment of Tier 1 requirements only upon a consolidated basis rather than (also) on solo basis.	the capital of the institution does not decrease. As long as this condition is fulfilled, it seems less important whether the motivation for an ACSM is solely tax reasons. Given that condition, it does, therefore, not seem necessary to maintain this condition.	shares to cover the loss incurred by the hybrid holders."

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	made out of 'already' authorised and unissued shares Not many respondents commented on this requirement. One respondent agreed with the requirement as it replicates the standard methodology available for existing Tier 1 capital instruments with this feature, although it raises some corporate law issues and hinders issuers to place treasury stock, which would also allow to free Tier 1 capital. Two respondents saw no need to restrict the ACSM to already authorized and newly issued shares as - the authorisation of new capital is a simple process which can be swiftly completed, so the word 'already' should be removed. - The requirement to only allow satisfaction with authorised share capital should not apply to unlisted or mutual organisations in order to not penalise them compared to publicly listed organisations. - treasury shares should also be eligible to settle deferred coupons via the ACSM.		
	Issued to hybrid holders only Many respondents rejected the requirement that hybrid instrument holders subscribe for any shares issued under an ACSM as too prescriptive and even counterproductive, for various reasons:	*Issued to hybrid holders only* CEBS acknowledges that this requirement might prove difficult to implement in practice. It is important, however, that the deferred coupon is contributed to	

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	- The majority of hybrid buyers are fixed income investors and as such are not willing to hold common shares or may even be prevented from doing so by their investment mandates. Consequently, this requirement could seriously impact the attractiveness of hybrid instruments for investors, limiting the marketability of the instrument and/or increasing its cost. - The proposed requirement does not improve the financial position of the issuer (nor of depositors and senior creditors): The financial position of the issuer would be the same if it were to (A) deliver shares having a specified value to hybrid instrument holders in lieu of payment or (B) sell shares having the same specified value to other investors and deliver the proceeds thereof to hybrid instrument holders in lieu of payment. Hence it is difficult to see how this requirement can be justified from a regulatory perspective. - CEBS fails to give a justification for this proposal. If the concern relates to finding a market for such shares this seems unjustified: In practical terms the amount of shares required to settle coupons (approx. 5 to 6% of 15% of Tier 1) is very small relative to bank market capitalisations such that monetisation opportunities are likely to be readily available. If the concern is that the bank may have some sort of liability unless they give the actual shares to hybrid holders, this is unjustified either as the institution's liability is restricted to any cash actually raised by sale of the shares. - In certain jurisdictions the delivery of shares direct to investors may not actually be feasible. From a legal perspective, in some countries shares need to be sold for some consideration – there needs to be	the capital of the issuer via new shares and that the commitment of the issuer is limited.	

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	some form of paid-in capital to add to the balance sheet. - hybrid investors are exposed to losses a) in case of coupon cancellation and b) in case of financial difficulties as these are listed and susceptible to loosing value in adverse circumstances. Therefore, CEBS should allow ordinary shares issued as a result of an ACSM to be sold to third parties and the proceeds of the sale to be used to fulfil the investor's claims. *Immediately* Many respondents found that immediate exercise of ACSM should not be required, for various reasons: - It is not necessary, as o Coupons could be postponed indefinitely and as deferred coupons will rank pari passu with the underlying instruments, it is difficult to imagine how an overhang [of liabilities over equity] could be created to the detriment of the solvency position of the institution. o Mechanisms exist to ensure that hybrid instruments do not create liabilities which affect the going-concern position of the issuer. Therefore, the accumulation of deferred payments is not a problem in their view. o An ACSM does not require the issuer to use the proceeds from any new equity issuance to settle deferred periodic payments; an issuer	*Immediately* CEBS believes that this requirement is necessary, as unpaid coupons are debt that should not be allowed to accumulate.	

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	may obtain new equity capital and continue to defer periodic payments on a Hybrid Instrument indefinitely, i.e. there is no danger to impair the issuer's ability to recapitalise because potential new equity investors would be reluctant to invest if proceeds from the equity issuance were used to settle deferred periodic payments on a hybrid Instrument. - It decreases the financial flexibility (that issuers look for when incorporating ACSM into their instruments so that they can avoid issuing their shares when market conditions are unfavourable) at the time when they most need it. In contrast, the CEBS proposal would force issuance of shares during time periods of financial distress which may not be beneficial for institutions during such periods (the share price is likely to be low anyway so the forced issuance may result in excessive dilution, and share issuance puts even more pressure on the share price) or even feasible. - A forced exercise of the ACSM after a certain lapse of time could interfere with other capital market activities aimed at restoring the capital adequacy position of the institution. - In certain jurisdictions, in order to preserve tax deductibility, the claim to deferred interest must never fall away and if it does after one year then tax deductibility will be jeopardised. - Leaving timing issues in the hand of the issuer may allow better market management, with the strong possibility that such an ACSM could be activated immediately to preserve investor's interest. Rather, the best option would be to provide full flexibility to the issuer to decide when the shares		

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	should be sold, being able to defer any payment indefinitely if necessary, until it is out of stress. Some respondents argued that there are other possible ways to achieve the objective of avoiding accumulation without creating the problems connected with immediate exercise: - making the deferred interest ranking junior to the hybrid securities (i.e. deferred interest rank pari passu with shares until they are paid). This was accepted by Moody's as sufficient to avoid accumulation. - a non-cash cumulative ACSM, exercisable immediately as per the Proposals and subject to a market disruption event. This would mean that any "obligatory" payments created would never lead to an actual outflow of cash. This pragmatic approach would not only alleviate CEBS' concerns as no cumulative liability is created beyond the payment date, and also simplify the relevant tax (i.e., the Profits Dependency Test should not apply) and accounting implications. - Therefore, one respondent proposed the requirement in subparagraph (iii) that ACSMs should be amended to read 'are structured to avoid the build up of debt'.		
	15% limit for instruments with ACSM Many respondents did not agree that instruments with ACSM should be limited to 15% of total Tier 1 capital, for various reasons: - ACSM do not provide the issuer with an incentive to	*15% limit for instruments with ACSM* CEBS reckons that the main economic reasoning for the limit on ACSM is to limit the dilution effect when an institution has a	Sentence in proposal deleted.

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	redeem, i.e. do not alter the permanence of the instrument - CEBS goes beyond the SPR when proposing to include principal stock settlement and instruments with ACSM features into the 15 % limit, putting EU institutions at a competitive disadvantage vis-à-vis their global competitors, particularly from the US and Japan, which in turn were likely to weaken the stability of the EU financial system. - the flexibility for issuers to issue Tier 1 with ACSM for tax reasons should not be restricted. - ACSM clauses do not result in any economic cash outlay of existing financial resources either during financial distress or even when a financial institution has restored its financial resources - there is no difference from a leverage perspective of skipping a coupon payment and paying one in equity. - In case of liquidation, the rank of ACSM is the same as the (subordinated) ranking of the underlying instrument, ensuring that hybrid holders' claims are not met before all more senior claims are satisfied. Any coupon to be satisfied with the use of ACSM, and for which the ACSM mechanism would not yet have been used, remain to be satisfied with the ACSM. - By subjecting instruments with ACSM to the 15% limit, the CEBS proposal introduces an unfair and unsustainable competitive disadvantage between issuers. Therefore, the 15% limit should apply to true innovative instruments only, i.e. with a principal	great proportion of these instruments in its Tier 1 capital. However, CEBS acknowledges that the exercise of the ACSM needs the approval of shareholders. An unintended drawback of maintaining this limit might be that institutions would issue more hybrids through SPV structures. Overall, the 15% limit for instruments with ACSM should be dropped. *Other instruments than common shares* CEBS requires an issue of common shares because the ACSM must achieve the same result as a cancellation of coupon, hence no depletion of core Tier 1 capital. These requirements may be applied mutatis mutandis to institution for which core tier I is not represented by common shares.	

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	incentive to redeem which give the instrument a dated nature. Some respondents believed that mechanisms can be put in place to mitigate any concerns. For example, the number of shares issued under ACSM in any given year could be limited to a pre-specified maximum, thus eliminating concerns about excessive dilution. *Other instruments than common shares* Some respondents indicated that settlement securities should not be limited to just ordinary and preference shares but to any Tier 1-qualifying items This was especially important in the context of entities which have no access to common share capital and would need payment in kind if tax deductible direct issuance was to continue to work.		
Part 4: Limits to inclusion into Tier 1			
Para 147	One response claimed it remains unclear to what extend the issuers as main affected parties could contribute to this view.		
Para 148	One respondent believed that the quite different approach of the rating agencies in no way should influence the regulatory capital discussion. It remains a management decision how to act in case of differing opinions of rating agencies and regulators. It would be a totally wrong and very disturbing signal if rating agencies could influence regulatory supervision of banks.		

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Proposal Overall limit: ordinary shares and disclosed reserves/retained earnings represent at least and at all times 70% of the required Tier 1 capital. When an institution operates above the required Tier 1 capital, ordinary shares and disclosed reserves/retained earnings represent at least and at all times 50 % of the total Tier 1 after deductions. Some CEBS members want the same 70% limit to prevail in all cases as in their view this would be more in line with the stated aim of improving the average quality of capital. Limit for instruments with incentive to redeem	***Overall*** Some/Many respondents were in general agreement with the CEBS proposals to harmonise the limits applicable to hybrid Tier 1 instruments across Europe in order to achieve a level playing field. They pointed out that the proposed limits should be applied on a uniform basis across Europe. In particular, regulators should not have any national discretion in order to impose different levels in their country. On the other hand, while supporting this view, one respondent suggested country-specific exceptions should be considered where institutions have no access to common equity. One respondent also agreed that low capitalised banks should have a higher proportion of core Tier 1. One respondent rejected any fixed limits as being arbitrary, not principles-based and acting as a disincentive to issuing capital above the prescribed limits because it is not counted as eligible capital even if it meets the eligibility criteria of capital and improve the capital base of an entity. One respondent pointed out that the CEBS document always refers to "common shares and disclosed reserves/retained earnings", but that common shares are not the only class of shares in Europe. ***Calculation of limits*** *i. deductions* Many respondents asked for guidance on how to take into account the various kinds of deductions when	***Calculation of limits*** CEBS agree that it is necessary to clarify the calculation of the limits. CEBS proposes that the	*Option 1* 5.3. <u>Limit for instruments with</u>

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and instruments with ACSM: 15 % of Tier 1 after deductions (this limit is included in the overall limit to hybrids)	calculating the limits, pointing to a lack of clarity in several respects in the consultation paper, allowing for different interpretations. One respondent understood that the limits take Tier 1 capital after deductions for goodwill as a benchmark. They found such an approach likely to contribute to achieving a level playing field within the EU as harmonised rules are currently lacking regarding (i) the composition of Tier 1, (ii) items which need to be deducted and (iii) risk weightings. One respondent understood that the CEBS proposal could be read as changing the current rule for calculation of the 15% limit (after goodwill but pre-deductions which impact 50% Tier 1 and 50% Tier 2) so that all deductions are taken into account before the limits are calculated, and considered that not to be justified. One respondent was unclear as to whether Tier 1 limits will be net of a broad set of deductions or just the deduction of goodwill under the Sydney Press Release, and suggested to include only the goodwill deduction for the purpose of calculating limits. One respondent specifically asked for clarification on how to take into account minority interests and deductible elements such as goodwill as well as the use of International Financial Reporting Standards for the calculation of these limits. Two respondents expressed the expectation that - the limits for inclusion of hybrids into Tier 1 capital will be applied consistently with the way the Tier 2 limit is currently calculated in the CRD [i.e. before deductions that have to be applied 50% to Tier 1 and 50% to Tier 2	limits will be calculated in accordance with the current regulation in the CRD with regard to the limit for additional own funds. Hence, the limit must be calculated on basis of total Tier 1 taking into account only specific Tier 1 deductions , but not the deductions from original and additional own funds.	<u>incentive to redeem</u>: At all times 15% of total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds). This limit is included in the overall limit on hybrids. *Option 2* 5.5. <u>Limit for instruments with incentive to redeem</u>: At all times 15% of total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds).This limit is included in the overall limit on hybrids.

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	(Reference is made to the limits for total Tier 2 and lower Tier 2 as defined in Articles 66-a) and 66-b) and to the 10% threshold for non material participations in other credit institutions as defined in Article 57-n)]; and - that they would be calculated on *Total* Tier 1 (including deductions for own shares, intangibles assets and material losses of the current financial year) The rationale for this treatment is that a deduction requires surplus Tier 1 capital to have the same level of targeted own funds as before deductions and that this surplus Tier 1 capital should be of the same composition as the Tier 1 capital before deductions (i.e. a mix of core Tier 1 capital and hybrid Tier 1 capital), and not only of core Tier 1 capital. . {By way of example, assume a bank had 100 of required Tier 1, divided in 70 of core Tier 1 and 30 of hybrids and no deduction. Subsequently, this bank buys a material participation and has to make a deduction in an amount of 10 from its Tier 1. It has to raise an additional amount of Tier 1 that should be allowed to be funded through 7 of core Tier 1 and 3 from hybrids. If the 30% limit were to be applied to Tier 1 after deduction, the additional own funds should be funded by core Tier 1 only.} One respondent found that limiting instruments with incentives to redeem (and with ACSM) to 15% of Tier 1 after deductions is contrary to Basel 2 where, once the basic capitalization test is met the calculation of the 15% limit on innovative capital instruments (and all the other gearing ratios) is made against a Tier 1 total calculated before deductions. One respondent rejected the notion of calculating the		

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	limits after taking into account deductions as not consistent with the current treatment in a number of jurisdictions. *ii. Calculation of minimum 70% limit of core Tier 1 minimum of required Tier 1 capital* Two respondents found it necessary to clarify the way in which the minimum 70% limit of required Tier 1 capital is calculated as the current proposals could in their view lead to (serious) misunderstandings. One respondent requested clarification on the application of the 70/30 or 50/50 rules around the 4% Tier 1 limit, pointing out that it were unclear whether the minimum of 2.8% (70% of 4%) is applicable at all times up to a ratio of 5.6% (50% of 5.6%), or is 50%, if core tier 1 > 2.8% the right approach?. Two other respondents concluded that the CEBS proposal could be read as a first 70% minimum level of core Tier 1 for the minimum required Tier 1 amount plus a second 50% minimum level of core Tier 1 for any amount of Tier 1 in excess or the minimum required Tier 1 amount, and was of the opinion that such a dual mechanism were not workable. The respondent's suggestion was that core Tier 1 should be greater than the lower of: i. 70% of the minimum Tier 1 requirement (i.e. 2.8 % of risk weighted assets, without taking into account any additional Tier 1 requirement under pillar 2); and ii. 50% of the actual Tier 1 amount		

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	15% limit One respondent expressed understanding that CEBS considers limiting instruments with an incentive to redeem. He/She pointed out, however, that if instruments are trading above their "stepped-up margin", as observable in recent months the incentive to redeem has diminished. Some respondents proposed the 15% limit for innovative hybrid instruments should be dropped, because: - there is no serious analytical background for a 15% limitation. The only reason for its application seems to be that it is included in the current regulation, in particular the SRP, - at the time the 15% limit has been set in the SPR, the market for hybrids was less developed than it is today. Today this limit has become obsolete. They recognized, however, that this limit is provided as such, even if at issuance, by the SPR. Therefore, they suggested to at least revisit level of this limit in the upcoming discussions to be held at the BCBS level. ***Overall limit*** Some respondents explicitly appreciated the opportunity to issue more hybrid capital within Tier 1 capital. A vast majority of the respondents argued that it should be possible for hybrids to account for up to 50% of Tier 1 capital without having to meet additional		

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	rules regarding the composition of Tier 1 capital. They argued further that this would be in line with the SPR. Divergence from this rule would risk placing EU institutions at a competitive disadvantage compared to institutions regulated outside the EU. Therefore, in the interest of a level playing field, any discussions about tighter limits should be conducted by the Basel Committee only. *i. Option 1* The link to required capital introduced in option 1 by requiring that ordinary shares and disclosed reserves/retained earnings should always represent at least 70% of the required Tier 1 capital was almost unanimously rejected as counterproductive, on various grounds: • it is seen as excessively complex • It would put EU banks at a competitive disadvantage vis-à-vis their global competitors. • the intended switch from 50% to 70% creates a cliff effect: which could cause severe additional problems in times of stress while, paradoxically, the actual amount of Tier 1 qualifying capital remains unchanged. In addition, it might lead to an increased the volatility and pro-cyclicality of the capital ratio. • Moreover, appropriate planning of capital issuance becomes difficult if limits put on hybrid instruments are linked to the actual level of the Tier 1 ratio, especially for institutions making strong use of the limits (since there would be a constant danger of exceeding certain limits).	***Overall limit*** CEBS's members agree that the overall limit may be 50 % of Tier 1 but some members have concerns with regard to impact of this higher limit on the overall quality of capital. In consequence, CEBS puts forward the following two options for consideration. The aim of the two options is to preserve the quality of own funds by ensuring that core Tier 1 is still predominant because core Tier 1 is more loss absorbent than hybrid instruments. In the two options, the overall limit for hybrids is also 50 % of Tier 1. Option 1 is the one proposed in CP 17 that sets a minimum level of core Tier 1 compared to the capital requirements; option 2 sets limits for hybrid instruments that take into account the different quality of these hybrids. Option 2 was not included in	The two options proposed by CEBS are *Option 1* 5.1. <u>Overall limit</u>: Tier 1 hybrids may not at any time represent more than 30% of the required Tier 1 capital. 5.2. When an institution operates above the required Tier 1 capital, hybrids may represent up to a maximum of 50 % of total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds). *Option 2* 5.4. <u>Overall limit</u>: Instruments which have additional features that make them behave in a way similar

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	• At present regulators in six EU countries, accounting for over 70% of all hybrid capital instruments issued in the EU currently, allow already a limit of 49% or 50%. There were no evidence that there are problems regarding the capital structure in those countries. Furthermore, a limit set below 50% will negatively impact banks in jurisdictions which today allow a 50% limit already. It would at least have to be implemented gradually to allow issuers with hybrid Tier 1 capital above the chosen limit to gradually increase their core Tier 1 capital. • Pillars 2 and 3 of the revised capital framework (Basel II) would offer sufficient possibilities to counteract any isolated instances of excessive reliance on hybrid instruments. One respondent rejected the trade-off suggested by CEBS between clearly defined eligibility criteria for hybrid instruments and limits for their inclusion in Tier 1 capital. In their view CEBS should clearly define what requirements hybrid instruments must satisfy to be recognized as Tier 1 capital. Then there would be no reason for restrictions that go beyond the prevailing limits. One respondent found option 1 of the CEBS proposal unclear. Their understanding was that CEBS' intention is to permit institutions operating above the pillar 1 minimum tier 1 capital ratio (of 4%) a hybrid limit of 50%. If, however, the 50% limit refers to individual prescribed guidance rather than pillar 1 requirements, it exposes banks to significant risk of derecognition of capital at the worst possible time (i.e. the bank "falls off the cliff" from a capital perspective). This can be illustrated as follows: Where a bank was operating at a Tier 1 level above the minimum (e.g. 6%, comprising 3% core Tier 1 and	CP 17.	to equity must not – together with all other Tier 1 hybrid instruments – represent at any time more than 50% of the total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds). For example, through mandatory conversion into a pre-determined amount and number of shares established at the moment of the issue of the instrument or through write-down of principal pari passu with shareholders. All other Tier 1 hybrid instruments must not represent at any time more than 25% of the total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds). The loss absorption mechanism shall be activated when the bank is in breach of capital requirements as defined by article 75 of Directive 2006/48/EC.

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	3% hybrid Tier 1), and for some reason the regulator prescribes that 6% level as the minimum, the bank's Tier 1 immediately falls (off a cliff) to ~4.3% (i.e. the permitted hybrid Tier 1 for 3% core capital, would be ~1.3%), and would be required to raise 1.2% of core Tier 1 to maintain a 6% total Tier 1 ratio. This would cause the bank to increase its capital requirements by such a substantial amount at a time when it most needs capital, which would be an extreme scenario. Managing its capital requirements in such a situation would not only be difficult, but might cause confidence issues which would cause the bank to go into further distress. *Applied only to a uniform fixed minimum requirement* Some respondents agreed or at least did not object that institution should always hold a minimum level of capital purely in equity form. They suggested, however, to alter option 1 by fixing a uniform minimum level for capital, ordinary shares and disclosed reserves/retained earnings of 2.8% of Tier 1 capital to be covered with equity (i.e. not to link it to the individual minimum level required by the respective supervisor). The rationale given for this suggestion is to simplify and clarify the limit on required Tier 1 capital, and not to put institutions in countries which oblige their institutions to keep a ratio of capital, ordinary shares and disclosed reserves/retained earnings beyond a required minimum of 2.8% core tier 1 at a competitive disadvantage, respectively. Two respondents thought that beyond this level, hybrids should be allowed up to 50% of tier 1 capital. Two other respondents held the view that there would be no reason for the amount of hybrids in excess of the regulatory minima to be limited at all and that it		

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	should be left to the institution to decide upon the appropriate level of hybrids in excess capital. This would be justified because redemption can only take place with the permission of the regulator and with replacement (unless it is determined that the institution has surplus capital). *Individual limit* One respondent suggested that any deviation from a general 50% limit on the proportion of hybrids in Tier 1 capital should be determined on an individual basis, in order to give supervisors more flexibility. *Limit above uniform minimum requirement not necessary at all* *ii. Option 2* Given that option 1 was already rejected by a vast majority of respondents, introducing a 70% limit in all cases - as suggested by some CEBS members was implicitly or explicitly rejected as well. In addition to the arguments put forward against option 1, one respondent found that this proposal would not foster the aim of improving the quality of capital since it would work only at a Tier 1 ratio above the required capital and would, therefore, introduce a competitive disadvantage for well capitalized institutions. Another respondent was of the opinion that the eligibility criteria suggested by CEBS, in particular regarding loss absorption (write-off) make tier 1 hybrids equal to equity. Under these circumstances they saw no justification for a reduced 30% ratio for the suggested tier 1 hybrids. *iii. Scope*		

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	One respondent stressed that saving shares should not be considered as hybrids instruments. Therefore the new limits related to hybrids instruments should take into account only hybrids instruments, excluding any other category of shares such as saving shares. ***At issuance*** Many respondents argued that CEBS should not deviate from the SPR in terms of limits. The percentage of hybrid instruments should therefore continue to be measured at the time of issuance, not at any time. The reasons given for that are: - The Eligibility of an instrument should be determined at the date of issuance, given its characteristics at that time. It should not be impacted by movements in levels of other capital as the terms and conditions attaching to the hybrid capital have not changed, still providing the institution with the required flexibility of payment and the ability to absorb losses. - Gearing effect, i.e. if equity is reduced then the hybrid Tier 1 may no longer fully qualify despite the fact that it is fully paid-in capital, thus creating a "double impact" effect on Tier 1 capital in times of stress, potentially exacerbating a crisis. Particularly dangerous given the volatility of reported shareholders' equity under IFRS and The greater volatility of capital requirements under Basel II. One respondent even feared that this may cause downward spiral: another that this would make capital management all but impossible. A third saw the danger that a disqualification of capital could	***At issuance*** CEBS believes that the limits should apply at all times. This is in accordance with the present supervisory practices on limits in the CRD and outside the EEA. The application only "at issuance" would raise concerns regarding a level playing field.	A new paragraph (119) is included in the text:

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	even trigger a requirement (within the terms and conditions of the Instrument) for the issuer to make the coupon payments as the capital no longer qualifies for regulatory purposes. - It would prove extremely difficult for institutions to manage this restriction on any basis other than at issuance (for example, it would be undesirable for foreign exchange movements to influence the composition of capital, where issuance is non-Euro). Two respondents recognized, though, that there are some merits in requiring that the 15% limit be observed at all times. In particular any foreseeable event that would reduce the Tier 1 amount (such as a share buyback or the goodwill resulting from a planned acquisition) should not permit the 15% limit to be exceeded. In contrast, in case of unforeseen events as losses brought forward, limiting the innovative hybrids to 15% of a reduced Tier 1 amount would accelerate the decline of the Tier 1 ratio. Therefore, they advocated a compromise solution that the 15% limit could be exceeded only when this excess would result from a net loss or a reduction of the reserves.	Further, the requirement to adhere to the limit at all times provides ample incentive to banks to exercise discipline over their level of gearing. The current waiver of the limit on Tier 2 capital under exceptional circumstances should be extended to the hybrid limits and be applicable to all hybrid limits. This possibility to waive the limit could also be seen as addressing the concern relating to the cliff effect of option 1 and the possibility to raise more hybrids if necessary in case of an emergency situation.	"119. CEBS also proposes that the limits apply at all times. However, as for the limits relating to additional own funds, the supervisor should have the ability to waive the limits temporarily in exceptional circumstances." … and the proposal: 5.6 The limits apply at all times. However, the supervisor should have the ability to waive the limits temporarily in exceptional circumstances.
Part 5: Grandfathering			
Para 158	One respondent sought clarification that hybrid capital not accepted as Tier 1 capital becomes <u>Upper</u> Tier 2 capital.	This will depend on the characteristics of the hybrids which must also comply with the eligibility requirements for upper tier 2 instruments to be considered as such.	
Proposal o Instruments	*Overall* Some respondents remarked that grandfathering of	*Unqualified grandfathering for existing instruments*	No change.

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with an incentive to redeem: instruments remain eligible until the first call date. o The eligibility of all other instruments (including hybrids with incentives to redeem which are not callable and those which are callable but have not been redeemed) will be gradually reduced over a period of 30 years (see below). Any redemption should be made at the initiative of the issuer and subject to prior supervisory approval.	existing instruments would be essential as the volume of outstanding hybrids instruments which may cease to qualify under the proposed rules could be substantial. Some respondents approved CEBS' proposal to limit the impact of the proposed common regulatory approach by introducing a grandfathering clause, in particular, they were supportive of the proposed gradual reduction over a period of 30 years. One respondent described the proposed grandfathering rules as in line with expectations, giving further confidence to most market participants that they will be able to start adjusting the documentation of their future Tier 1 hybrid transactions shortly after the local legislations are put in place. *Unqualified grandfathering for existing instruments in general…* The grandfathering provision should be unqualified, i.e. all existing hybrid instruments that at issuance qualified as Tier 1 capital under the rules that are currently in place in that jurisdiction should continue to qualify without limitation. The rationales given for that proposal were: - The grandfathering provisions proposed by CEBS are of major concern to our members. CEBS have recognised that the proposals will render the majority of current EU-issuance as ineligible. It is therefore recognised the proposed common regulatory approach will have major impacts for the hybrid market as it currently stands. The grandfathering provisions as set out in the paper do not in our view sufficiently address this. - It is not appropriate for Banks to be operating in a	The stricter criteria proposed requires that instruments not fulfilling the criteria must ultimately be disqualified as Tier 1 instruments. CEBS considers that this is in line with the Commission's mandate to improve the quality of capital within a reasonable period of time. CEBS believes that the grandfathering provisions must apply to all hybrids instruments and that 30 years is a reasonable timeframe for firms to redeem their outstanding non-compliant instruments without causing market disruption.	

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	capital environment whereby a previously qualifying capital instrument can be rendered ineligible by a change in the rules. - In general grandfathering provisions, where instruments no longer qualify as regulatory capital either after a pre-set period of time or after the first call date, have a number of adverse consequences. Both options effectively date tier 1 instruments. This is likely to lead to the repricing of instruments in the secondary market. Such grandfathering options might also reduce the flexibility that firms have over their capital management and may put firms under strong pressure to redeem non-qualifying instruments. - From an economic perspective, hybrid instruments created under the current regulatory framework are still equity-like items which remain worthwhile to both shareholders and regulators. Even if some new specific provision makes the major part of current hybrid instruments allowed today in Tier 1 capital ineligible, this does not mean that they would no longer meet regulatory needs and would not constitute a useful and diversified source of "own funds". - instruments which were created under the previous regulatory framework will naturally be called and will need to be replaced with new issuances. This, in addition to the banking sector growth, will lead to a decrease of the proportion of own funds composed by historical hybrid instruments. However, the replacement of hybrids can take place only if a deep liquid market for hybrid instruments corresponding to the new regulatory framework exists. If market forces fail to deliver such a market, the issuer will face a deadlock where he cannot replace the current instruments		

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	with new one complying with the new regulation and where those instruments do no longer qualify as regulatory capital, putting therefore the solvency ratios into unnecessary pressure. - No definite decision on grandfathering should be made until the Basle Committee concludes its discussion on the definition of capital. Should the Basel Committee adopt in the future a wider grandfathering clause on existing hybrid instruments, this would create a competitive distortion between European and non-European market participants. In this context it needs to be reminded that the SPR advocated for a total grandfathering. *...and for specific instruments* A number of respondents advocated permanent grandfathering for specific instruments or specific cases: One respondent suggested that in Member States in which the current requirements for Tier 1 hybrid instruments are in close proximity to the conditions that are recommend by CEBS Draft Proposal, the alternative of "permanent grandfathering" should be granted to national supervisors for current hybrid instruments. One respondent suggested that permanent grandfathering is required (on a non-amortising basis) for securities with no issuer right to redeem, for example non-callable preference shares. One respondent argued for grandfathering all PIBS without call dates issues to maturity, as those building societies that have such PIBS (which are truly loss absorbent on a permanent basis), the proposed tiered		

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	transition will effectively turn irredeemable core capital into prohibitively expensive Tier 2 capital in the long-term. One respondent pointed out that the CEBS draft proposal does not take into account that, in line with the permanence principal, some of the issued Tier 1 hybrids are truly perpetual and will inevitably lead to their conversion into ordinary shares at an undefined time in the future (i.e. Fortis FRESH, Monte Dei Paschi Di Siena). Issuers have no control on these instruments to accelerate their conversion and these instruments should be included in a permanent grandfathering. We have Tier 1 instruments, issued through subsidiaries, which can be converted into Preference Shares of the parent company, under certain circumstances, at the request of the Financial Regulator. The terms and conditions of these new Preference Shares (which will also be hybrid instruments under the CEBS definition) cannot be dissimilar from the terms of the original issue. Under the Draft Proposals these replacement Preference Shares would not qualify as Tier 1 capital. Thus the purpose of replacement would be lost from an entity's capital ratio perspective. *Distinction between innovative and non-innovative instruments* Many respondents understood that CEBS intended to make a distinction between instruments with an incentive to redeem and those without in that CEBS' proposal could be interpreted as meaning that an instrument with an incentive to redeem is no longer eligible as Tier 1 capital after the first call date, even if it was not redeemed. They suggested that this distinction should be dropped, for the following	*Distinction between innovative and non-innovative instruments* CEBS acknowledges that the proposals on grandfathering were misleading. CEBS did not intend to make a distinction between innovative (i.e. instruments with an incentive to redeem) and non-innovative instruments in terms of grandfathering. The text is	"6.1 The eligibility of instruments that do not fulfil all the criteria mentioned above as Tier 1 capital will be gradually reduced over a

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	reasons: - An issuer should be able to leave a step-up transaction outstanding without losing regulatory capital treatment if this is deemed in its interest. - The proposal as it stands effectively encourages institutions to call instruments, as the issuer will be forced to maintain the cost of servicing these instruments with no corresponding contribution to regulatory capital requirements. This in our view undermines the principles of permanence as it may not be an appropriate time for the issuer to call. In addition, the issuer may not always be in a position to redeem because of: o difficulties to replace the called issuance with hybrid instruments which qualify under the new regulatory framework : ▪ linked to the marketability of such hybrid instruments (investors' basis might be dramatically reduced); ▪ linked to the pricing of such instruments (terms and conditions might increase the investors' requirements); ▪ linked to the legal and tax environment constraints with which the issuer is faced (write-down obligation might lead to adverse tax consequence, coupons could become non deductible); o a refusal from the regulator to allow the call of the instrument to be called.	amended accordingly.	period of 30 years (see below). 6.2. Any redemption should be made at the initiative of the issuer and subject to prior supervisory approval."

Draft text CP17	Comments received	CEBS' analysis	Amended text
	- Under normal market conditions the vast majority of these instruments will be repaid by the bank. Only a crisis situation will normally lead to the instrument not being redeemed. If the instrument would then no longer be eligible as Tier 1 capital, this would plunge the bank into an even deeper crisis than before and could cause market disruption. - Both types of instruments are all eligible as "original own funds" under the current rules. In addition, once the step-up has occurred, if the instrument is not redeemed (for example because it provides the issuer with a funding source which is more favourable under the market conditions which were prevailing), it will turn into an instrument without incentive to redeem. One respondent noted that some instruments may have call options which can be exercised before the date when the step-up is activated. It would be appropriate for former hybrid instruments to remain eligible as Tier 1 until the last call date preceding the incentive to redeem. One respondent made a particular drafting suggestion to delete the first paragraph of the proposal and the text in brackets in the second paragraph. *Great grandfathering* One respondent noted the possibility for great grandfathering – i.e. that Tier 1 capital issues issued before the 1998 SPR should fall outside CEBS's proposed grandfathering limitations and remain grandfathered for life. *Supervisory approval*	*Great Grandfathering* All hybrid instruments that do not comply with the new criteria will be subject to the grandfathering, including those instruments that are effectively "Great Grandfathered".	

Draft text CP17	Comments received	CEBS' analysis	Amended text
	One respondent held the view that this requirement can only be valid for instruments which effectively form part of the regulatory capital. If for whatever reason (end of grandfathering, limitations, changes in mix of capital instruments etc.) an instrument no longer qualifies as Tier 1 capital, it should be redeemed without supervisory permission. *Specific comments on the Table* Two respondents suggested modifying the grandfathering rules for the final 10% from 30 years, either to the effective maturity of the relevant instruments or, as swaps exceeding a duration of 50 years are very uncommon, to 50 years. The rationale given was that non innovative hybrids (no step up) have been issued with perpetual maturity and call rights for the issuer starting at year 5. In the absence of redemption incentives these instruments were considered to be of a perpetual nature with long dated swap agreements (40-50 years, sometimes even perpetual) against them. With the end of grandfathering after 30 years such instruments economically have to be called while it may be impossible to call the corresponding swap agreement – which may, depending on the then current spread environment, well yield an economic loss to the issuing bank. *Requests for clarification* Some respondents thought that the current text requires more clarification regarding the application of the suggested rules, with one respondent suggesting that concrete examples would probably be helpful. Many respondents sought clarification about the intention of the proposed rules with respect ineligible	*Supervisory Approval* CEBS considers that redemption of all hybrid instruments must be subject to supervisory approval. This is consistent with the current practice in most jurisdictions.	

Draft text CP17	Comments received	CEBS' analysis	Amended text
	instruments with an incentive to redeem but that have not been redeemed, as they found the CP not entirely clear on this point. They pointed out that there seems to be a conflict between the first bullet point of the proposal, stating that "instruments with an incentive to redeem remain eligible until the first call date." on one hand and the second bullet point stating that "…hybrids with incentives to redeem which are not callable and those that are callable but have not been redeemed will be gradually reduced over a 30 year period." The latter would seem to indicate that an instrument will remain eligible after its call date, whereas the first bullet point could either mean that instruments do not have to be counted within the limit for Grandfathering until after the first call date has passed, or that they are not eligible after the first call date? One respondent sought confirmation of its view that irredeemable hybrid Tier 1 securities that have been issued by UK building societies would remain forever as hybrid Tier 1 and not be excluded from Tier 1 capital in 30 years time. One respondent did not understand what is meant by "hybrids with incentives to redeem which are not callable" and requested clarification. One respondent sought clarification that the limits on grandfathering exist on top of limit stated in other parts of the paper. One respondent found the table setting out the continuous reduction of instruments that do not fulfil all criteria for eligible hybrids not sufficiently clear. In order to leave no room for diverging interpretations they therefore kindly asked CEBS to provide some examples.		

Draft text CP17	Comments received	CEBS' analysis	Amended text
	Another respondent in particular found unclear to exactly what the percentage figures in the appended table refer to. In the interests of avoiding different interpretations, CEBS should provide an example calculation showing how the limits function and how they are to be calculated.		