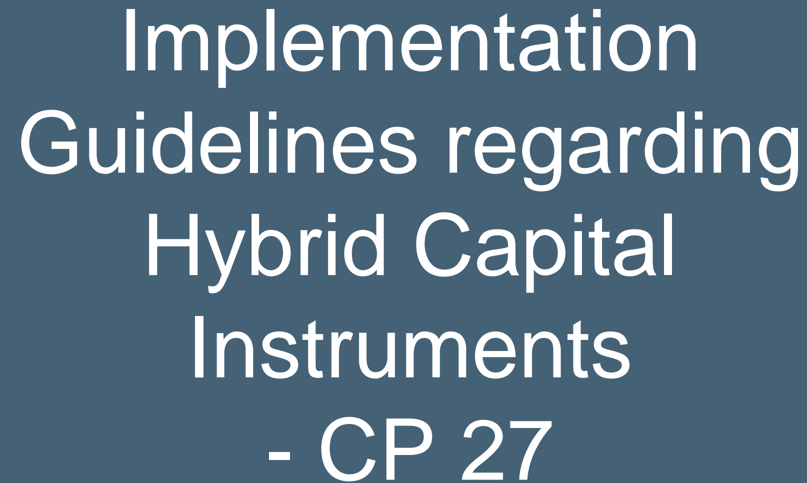

Implementation Guidelines regarding Hybrid Capital Instruments - CP 27

Public hearing

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Overview

- Background
- Objectives of the draft guidelines
- Permanence
- Flexibility of payments
- Loss absorbency
- Limits
- Issuances via SPV
- Next steps and outlook

Background

- CRD II review introduced for the first time **explicit EU-wide rules regarding the eligibility of hybrid capital instruments** as original own funds.
  - First application from 31 December 2010.
- The provisions are largely based on CEBS's proposal for a common EU definition of Tier 1 hybrids of April 2008.
- The present CP responds to the request in Art. 63a (6) of Directive 2006/48/EC recast for CEBS to elaborate **guidelines for the convergence of supervisory practices with regard to hybrid instruments**.

Objectives of the draft guidelines

- achieve **common understanding** among competent authorities across the EU on the implementation and application of the new provisions

- foster their **convergent transposition**

- create more **transparency for market participants**

BUT

- **no comprehensive guidelines** covering all aspects of Tier 1 hybrids

- instead additional guidance **complementing the CRD provisions** in Art. 63a and 66 (1a) where appropriate because in CEBS's view
  - CRD text is too principles based, or
  - A relevant issue is not explicitly addressed by CRD

Permanence

Article 63a (2)

“2. The instruments shall be undated or have an original maturity of at least 30 years. Those instruments may include one or more call options at the sole discretion of the issuer, but they shall not be redeemed before five years after the date of issue. If the statutory or contractual provisions governing undated instruments provide for a moderate incentive for the credit institution to redeem as determined by the competent authorities, such incentive shall not occur before ten years after the date of issue. The statutory or contractual provisions governing dated instruments shall not allow for any incentive to redeem other than the maturity date.

Dated and undated instruments may be called or redeemed only with the prior consent of the competent authorities. The competent authorities may grant permission provided the request is made at the initiative of the credit institution and either financial or solvency conditions of the credit institution are not unduly affected. The competent authorities may require institutions to replace the instrument by items of the same or better quality referred to in point (a) or (ca) of Article 57.

The competent authorities shall require the suspension of the redemption for dated instruments if the credit institution does not comply with the capital requirements set out in Article 75 and may require the suspension of the redemption at other times based on the financial and solvency situation of credit institutions.

The competent authority may grant permission at any time for an early redemption of dated and undated instruments in the event that there is a change in the applicable tax treatment or regulatory classification of such instruments which was unforeseen at the date of issue.”

Permanence

- CP addresses three topics:
  - Incentives to redeem
    - any feature that, in the perception of market participants, provides for an expectation of the hybrid instrument being redeemed at the call date, notably an interest-rate step-up or a principal stock settlement clause, in conjunction with a call option
    - no reclassification if the instrument is not called
  - Supervisory consent to a call or redemption of a hybrid instrument
    - will be granted if the institution can demonstrate that it is neither at present, nor in the foreseeable future, materially in danger of not meeting its capital requirements and that after the redemption it will still have adequate capital buffers above the regulatory minimum requirements
    - competent authority may also take into account other factors like the institution's liquidity positions or its profitability
  - Buybacks of hybrid capital instruments in the market
    - economically equivalent to a call or redemption
    - therefore the same supervisory approval process should apply and buy backs should, in general, not take place before five years after the issuance

Flexibility of payments

<u>Article 63a (3)</u>

“3. The statutory or contractual provisions governing the instrument shall allow the credit institution to cancel, when necessary, the payment of interest or dividends for an unlimited period of time, on a non-cumulative basis.

However, the credit institution shall cancel such payments if it does not comply with the capital requirements set out in Article 75.

The competent authorities may require the cancellation of such payments based on the financial and solvency situation of the credit institution. Any such cancellation shall not prejudice the right of the credit institution to substitute the payment of interest or dividend by a payment in the form of an instrument referred to in point (a) of Article 57, provided that any such mechanism allows the credit institution to preserve financial resources. Such substitution may be subject to specific conditions established by the competent authorities.”

Flexibility of payments

- CP addresses three topics:
  - Criteria supervisors should take into account when deciding on whether or not to request the cancellation of payments, e.g.
    - the existence of available distributable items,
    - the solvency data before and after the payment,
    - the evaluation of the risks to which the credit institution is exposed, and
    - the evaluation of the business plan of the credit institution, assessing if circumstances arise that might jeopardize the positive business development.
  - Other features regarding flexibility of payments – dividend pushers/stoppers
    - acceptable if the issuer has a large degree of flexibility to cancel payments
    - but to be waived if an institution no longer complies with the capital requirements set out in Article 75 or if the competent authority requires the cancellation of payments based on the financial and solvency situation of the institution.
  - Alternative Coupon Satisfaction Mechanisms (ACSM)
    - only acceptable if it achieves the same economic result as a cancellation of the coupon (i.e. there is no decrease in capital) and when the issuer has full discretion over the payment of the coupons or dividends at all times
    - if circumstances arise preventing the ACSM to work as originally envisaged, the payment of coupon or dividend shall be cancelled

Loss absorbency

Article 63a (4) and (5)

"4. The statutory or contractual provisions governing the instrument shall provide for principal, unpaid interest or dividends to be such as to absorb losses and to not hinder the recapitalisation of the credit institution through appropriate mechanisms, as elaborated by the Committee of European Banking Supervisors under paragraph 6.

5. In the event of the bankruptcy or liquidation of the credit institution, the instruments shall rank after the items referred to in Article 63(2)."

Loss absorbency – in liquidation

- Instrument must rank junior to depositors, creditors and subordinated debt
- Senior only to capital instruments referred to in Article 57(a)
- No guarantee, security or arrangement that may enhance the seniority of the claim

Loss absorbency – in going concern

- Instrument helps preventing insolvency
  - Instrument holder may not be in a position to petition for the institution's insolvency (no obligation to redeem or pay a coupon)
  - Instrument is not taken into account for the purpose of determining insolvency
- Instrument is not hindering the recapitalisation of the institution
  - When losses arise, the flexibility to cancel the coupon is not sufficient to restore the financial situation. The principal must also be used to cover losses.
  - Hybrids must contain a mechanism that makes the recapitalisation more likely by reducing the potential future outflow.
  - This mechanism has to be used at a prudent and timely enough trigger point.

Limits

Article 66 (1a)

“1a. Notwithstanding paragraph 1, the total of the items in point (ca) of Article 57 shall be subject to the following limits:

(a) instruments that must be converted during emergency situations and may be converted at the initiative of the competent authority, at any time, based on the financial and solvency situation of the issuer into items referred to in point (a) of Article 57 within a pre-determined range (…) shall in total not exceed a maximum of 50% of the items in points (a) to (ca) minus (i), (j) and (k) of Article 57;

(b) within the limit referred to in point (a) of this paragraph, all other instruments shall not exceed a maximum of 35% of the items in points (a) to (ca) minus (i), (j) and (k) of Article 57;

(c) within the limits referred to in points (a) and (b) of this paragraph, dated instruments and any instrument, whose statutory or contractual provisions provide for an incentive for the credit institution to redeem shall not exceed a maximum of 15% of the items in points (a) to (ca) minus (i), (j) and (k) of Article 57;

(d) the amount of items exceeding the limits set out in points (a), (b) and (c) shall be subject to the limit set out in paragraph 1."

Article 66 (4)

4. The competent authorities may authorise credit institutions to exceed the limits laid down in paragraphs 1 and 1a temporarily during emergency situations."

Limits

- Features of hybrid instruments that may be included beyond the 35% limit
  - Convertible into instruments referred to in Art. 57(a)
  - Not redeemable in cash
  - Mandatory conversion during emergency situation and optional at any time
  - Predetermined conversion ratio must ensure that the instrument will share losses
  - Optional conversion at the discretion of the supervisor, at any time, based on the financial and solvency situation
- Authorisation to exceed limits in emergency situation
  - Can relate either to the overall 50% limit or to the 15%/35% limits
  - Authorisation confined by the duration of the emergency situation

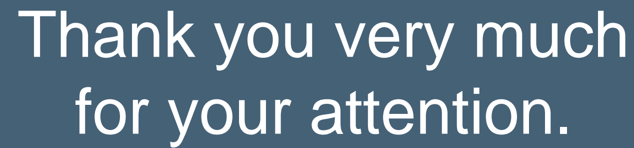
SPV issuances

- CRD is silent regarding **hybrid instruments issued through an SPV**
- CEBS believes that such instruments shall comply with the conditions for the qualification as original own funds as if the SPV was itself an institution seeking to include the instruments into its original own funds
- Investors in the hybrid instrument shall
  - retain at least the same degree of subordination in insolvency and on an ongoing basis as if the instrument was issued directly by the parent institution
  - not be in a position to place the SPV into insolvency nor should they, in the case of the collapse of the SPV structure, have a better claim against the institution than holders of the same type of instrument directly issued by the institution.
  - minimize cross border and legal risk

Next steps and outlook

- Next steps
  - Finalisation of Guidelines on Hybrids Capital Instruments based on the feedback received on CP 27
    - Responses are still welcome at cp27@c-ebs.org
    - Consultation closes on 23 September 2009
    - CEBS endorsement and subsequent publication envisaged in December 2009

- Outlook
  - Upcoming Consultation Paper on Guidelines regarding instruments referred to in Article 57(a)
    - CEBS endorsement and subsequent publication envisaged in December 2009
  - CEBS considerations regarding a definition of core Tier 1 capital
    - Closely linked to work in Basel



Questions?

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