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D0322
22.2.2008

**EBF COMMENTS ON THE CEBS DRAFT PROPOSAL**
**FOR A COMMON EU DEFINITION OF TIER I HYBRIDS**

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## I. GENERAL OUTLOOK

The EBF welcomes the CEBS draft proposal as a valid starting point for a thorough examination and public discussion in Europe on the treatment of hybrid instruments as eligible capital. The document provides valuable input and demonstrates that progress is being made in this area. However, the document still has a significant number of weaknesses (which will be explained below). These need to be addressed before envisaging implementing the proposals made by CEBS into EU legislation as they might end up deteriorating standards and practices as well as the quality of capital.

Moreover, as evidenced by the Discussion Paper on the Definition of Capital which was issued by the UK FSA, an in-depth reflection on bank capital and the many questions involved are still ongoing in various Member States. Furthermore, a Discussion Paper on the accounting dimension entitled “Distinguishing between Equity and Liability” has been published under the aegis of EFRAG, which proposes adopting a loss-absorption approach. The International Accounting Standards Board (IASB) is also expected to publish a Discussion paper on the same issue shortly. Clearly, therefore, as ideas are still evolving, the CEBS document definitely would need further refinement.

Against this background it would seem appropriate to adopt a staged approach: for the time being: pending the outcome of the forthcoming discussions within the Basel Committee, <u>the EU should satisfy itself with swiftly resolving only those differences amongst Member States which truly matter from a competitive point of view</u>.

1) All EU banks should be authorized as a matter of principle to issue hybrids to strengthen their capital base.
2) The total limit for inclusion of hybrids into Tier 1 capital - which currently vary considerably across the EU (ranging from 0 % to 50 %). - should be harmonised as this creates substantial distortions of competition which need to be addressed. Our proposal would be that the EU would impose a 50 % maximum limit. Various argument advocate for this:
   - a 50 % limit would be most in line with the text of the Sydney Press Release;
   - it is being used by those Member States where the main issuers of hybrids have their head office (DE, FR, NL, UK);
   - market discipline following from (i) increased disclosures by both banks and supervisors as well as (ii) from actions taken by rating agencies, market analysts and investors will usually prevent banks from fully exploiting the maximum limit;

To avoid competitive distortions between Member States, those common rules must be construed as a <u>full harmonization</u>: Member States should not be allowed to impose additional and/or stricter requirements.

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Finally, the EU supervisory community should be provided with tools enabling it to enhancing its knowledge and understanding of hybrid instruments as well as the environment in which they are being used. More particularly, a common knowledge centre needs to be established at EU level which would be able to undertake a thorough but swift common assessment of any new product that would be put on the market.

## II. GENERAL OBSERVATIONS

**1. The document's major weakness is that it is not based on general principles.**

a) The perception which the document creates is that CEBS merely wished to achieve a compromise between Member States on the basis of their current rules and that the proposed new requirements are the weighted sum of the requirements in many jurisdictions. As a result, the document fails to bring sufficient clarity about the motives underlying many of the proposals made.

b) It may be useful to recall in this context that, at the hearing which CEBS organised in June 2007, the most important comment made by industry participants had been that a fresh look needed to be taken at the three main eligibility criteria which have traditionally been accepted (permanence, loss absorption and flexibility of payments). The industry agreed unanimously that these three criteria should not be taken and analysed in isolation from each other as they are closely inter-related and that, in fact, "loss absorption" was the key criterion. CEBS has ignored this basic observation. (See also our comments below)

The piecemeal approach which the CEBS document has adopted obscures its underlying principles. Therefore, its proposals are likely to be understood in a differing way across the EU, thus increasing instead of reducing diverging practices amongst Member States.

c) The Basel Committee will start reviewing its definition of eligible capital in the years to come.

It would, therefore, be damaging if CEBS proposals - and particularly those which go beyond the SPR - were to be transposed into EU legislation before the Basel Committee will have adopted a common view.: (i) damaging to the European industry (as EU banks will be obliged to adapt twice to a new regulatory environment within a relatively short time frame), (ii) damaging to the hybrid market (as its practices will be overhauled twice, which is likely to bring confusion and provoke litigation); (iii) damaging to legal certainty in the interim period.

Therefore, in order to be in a position to strongly influence discussions held at the level of the Basel Committee, Europe has to develop a common, precise and clear vision on the basic principles underlying the eligibility of capital.

d) It is stated in the CEBS document, without any justification or further qualification, that "*instruments eligible for inclusion in Tier 1 capital have to be*

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*measured against the* *benchmark of 'equity'"* This seems to ignore that hybrid instruments may increase financial stability – and should, therefore, more readily be accepted as Tier 1 - because:

(i) they provide for an additional cushion protecting depositors and senior bond holders;
(ii) they diversify and broaden the investor base, which can be crucial to maintain access to funding and capital in times of economic downturn;
(iii) they may provide cheaper funding;
(iv) whilst equity tends to be highly volatile, fixed-income instruments are much more stable;
(v) hybrid instruments can be denominated in foreign currency whilst subscribed capital and reserves are mandatorily denominated in the reporting currency - which is important from a foreign exchange rate risk point of view;
(vi) from a hedge accounting perspective, classification as debt, when applicable, allows them to qualify as hedged items.

e) The CEBS proposal seems to assume that the concept of "loss" is a generic one. This is, however not so and in order to device general principles underlying the harmonisation of Tier 1 hybrid capital, one should achieve a common understanding of this concept before turning to the loss absorption criterion and related issues.

"Loss" can mean operating loss, i.e. the deficit recorded on the profit and loss account, but also balance sheet loss, i.e. that portion of the operating loss which was not applied against reserves plus probably any loss carry forward already existing on the balance sheet. Certain triggers with capital ratios contained in CEBS' proposal suggest that CEBS also considers that falling below such thresholds is considered as loss.

Moreover, references made in the CEBS paper to distributable items suggest that the term "loss" should be tied to the non-consolidated accounts of the issuing entity being the source of dividends and other distributions. References to IFRS would primarily point to consolidated accounts as the ones which are mandatorily prepared under IFRS whereas the non-consolidated accounts may be prepared under IFRS or national GAAP of the relevant Member State (*cf.* Article 4 and 5 of Regulation (EC) No 1606/2002).

In a crisis scenario all these items would only by chance be identical. Given the details of CEBS' proposal on loss absorbency, it is indispensable to first have clarity about which item must be absorbed by the instrument in question.

f) There seems to be a general agreement when discussing the treatment of hybrids that "substance-over-form" principle needs to be used as a main guiding principle. However, there appears to be a lot of confusion about its meaning.

CEBS seems to have interpreted the principle exclusively in conformity with a suggestion made in the European Commission's call for advice: to be eligible for

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inclusion in Tier 1 capital, an instrument should not only comply with prudential requirements, "*regardless of its legal form, but also must result in the effective transfer of the issuer's risk to the market*" (Paragraph 20). While we accept such a statement to be plausible, we believe that the "substance-over-form" principle is not merely meant to look through legal concepts but also to put into question an approach which would be overly determined by accounting concepts.

A careful analysis of the "substance-over-form" principle is in any event lacking.

**2) The proposals are, moreover, deficient in significant other respects.**

a) The various requirements are more restrictive than the Sydney Press Release. This will create competitive distortions which will disadvantage the position of EU banks (both in their capacity of regulated entities and of issuers of hybrid instruments).

b) In every Member State, the treatment of hybrids is embedded in a specific legal environment with diverging rules in the area of bankruptcy law, company law and tax law. Achieving tax deductibility is particularly critical to issuers. CEBS has, however, ignored such differences. Therefore, the harmonised instrument that CEBS is proposing will work differently in each Member State. As a result, an unlevel playing field is created within the EU. Such an approach is, moreover, not likely to encourage a good dialogue and deep understanding of the instrument in the relevant legal context and, moreover, increases the complexity of the instrument and limits the ability for issuers to tailor hybrids to the needs which they have from an economic, legal and tax perspective. Market participants have become familiar with these specificities and have adapted their practices accordingly; these should not be disrupted unnecessarily.

c) As the CEBS proposals are rules-based, they are overly detailed and restrictive. The EBF advocates for an approach which would transpose the SPR into EU legislation by means of a qualitative and non-prescriptive approach which would:
   (i) leave flexibility to issuers when designing a structure which complies with all relevant legislation in a specific country (inside or outside the EU);
   (ii) contribute to achieving further convergence across sectors (banking and insurance);
   (iii) facilitate innovation processes for hybrids resulting in state-of-the-art structures and providing full economic benefits (efficient instrument at lowest cost).

## III. GUIDING PRINCIPLES

### 1. Loss Absorption

1. CEBS had been made aware at the hearing which it organised in June 2007 about the financial industry's unanimous believe that loss absorption, permanence and flexibility of payment are closely interwoven with one another and that it is not possible,

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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.

2. The SPR did not clarify how the loss absorbency requirement needs to be understood. This was not too much disturbing to the extent that the SPR did not propose a set of detailed requirements.

   The CEBS document, in contrast, is highly prescriptive and goes beyond the guidelines which the SPR developed. One would have expected, therefore, that CEBS would have come up with a more precise definition of "loss absorbency" which it would use as a guiding principle when elaborating its more detailed requirements. CEBS did not make an attempt to do so, however but merely provided a set of paraphrases which frequently result in overlaps and ambiguities.

3. <u>In our 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[1].
   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.

   <u>The second requirement</u> in particular requires closer scrutiny

   (a) To help a bank to continue its operations as a going concern, <u>the instrument must</u> firstly<u> contribute to enabling the bank to meet its obligations and avoid that its liabilities exceed its assets</u>.[2] 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[3].

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[1] The CEBS document takes the view "*that hybrids are senior **only** to ordinary share capital*". (Grey Box at page 20). This wording seems to imply that the CEBS document is much stricter than the SPR and, more particularly, that there would be no room for intermediary instruments that would be junior to Hybrid Tier 1 instruments. Informal exchanges of views held with CEBS' membership has revealed that this was not the intention and that the word "only" will be ultimately removed from the document's wording, thus confirming that it should be sufficient for the instrument to always rank junior to depositors, general creditors and subordinated debt of the institution and senior to ordinary share capital".

[2] 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.

[3] This requirement is traditionally been captured under the heading of the "permanence" and "flexibility of payment" criteria which ensure that hybrid investors will be unable to provoke a bank's insolvency because they have no enforceable claim to coupon payments or to the repayment of the principal.

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 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.

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 is a 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. We outline a method of solving this problem below.

(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>[4].

We do not consider the various options which the CEBS document examines to address this in stressed situations (see Paragraphs 108) to be appropriate. Quite apart from the fact that the suggested requirements go far beyond the SPR guidelines and would therefore cause considerable competitive distortions, they would not achieve their desired objective and, moreover, be difficult, if not impossible, to apply.

What is most disturbing, however, is 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 makes it unclear why it would be helpful to write down hybrids or convert them into ordinary shares.

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.

[4] See Paragraph 107 of the CEBS document.

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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.

The other rules which CEBS proposes go beyond the SPR guidelines and are in any event impracticable and, in part, also inappropriate for the following reasons:

- Different company and tax law regimes in Member States result in the proposed write-down mechanism having widely diverging effects, which would obstruct harmonisation.
- From an accounting perspective, the rules would be difficult to apply, especially if instruments are issued by special purpose vehicles (SPVs). Losses are incurred at solo level while SPV capital can only be reported at consolidated level. The instrument would, however, need to be written down at the level of the SPV. The entries and mechanisms which this would entail cannot possibly comply with the requirements set out in the sixth paragraph of the box on page 20 of the paper.[5] They would not be transparent and it is at least questionable whether the instrument could be written down only on the issuer's balance sheet.
- Tax and accounting frameworks are not necessarily stable.

In addition the following needs to be highlighted:

- Cancellation of coupon payments as a result of a temporary write-down of the principal of a Tier 1 hybrid can be achieved on the basis of the principle of flexibility of payment (see above). A temporary write-down of the nominal amount of the claim is not necessary for this purpose.

- The write-up mechanism referred to in the second sentence of Paragraph 111 produces the same result, once the bank has been restored to its "normal situation", as suspending payments and not repaying the principal. Instead, half would be offset against retained earnings/share capital and half against hybrid instruments. This is basically no more than an accounting exercise and would have no effect on the bank's regulatory capital situation or cash. Furthermore, the write-up mechanism would interfere with the shareholders' rights to distribute profits. It would have to be authorised by the shareholders' meeting, thereby reducing considerably the flexibility of payments and of the instruments themselves.
- In addition, CEBS suggests (in the penultimate paragraph of the box on page 20) that, if the bank goes into liquidation despite a temporary write-down, hybrid holders should be able to claim the full original principal amount. The EBF supports this suggestion, which reflects general market practice. Nevertheless, this rule also produces the same result as refraining from payments without a temporary write-down of the instrument.
- In the final paragraph of the box on page 20, CEBS proposes that it should only be possible to redeem a written down instrument at the written down amount. The EBF believes this rule to be superfluous in light of the principle of

[5] Furthermore, the meaning of the second sentence of this sixth paragraph is unclear. The EBF would ask CEBS to explain what is meant by this requirement and what it intends to achieve.

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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 will discourage a bank from redeeming an instrument at the written down amount as this would severely hamper its chances of attracting future investors.

- The proposed alternative of converting the hybrid into ordinary shares would merely change the bank's capital structure on the balance sheet. There would be a debt-for-debt swap of hybrid capital for shareholders' capital. Cash and regulatory capital would not be affected. We, therefore, agree with CEBS that the conversion itself would not absorb losses (see Paragraph 112). It would merely change the composition of the bank's capital.
- Finally, it should also be borne in mind that this mechanism may only be available in a limited number of Member States.

- The CEBS document comments on possible triggers for loss absorbency mechanisms to be activated. As we reject the idea of a write-down or conversion mechanism for the reasons outlined above, such triggers seem superfluous to us. We recognise, nevertheless, that the reasoning behind CEBS's choice of the triggers and the triggers themselves make good sense. They offer a sound basis for further discussion at the level of the Basel Committee.

4. As indicated above, the highly unlikely situation could theoretically arise in which a bank faces over-indebtedness. Should this happen, the bank would have to file for bankruptcy and would be liquidated. Shareholders would lose their investment and hybrid investors would most probably get nothing or very little since their claims would be subordinate to those of all other parties.

   To save the bank in such circumstances, the management would try to persuade the providers of debt capital, including first and foremost hybrid investors, to waive a portion of their claims. And in all probability, creditors holding hybrid instruments would agree to what essentially constitutes a permanent write-down. This is because, if the bank succeeded 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 subordinate.

   The EBF opposes any change which would introduce rules going beyond this established practice applied by companies in difficulty in all sectors of the economy. The write-down and conversion mechanisms proposed by CEBS would actually be less effective than this customary market practice.

## 2. Flexibility of Payments

Regulators should not unduly complicate the issuance of hybrid capital.

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The ultimate objective of hybrid capital instruments is to provide financial flexibility to the issuer of the instrument. Regulation should constrain an issuer's flexibility as less as possible and, more particularly, build in sufficient flexibility to allow the issuer to suspend payments in times of financial distress and to continue its business as a 'going-concern' without causing a default or other potential disruptions.

### a) Investor protection

Hybrid capital is sold as an alternative to senior and subordinated bonds to fixed income investors, who are willing to provide tier 1 capital in exchange of a slight premium. By definition, the instrument needs to be structured as a fixed income security creating an expectation that the investor will receive timely payments under normal circumstances. As investors are holding a more subordinated piece of paper and, moreover, are not entitled to claim for the issuer's bankruptcy, they wish the issuer to have the right incentives to service the debt.

One of the few possible ways to accomplish this is to make sure that payments on hybrid capital are commensurate with the ranking of the instrument. That means that if payments are made on more junior paper (e.g. dividends on ordinary shares), payments on hybrid capital become due as well . This makes perfect sense: if a company pays on the most superior form of capital (equity) why should it not be allowed to satisfy holders of hybrid capital?

Payments on hybrid capital can be ensured by dividend stoppers or dividend pushers.

- A <u>dividend stopper</u> makes sure that an issuer cannot pay dividends on ordinary shares when it is not paying interest on its hybrid capital. It must be added that, as this requires approval from shareholders, dividend stoppers are less flexible.
- As it is not possible in some jurisdictions to restrain shareholders from the right to propose dividends at the AGM, a <u>dividend pusher</u> can be used to make sure that interest is paid on hybrid capital whenever dividends are paid on ordinary shares.

The CEBS proposal takes the view that dividend pushers must be waived if the institution is in breach of its minimum capital requirements (or another level defined by supervisors) or whenever its supervisor requires the institution to waive payments based on its financial situation. We question if such an approach would indeed be appropriate. Why should a fixed income investor not be entitled to payments when junior instruments do receive payments? The CEBS paper should provide clarity on why it believes such a discriminatory treatment of hybrids holders in comparison to common equity holders to be justified. It should, moreover, be observed that regulators in various Members State are entitled to stop dividend payments and, therefore, are always in a position to avoid that dividend pushers are triggered

### b) Protecting market access and reputation

An issuer will, of course, make a cautious use of his leeway to defer or waive payments. Once an investor will have taken such an initiative, investor appetite for further capital issuance will be seriously 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.

However, a big difference between hybrid capital issued by banks compared to instruments issued by corporates is the presence of a regulatory framework which makes sure that the hybrid instrument works in the way it is intended. This is also recognised by rating agencies when giving equity credit to hybrids issued by banks compared to the equity credit which non-regulated corporates issue. They feel more comfortable about a bank issuing hybrid capital because they know that, in case of need, the regulator will eventually step in to make sure that the instrument does its job.

The CEBS proposal states that an issuer must waive payments if the institution is in breach of the minimum capital requirement. It also takes the view that supervisors can require institutions to waive payments at their discretion based on the financial situation of the institution. We believe, however, that the latter situation will always precede a situation where minimum capital requirements are breached. Nevertheless a prudent issuer will be inclined to include both situations as explicit deferrals in the documentation of its instruments, if only to be transparent to the market. As timely regulatory intervention can safely be assumed anyway, we believe that CEBS should not be overly prescriptive (and limit flexibility) with respect to mandatory deferral following a breach of capital requirements. On a national level there should be sufficient flexibility to discuss the most appropriate way to fill in these rules, taking into account each jurisdiction's specifics.

Nevertheless, to enhance harmonisation within the EU, no supervisor should be entitled to generally require waiving payments by a breach of higher triggers than the cpital requirements. Therefore, the words "(or another level defined by supervisors" need to be removed.

### c) Other

The CEBS proposal discusses some technical issues with respect to the requirement of deferral. According to the proposal, distributions can only be paid out of distributable items.

However, it is unclear what is meant in the proposal. It seems as if this requirement would serve some kind of accounting issue. We believe 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.

## IV. CEB'S PROPOSALS ON LIMITS

### a) Overall Limit

Under the SPR ”*voting common shareholders' equity and the disclosed reserves or retained earnings that accrue to the shareholders' benefit should be the predominant form of a*

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*bank's Tier 1 capital*". Some regulators introduced limits to non-innovative hybrids up to 35% of Tier 1 setting an overall limit up to 50%.

The CEBS proposal adopts a different approach as it introduces a link to required capital: "*only banks that have met 70% of their required Tier 1 with common shares and disclosed reserves/retained earnings will be able to count additional hybrid 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*" (referred to new issues and to existing hybrids ).

This overall limit raises the following concerns:

- The proposed system creates a "cliff effect": although banks usually observe stricter capital requirements than those imposed by regulators, a part of their outstanding hybrids will no longer be eligible as capital as soon as their Tier 1 ratio decreases. This is likely to accelerate a crisis as, in situations of stress, a decrease of the Tier 1 ratio below the required capital will reduce the possibility to issue new hybrids and make it impossible to include a large part of previously issued instruments in Tier 1. Moreover, an appropriate planning of capital issuance becomes difficult if limits put on hybrid instruments are linked to the actual level of the Tier 1 ratio.

- It puts EU banks at a competitive disadvantage vis-à-vis their global competitors.

Introducing a 70% limit "in all cases - as suggested by some CEBS members (see Paragraph 153) – would in any event not be useful to foster 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 capitalised Banks.

### b) 15 % Limit – General Comments

The SPR took the view that innovative instruments (i.e. "*instruments with any explicit feature - other than a pure call option - which might lead to the instrument being redeemed*") are acceptable as eligible Tier 1 capital, subject to stringent conditions and limited – at issuance - to a maximum of 15 % of Tier 1 capital.

CEBS goes beyond the SPR.

Firstly, CEBS requires the 15% limit to be observed at all times. The Sydney Press Release proposed that "the aggregate issuances of non-common equity Tier 1 instruments with any explicit feature – other than a pure call option – which might lead to the instrument being redeemed is limited – at issuance – to 15% of the consolidated bank's Tier 1 capital". The term 'at issuance' has been omitted from the CEBS proposals. It is in our view, imperative that this 15% limit be applied in line with the Sydney Press Release. 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. It is also important to note that while the CRD states that the capital ratios must be met at all times, it is not stated

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that the composition of own funds must be the same at all times. In addition to the difficulties in managing capital base, the application of limits “at any time” as opposed to “at time of issuance” will lead to a double negative impact on Tier I when an institution starts to report losses affecting its core Tier I.

Secondly, it proposes to broaden the range of instruments to which the limit would apply. It proposes, more particularly, to also include principal stock settlement and instruments with ACSM features into the 15 % limit. This raises many concerns:

- It puts EU banks at a competitive disadvantage vis-à-vis their global competitors, particularly from the US and Japan. This is likely to weaken the stability of the EU financial system.

- The consequence of the approach advocated by CEBS is that most of the current hybrid instruments would fall under the 15% limit of Tier 1 after deductions. These products have a wide and well understood market which will be affected by the proposal as banks will be forced to develop new instruments or to reintroduce, if possible, indirect structures (SPV’s). This is likely to contribute to increasing the various types of instruments outstanding, to creating additional legal uncertainty and to introducing possible confusion. Clearly, this is not helpful to enhancing financial stability within the EU.

- The impact on small banks will be deeper due to the cost of alternative structures (such as expensive SPVs) as well as to the reduced size of their issues.

- The broadening of the 15 % limit to instruments with ACSM features is commented below under a separate section.

By subjecting these Tier-1 instruments to the 15% limit, the CEBS proposal introduces an unfair and unsustainable competitive disadvantage between issuers. We, therefore, believe that it would not be appropriate to go beyond the SPR: the 15% limit should apply to true innovative instruments only, i.e. with a principal incentive to redeem which give the instrument a dated nature.

**c) 15% Limit - ACSM**

CEBS proposes the following concerning Alternative Coupon Satisfaction Mechanisms (“ACSM”):

1) They 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.
2) 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.
3) These instruments are limited to 15% of total Tier-1 capital after deductions.”

Our comments on these proposals are as follows.

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1. Instruments with ACSM features (ACSM) exist in several jurisdictions to ensure tax deductibility and it is essential to have a level playing field amongst EU Member States in the area of tax deductibility. ACSM do not alter the equity like nature of the hybrid instrument.

   The EBF agrees 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 mandatory after first call date, …).

2. The EBF acknowledges that ACSM need to be submitted to relevant conditions to ensure compliance with the principles of permanency, loss absorption and flexibility of payments. However, it disagrees with two conditions included in the CEBS draft proposal.

   First, it should not be required that the newly issued shares be subscribed <u>by the hybrid holders</u>. The CEBS proposals do not provide any explanation as to why there would be a need whatsoever to restrict the type of investors who are entitled to subscribe to newly issued shares. Such a requirement does not bear any relationship to the principles of permanence, loss absorption and payment flexibility. Moreover, investors who invest into Tier-1 securities are exposed to losses in case of financial difficulties as these are listed and susceptible to loosing value in adverse circumstances.

   Secondly, it should not be required that ACSM be exercised <u>immediately</u> to avoid accumulation of debt. Imposing such a constraint unduly restricts the use that can be made of ACSM and reduces the required flexibility and discretion of issuers on payments and capital management. This timing detail concerning the use made of the ACSM should remain a prerogative of the company's management. A timing constraint on the exercise of the ACSM would be a serious limitation of the flexibility of the institution to repair its solvency situation in an optimal way. As deferred coupons will rank *pari passu* with the underlying instruments, it is therefore difficult imagine how an overhang could be created to the detriment of the solvency position of the institution. Coupons could be postponed indefinitely. Instead 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.

3. In a going concern and stressed situation, ACSM leave full flexibility and discretion over the payment to the issuer's management.

   In stressed situations, ACSM increase the capacity of the instrument to absorb losses, preserving cash without any risk of investors invoking default and triggering liquidation. Moreover, ACSM are non-cumulative from the issuer's perspective as they do not deplete the institution's capital resources.

   In case of liquidation, losses are absorbed in accordance with the degree of liquidation. 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

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ACSM. Its ranking is the same as the subordinated ranking of the instrument ensuring that hybrid holders' claims are not met before all more senior claims are satisfied.

Most importantly, ACSM do not alter the permanency of the instrument, which is a key feature for hybrid instrument to be eligible as Tier-1 capital and ensure that capital is available in stress situation.

Therefore, the flexibility for issuers to issue Tier-1 with ACSM for tax reasons should not be restricted by limiting them to 15% of total Tier-1 capital after deductions.

**d) Other Concerns raised by the Proposed Limits**

- Both limits referred to above take Tier 1 after deductions for goodwill as a benchmark. Such an approach is not 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.

- The CEBS document always refers to "*common shares and disclosed reserves/retained earnings*". However, common shares are not the only class of shares in Europe.

## V. GRANDFATHERING & TRANSITIONAL PROVISIONS

Grandfathering of existing instruments would be essential as the volume of outstanding hybrid instruments which may cease to qualify under the proposed rules could be substantial.

*a) No distinction should be made between hybrid instruments with incentives to redeem and other hybrid instruments*

1. The general approach adopted in the CEBS document in this regard is puzzling. It proposes to discriminate between hybrid instruments with incentives to redeem and other hybrid instruments – without providing any explanation as to why such a distinction should be relevant and appropriate from a grandfathering perspective. We question whether such a distinction is indeed relevant on the basis that 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.

2. Uncertainties remain on the exact meaning of the proposed grandfathering mechanism proposal. We understand the CEBS proposals as follows:
   a) instruments with incentives to redeem are eligible to count as Tier 1 up to the first call date (whenever the call date is, even if in 30 years ahead);

b) instruments with no incentive to redeem and instruments with incentives to redeem which first call date has already occurred and that have not been redeemed must not exceed 20% of total Tier 1 in 10 years time, 10% in 20 years time and will stop counting as Tier 1 capital at year 30.

3. Another interpretation of the CEBS proposals according to which instruments with incentives to redeem would no longer qualify as regulatory capital after the first call date could have adverse consequences as it would make the instrument becoming regulatory-wise dated. This would create a strong additional incentive to exercise the call (because, otherwise, the instrument will no longer qualify as Tier 1) in a context where the issuer is not always in a position to redeem because of:
    - 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);
    - a refusal from the regulator to allow the call of the instrument to be called.

Therefore, under any interpretation, it would seem more appropriate to apply the grandfathering equally to all instruments, so that the call exercise decision remains at the discretion of the issuer (subject, of course, to prior supervisory approval).

It also needs to be observed that we do not understand what is meant by *"hybrids with incentives to redeem which are not callable"*, to which paragraph 62, b refers.

Finally, it should be noted that some instruments may present 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.

*b) Total grandfathering would be appropriate until an agreement is reached within the Basel Committee*

1. 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".

2. Once the new European rules will have come into force, new hybrid instruments issuances will need to bear the characteristics finally defined. As a consequence, those 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

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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 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.

3. 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 players. It needs to be reminded in this context that the SPR advocated for a total grandfathering.

4. On the basis of the arguments mentioned above, a total grandfathering of existing instruments is strongly required, at least until Basel Committee defines a new framework and gives grandfathering indications. All pre-dated instruments which qualified as Tier 1 capital under the rules-that are currently in place in that jurisdiction should continue to qualify.