ZENTRALER KREDITAUSSCHUSS (GERMAN CENTRAL LOANS COMMITTEE)

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Comments of the
German Central Loans Committee (Zentraler Kreditausschuss)
on

Consultation Paper "Implementation guidelines regarding hybrid capital instruments" – CP27

23 September 2009

Dear Sir or Madam,

We are pleased to take the opportunity provided to us to comment on the contents of Consultation Paper CP 27 entitled 'Implementation Guidelines regarding Hybrid Capital Instruments' and present our responses to the questions raised in the consultation paper below.

A. Permanence

I. Incentives to redeem – Article 63 a (2), subparagraph (1), sentence 3

Question 1:

1.1 Are the guidelines in relation 'incentive to redeem' sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

1.2 Please describe the potential impact of a cap of 150% relating to stock settlement of the conversion ratio. Please provide evidence.

For the most part, the guidelines on 'incentive to redeem' are sufficiently clear in our opinion. An illustrative example of how the conversion ratio works when there is a 'principal stock settlement mechanism' in place would be helpful and desirable. In particular, the basis for the conversion ratio is not clear (e.g. units, nominal value, market value).

The provisions for the design of a moderate step-up clause correspond primarily to the previous specifications of the Sydney Press Release. However, the definition in sub-paragraph 53 goes beyond that: 'Incentives to redeem can be defined as those features that, **in the perception of market participants**, provide for an expectation of the hybrid instrument being redeemed at the call date.' The reference to the market participants does not appear to us to be useful in achieving the intended purpose. It is difficult to anticipate what the market 'subjectively' defines as a redemption incentive. To this extent each institution should document its own assessment for the supervisory authorities and in doubtful cases coordinate it with its auditor or the supervisory authorities.

Furthermore, in our view it is not clear why an innovative instrument should not be handled like a non-innovative instrument with correspondingly higher restrictions after the expiration of the right to exercise options/call right (sub-paragraph 58). After the appearance of the incentive to call without exercising repayment by the issuer, there is no more incentive - and often no more possibility - left to terminate the instrument. It is thus necessary to assess it in its overall configuration and - if necessary - to reclassify it according (e.g. as an 'other hybrid' with the restriction to 35% of the core capital). We therefore request that sub-paragraph 58 be changed in this sense.

II. Supervisory consent to a call on redemption of a hybrid-instrument – Article 63 a (2), subparagraph (2), sentences 1 and 2 and subparagraph (3)

Even if question 2 deals exclusively with the issue of the buy-back of an institution's own hybrid capital, we would like to take the opportunity to make the following comments on the statements in the sub-paragraphs 61-70 of the guidelines.

The minimum information to be provided by the institutions as part of the approval process for redemption is too extensive in our opinion, nor is it justified in view of the documentation already available to the supervisory authorities. The data to be supplied by the institutions should therefore be limited to the information not yet provided to the supervisors. In particular, this applies to the information already available to the supervisory authorities from Pillar 2 (ICAAP). The results of the ICAAP are at risk of not being taken sufficiently into account, which would lead to a doubling of the disclosure duties of the institutions, among other things. Rather, the (approved) results of the ICAAP should be recognised as correct and sufficient. This is already entered in sub-paragraph 62.

Sub-paragraph 62 specifies that the institutions are obligated to provide the required documentation to the supervisory authorities 'well in advance of the call or redemption date'. However, any repayment or call depends on the market conditions at the actual date. This ambiguous formulation should therefore be made more specific in order to ensure a sufficient degree of reliability in favour of the institutions. For instance, this could be accomplished by establishing a maximum audit period for the supervisory authorities. In this case, the institution wishing to call would have a clear indication of the latest time by which the required documentation has to be submitted in order to achieve repayment on the scheduled date. Furthermore, keeping the lead times as short as possible for a call or repayment would significantly restrict the possibilities for insider dealings, which always exist in the case of long lead times.

The information and documentation to be provided by the institution as specified in sub-paragraph 64 appear to be practically prohibitive, particularly with regard to the requirements of letters c and d. Supplemented by the further possibilities for the benefit of the supervisory authorities listed in sub-paragraphs 65 and 66, in our opinion disproportionately high hurdles are established for the institutions. Beyond that, the formulation of the specifications in sub-paragraphs 65 and 66 as options in favour of the supervisory authorities, the desired goal of uniform handling to the greatest extent possible within the EU is likewise not adequately achieved.

It would therefore be advantageous to clarify in sub-paragraph 64 that the list is not a generally applicable checklist that must always be completed ('at a minimum'). Rather, the list should be an indication for the supervisory authorities as regards the information they 'should consider among others'. Furthermore, it should be clarified that it is the responsibility of the relevant supervisor to determine the level of review (individual company accounts or consolidated accounts) of the information to be provided. In particular, it should be possible for institutions that use the so-called waiver to provide corresponding documentation only at the consolidated level.

Moreover, the planning period specified in sub-paragraph 64, letter c) is far too long. A five-year planning period is neither usual nor are the planning results informative or useful - particularly in the current market situation. We request that the planning period be limited to three years.

Precisely the information specified in sub-paragraph 64, letter d) is completely included in the ICAAP, which is reviewed by the supervisory authorities. However, to prevent misunderstandings, it would be necessary to clarify with regard to the stress tests mentioned in the last clause what type of stress tests and stress test results are to be submitted to the supervisory authorities.

With reference to the regulation in sub-paragraph 67, in our opinion the specified mere possibility of reducing the information requirements is not acceptable. If the hybrid capital intended for repayment was already replaced by at least equivalent equity capital and thus after the repayment no negative change whatsoever compared to the status quo before the collection of the replacement capital, in our view there is no reason why an institution should be obligated to provide extensive documentation. Thus we advocate completely foregoing the provision of documentation or at least creating clearly defined forms of relief with regard to the information to be provided.

With reference to the stipulations in sub-paragraphs 68-70, it would be helpful if the guidelines contained a specification of those cases in which the approval for repayment must always be issued. The current formulation in sub-paragraph 60 of a 'sufficient' capital buffer above the regulatory minimum capital requirements is so ambiguous that on this basis no uniform handling within the European Union will be achieved.

Keeping in mind the regulatory content of sub-paragraphs 65 and 66, the content of sub-paragraph 70 appears to us to be redundant. These statements could be deleted.

III. Supervisory guidance on buy-backs of hybrid capital instruments in the market

Question 2:

2.1 Are the guidelines in relation to 'buy back' sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

2.2 CEBS is considering whether buy-backs should under certain conditions also be permissible before five years and without replacement. A number of CEBS members would support such a provision under strict conditions and subject to prior supervisory approval, notably if the buy-back responds to exceptional circumstances, is acceptable from a prudential point of view and results in a lasting improvement of the institution's solvency situation. A number of other members have concerns regarding such an exemption, in particular as it may compromise the permanence of the hybrid instrument by enhancing investors' pressure on banks to buy back outstanding hybrids and by providing incentives for banks to reduce their overall capital position at times when their own credit quality is decreasing.

As a basis for its decision CEBS therefore wishes to gather further evidence on the following points:

2.2.1 What would be the impact if buy-backs before five years after the issue of the instrument were allowed only under the conditions described in paragraph 72? Please provide evidence.

2.2.2 Please describe circumstances – other than current market conditions – in which a buy-back at an earlier stage without the requirement to replace them with instruments of the same or better quality would be justified from a prudential perspective.

2.2.3 Which criteria should be provided in order to address the above mentioned concerns, and in particular to avoid setting incentives to deplete the capital base of banks whose credit quality is decreasing?

2.3 What would be the impact of limiting the amount of repurchased instruments held by the institution at any time to 5 % of the relevant issuance? Please provide evidence.

2.1

The regulations for buy-backs are sufficiently clear. However, we advocate deleting the issue of buy-backs from the present guidelines entirely. This topic is in no way an original issue relating to hybrid capital. The question of buy-backs of issued equity capital instruments is raised in comparable form for components outside of the area of core capital and must thus be fundamentally discussed within a more comprehensive context. Neither the European legislators nor the Basel Framework nor the Sydney Press Release have contained such regulations up to now. In our view, and keeping ICAAP in mind, they are not necessary, either. Thus, before a purely European regulation is created that is limited to hybrid core capital instruments, a uniform international regulation for all tradable capital components should be aimed for, insofar as this is considered necessary.

Apart from this fundamental position, in our opinion the concept of regulatory approval for buy-back programmes beyond that is generally inappropriate.

Here two very different issues (call at par/100% solely on the initiative of the issuer and buy-back at market prices with the approval (will to sell) of the investor) are treated identically, but cannot be compared in this form. In comparison to calls, buy-backs should be handled significantly less restrictive and should not require any regulatory approval.

2.2

Regardless of the requirement for approval for buy-backs which is fundamentally unnecessary in our view (see comments under 2.1), we wish to take this opportunity to provide brief responses to the questions.

As a rule, no regulatory approval should be necessary if the amounts bought back were previously replaced by instruments of at least equivalent value.

Furthermore, the buy-back of instruments generally reduces the core capital. However, it regularly increases the volume of the traditional core capital. The buy-back of hybrid instruments below par creates profits which lead to an increase in the revenue reserves, which are allocated to the traditional core capital. In exceptional situations such as exceeding of the limits of hybrid instruments as core capital and thus a lack of regulatory recognition of these instruments as components of the core capital, the volume of the core capital can actually be increased.

Thus, from the point of view of the German Central Loans Committee (ZKA), an easier buy-back without regulatory approval should be possible at least for the components of issues of hybrid equity capital instruments which can be recognised only as supplementary capital due to the exceeding of the recognition limits. This should apply because, for example, the reduction of the overall capital level can lead to such exceeding and then unnecessarily high premiums must be paid for 'unneeded' capital.

Beyond that, certain exceptional situations such as a reorganisation of the institution may necessitate a buy-back of hybrid instruments. However, in these cases a buy-back before the end of a five-year period should be possible even without replacement by equivalent or higher-value capital.

2.3

We support CEBS in its view that a minimum level of market making is absolutely necessary. Today there is already a 'market support clause' is based on 3% of all outstanding issues. Five percent based on an individual issue, on the other hand, is insufficient, particularly in the initial phase of an issue (for market making). Thus the proposed limit of market support to 5% should not be based on the individual issues, but on the total amount of all hybrid instruments issued.

The stipulation contained in sub-paragraph 73 that corresponding regulations should apparently be designed only as national discretions appears dubious. In the interest of a playing field as level as possible for the competition, such a regulatory approach should fundamentally be made available to all institutions.

B. Flexibility of payments

I) Supervisory request for the cancellation of payments

In sub-paragraph 78, CEBS should clarify the specific definition of 'distributable items'. We assume that a coupon payment from 'retained earnings' or 'disclosed reserves' is possible.

With regard to the comments in sub-paragraph 79 in conjunction with sub-paragraph 81, the guidelines contain no statements whatsoever as to who is responsible for providing the required data basis for the evaluation by the supervisory authorities. In contrast to sub-paragraph 64, it will surely not be possible to obligate the institutions to provide the corresponding data (in particular sub-paragraph 81, letter b). Rather, we assume that the necessary information is already available to the supervisory authorities via the review of the individual ICAAP.

Apart from this it appears doubtful on the whole whether the cancellation of coupon payments and/or dividends of the hybrid instruments should ensue on the basis of forecast decisions of the supervisory authorities. Indeed, premature cancellation of these payments can trigger crises in the individual institutions. Furthermore, based on experience, such forecast decisions can conceal considerable risk of compensation for damages at the expense of the supervisory authorities. Thus the use of criteria based on the principles of the ICAAP that are understandable and traceable for investors and market participants should be considered, at least in supplementary form. In our view, this is also necessary from the standpoint of a level playing field, as the various interpretations of the national bank supervisory authorities can be disadvantageous for individual institutions. For instance, if coupon payments are regularly cancelled early in one country, this institution will have more difficulty finding investors.

II. Flexibility of payments – other features of hybrid instruments (e.g. dividend pushers and stoppers)

Question 3:

Are the guidelines in relation to dividend pushers or stoppers sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.
What would be the impact of the restriction on the use of dividend pushers and stoppers? Please provide evidence.

The comments in sub-paragraphs 82-85 regarding 'dividend pushers and stoppers' are fundamentally clear with regard to their comprehensibility.

A restriction on the usability of dividend pushers and stoppers would create confusion among investors and market participants and make the market opaque. Hybrid instrument creditors could be placed at a disadvantage compared to the providers of share capital. This would lead to non-saleable instruments or ones that would at least be difficult to place.

C. Loss absorbency

Question 5:

5.1 Are the guidelines relating to the definition of loss absorbency in going concern sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.
5.2 Do you agree with the definition of loss absorbency in going concern? If not, why not, and what alternative would you propose?
5.3 Do the guidelines provide sufficient flexibility for institutions to design mechanisms that fulfil the objective of loss absorbency in a going concern? What alternative would you propose? Does this flexibility raise level playing field issues?
5.4 Do you think that different levels of subordination allow sufficient transparency on the ability of these instruments to cover losses in liquidation? Alternatively, would you prefer to preclude different ranking between hybrids completely?

5.1
The term 'viable' used in sub-paragraph 96 is not precisely defined in our view; therefore it is inappropriate for purposes of capital definition. The reference to the solvency of an institution appears adequate. On the contrary, if one assumes that the formulation of sub-paragraph 111 could apply as a legal definition ('viability measured as ability to raise funds (…)'), then one would have to deny the viability of nearly all banks worldwide at particular times of the current crisis. We therefore propose reformulation of the definition or better yet a complete omission of the term.

We emphatically reject the consideration expressed in sub-paragraph 97 by CEBS to create an independent insolvency term for regulatory purposes. Domestic insolvency regulations must have unrestricted validity for banking industry too. A division of terms for insolvency is scarcely manageable in practice and would moreover carry with it particularly noticeable liability risks for supervisory authorities in the case of erroneous decisions.

The term 'winding-up' in sub-paragraph 100 is not precisely defined in our view. Clarification here would be helpful.

5.2

We agree with the definition of loss absorbency in the going concern case as explained in sub-paragraph 105.

5.3

The explanations in the sub-paragraphs 106 to 109 on the capacity of an instrument to prevent insolvency or at least not be able to trigger it appear to be appropriate. Sub-paragraph 106 letters a) and b) and 107 are satisfied by the principles of stability and flexibility of payments.

Sub-paragraphs 108 and 109 for non-consideration in the determination of insolvency are drafted with adequate breadth to apply to the specific jurisdictions – in particular Germany – and arrive at the same economic result.

With respect to the mechanism described in sub-paragraph 114 for ensuring recapitalisation of an institution, it must be noted that the mechanism of permanent depreciation to the nominal value of the hybrid capital (letter a) would lead to investors pulling back from investment in the hybrid instruments. Providers of hybrid capital would be disadvantaged compared to shareholders by this mechanism, since the latter once again participate in the success of the company via the increase in share price and dividend payments if the economic situation improves. In this regard it will not be possible to make investors understand why the unlimited term hybrid capital instruments are not assigned the original nominal value again. Consequently, hybrid instruments equipped with this mechanism could be placed on the market only with difficulty and significant expense.

Sentence 2 and sentences 4 to 5 in sub-paragraph 114 letter b) contain contradictory statements. The ZKA considers the statements in sentences 4 and 5 adequate and recommends eliminating sentence 2.

The description in sub-paragraph 117 of the mechanism for triggering loss absorbency by investors is important, especially in the context of the structuring of contracts. However, disclosure to the market as required in the second clause does not make sense and goes much too far. This would lead to an information overload for interested market participants and would tend to obscure important information. Therefore the phrase 'to the market' should be replaced by 'to the investor' and 'for example as part of the pillar 3 requirements/ disclosures' should be deleted. Rather, it would be more practical to place a disclosure to interested parties in the product prospectus.

5.4
In our estimation, different grades of hybrids equity are welcome as long as they are disclosed and investors correspondingly informed in a transparent manner. Depending on the embodiment, a differentiated ranking of hybrid capital instruments can even lead to improved core capital quality, because in the case of liquidation, hybrid instruments are in part of equal standing with share capital. The option of issuing instruments of various grades within the hybrid capital constitutes an important adjustment tool for the institution with regard to the assessment of the respective securities by rating agencies.

D. Limits

Question 6:

6.1 Are the guidelines relating to the assignment of hybrid instruments to one of the three limits sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals on how the text could be amended.

6.2 Do you believe that the conditions imposed to mandatory convertibles are proportionate and balanced? Would you propose any other options?

6.1
Fundamentally, the guidelines are sufficiently understandable with respect to the assignment of the hybrid equity instruments to one of the three categories. However, the way in which the conversion ratio in sub-paragraph 135 works could be made more transparent for normal users by means of an illustrative example.

6.2
The reference in sub-paragraph 130 to pillar 2 does not appear appropriate and should therefore be removed. The requirements and bases for assessment of pillar 2 are significantly broader than the risks which are to be covered by the regulatory capital (such as changes in interest rate of the banking book, liquidity risks, etc.).

With sub-paragraph 131 it should be clarified that the investor's conversion option need not be mandatory. Such a regulation would be difficult in our view, because the institute would otherwise cause considerable dilution risks with use of a corresponding instrument and it is possible that the attractiveness of the equity instruments would suffer considerably. Moreover, the requirement is not plausible from regulatory standpoints. It does not lead to an improvement of the capital position of an institution. A corresponding regulation should in any case only occur on a voluntary basis. Therefore the last sentence of sub-paragraph 131 should be taken out.

In the sub-paragraphs 136 to 138 it should be explained more clearly what is to be understood as an emergency situation. Otherwise the goal of harmonized application for the new regulations within the EU is not achievable.

E) Hybrid instrument issued through an SPV

Question 7:

Are the guidelines relating to the indirect issues of hybrids instruments sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

The fundamentally embodiment for SPV analogous to directly issued instruments makes sense from the perspective of the banks in Germany. Fulfilment of the principles of stability, flexibility of payments and as well as compliance with limits appears to pose no difficulty.
In sub-paragraph 139, sentence 2 explains that 'SPVs are consolidated within the accounts of their parent institution'. This could be understood so that with hybrids issued by SPVs there is an implicit requirement that the medium for the public offering is counted among the companies included in the consolidation of the credit institution. However, with a look at the applicable accounting rules, this need not be the case with every transaction structure. Therefore sentence 2 should be stricken to avoid misunderstandings.

There is additional need for clarification with respect to the organisation of loss absorbency. In particular, it must be made clear here at which level a loss must be determined and which functions as a trigger for the loss sharing mechanism. Conceivable levels would be the consolidated group level (generally preparing the financial statement according to IFRS), the lone institution level (generally preparing the financial statement according to local GAAP), the level of the individual SPV (generally preparing the financial statement according to local

GAAP) or any levels between these stages if present. From the perspective of the ZKA, the simplest option would be a link to the "lowest" level – the SPV level.

Furthermore, in our view it is difficult to define how the support of recapitalisation is to take place.

Further detailed definition, such as how proof of minimising legal risks based on the issuance of hybrids instruments abroad is to take place (sub-paragraph 144), appears necessary.

Kind regards

on behalf of the

ZENTRALEN KREDITAUSSCHUSS (German Central Loans Committee)

Bundesverband der Deutschen
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p. p.

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