POSITION PAPER

ESBG Response to

CEBS Consultation paper on Implementation Guidelines regarding hybrid capital instruments

(CP 27)

European Savings Banks Group Register ID 8765978796-80

September 2009

The European Savings Banks Group (ESBG) welcomes the opportunity to comment on CEBS' Consultation Paper on Implementation Guidelines regarding Hybrid Capital Instruments (CP 27).

The consultation paper as well as the public hearing with CEBS at the beginning of September highlighted that there is a genuine risk that, under new regulatory requirements, fixed income investors will no longer be willing to buy Tier 1 securities. Fixed income investors have provided substantial amounts of bank capital in recent years. Without this investor base, banks will need to turn to equity and convertible bond investors, making it more expensive and more difficult to raise Tier 1.

Especially the "Loss absorbency topic" is very crucial in this context. Some of the proposed changes/ guidelines (e.g. permanent write down, disabling dividend stoppers/ pushers when the securities has "absorbed losses or when a recapitalization took place) literally subordinate hybrid Tier 1 securities to ordinary shares, making it simply impossible to attract fixed income investors for this product. This will of course have a negative impact on pricing of banking services and products.

A. <u>Permanence</u>

I. Incentives to redeem

1.1 Are the guidelines in relation to "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.

ESBG deems that CEBS guidelines on "incentives to redeem" are generally clear; however some aspects would need to be further specified.

Specifically, it might be helpful and desirable to provide an example in order to ensure a better understanding of the functioning of the "cap on the conversion ratio" in the case of a "principal stock settlement mechanism", especially in view of clarifying to what the conversion ratio applies (face value, market value etc.).

The provisions on the moderate step-up generally correspond to the requirements in the Sydney Press release. However, the definition of "incentives to redeem" referring explicitly to "the perception of market participants" goes, in our view beyond the "Sydney Press release". This reference to market participants does not seem appropriate to us, as it is difficult to anticipate what the market "subjectively" perceives as being an incentive to redeem. Therefore, in our view it is for every institution to present comprehensively its own assessment to the supervisory authority and find an agreement with its auditors or supervisors in cases of doubt.

In addition it is not clear why innovative instruments with incentives to redeem that are not called cannot be re-classified as non-innovative instruments, which benefit from different limits (paragraph 58). Once there is an incentive to redeem but the instrument is not called by the issuer, there are no more incentives – and often, also no more possibilities – to redeem the instrument. Therefore, the instrument should be assessed according to its overall configuration and, if necessary, re-classified accordingly (for instance as 'other hybrids' corresponding to the 35% of core capital limit). We therefore urge CEBS to change the text in paragraph 58 in this sense.

II. Supervisory consent to a call or redemption of a hybrid instrument

ESBG considers that the minimum information required from an institution in the context of an application for calling or redeeming a hybrid instrument is too extensive. Given the information already available to supervisory authorities such a burden is not justified. The information to be provided by the institutions should therefore be limited to what is not yet available to the supervisors. In particular, it is important to consider the results of the ICAAP, and to avoid any tendency to double notification duties. We would suggest recognising the approved results of ICAAP as correct and sufficient; this is only partly foreseen in paragraph 62.

Paragraph 62 requires that the issuer schedules the submission of the application to call or redeem a hybrid instrument "well in advance of the call or redemption date". However, the call or redemption depends on the market conditions at the actual date. Therefore, the vague wording should be specified so as to provide institutions with a sufficient degree of reliability. This could occur – for instance – by establishing a maximum control interval for the supervisors, which would offer a clear indication as to the latest moment when an institution willing to redeem or call an instrument can submit the required documentation.

The additional information listed in paragraph 64, especially in letters c) and d), appears to us almost prohibitive. Complemented with the wide powers attributed to supervisors under paragraphs 65 and 66, these requirements will impose disproportionate burden on the institutions. Therefore, it is necessary to specify that the information enumerated in paragraph 64 does not represent a checklist that should always be applied ("at a minimum"). The list should rather represent a reference for the supervisors as regards the information they should consider "among others".

As regards the details, we maintain that a 5 year planning period, as proposed under paragraph 64 letter c) is too wide, and is neither common nor relevant especially under the current circumstances in the financial markets. Therefore, ESBG would plead for a 3-year time horizon.

The requirements listed under paragraph 64 letter d) are contained in the approved ICAAP. In order to guard against any misunderstandings, it should be made clear in the last sentence which kinds of stress tests/ results of stress tests have to be presented to the supervisors.

In case that a hybrid instrument has already been replaced by capital of at least the same or better quality there are no negative changes as regards repayment when compared to the *status quo*. Therefore there is no reason, from our point of view, for an entity to submit extensive documentation. Consequently, we consider that it is not acceptable to merely foresee the possibility that competent authorities require less information. The requirement to submit documentation should be completely waived or there should be, at least, a clearly defined relief as regards the information to be submitted.

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

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.

The proposed guidelines seem to be clear. However, ESBG urges CEBS to completely delete its recommendations regarding buy-backs. “Buy back” is not a topic typical for hybrid capital instruments, but concerns a wider series of capital instruments, beyond the core capital and should therefore be discussed in principle in a wider context. So far there are no rules on buy back, be it in European legislation, in recommendations of the Basel Committee or in the Sydney Press Release. The main question is whether there is at all any need for regulating buy-backs. In case it would ever be decided that such regulation is needed, then there should first be an agreement at international level before any attempt is made to impose European rules that would be limited to hybrid core capital instruments.

Beyond this position of principle, ESBG regards the very idea of imposing supervisory approval for buy back programmes as inadequate. Two very different issues (redemption at par at the sole initiative of the issuer and buy backs at market prices with the agreement of the investor) are treated equally in CEBS guidelines although they are not comparable. Buy backs should obviously be less restrictive as compared to redemption and should not be subject to supervisory approval.

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 only allowed 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?

As stated in our answer to the previous question our main stance is that in principle there should be no approval required in case of buy backs. However, should CEBS decide to persist with the proposed approach, it is imperative that the proposed minimum threshold of five years after issuance be rendered more flexible, in order to take due account of specific situations, such as bank restructuring, Tier 1 exchange offers, etc.

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.

ESBG supports CEBS’ view that a minimum limit is needed to allow institutions to undertake activities for market making or market smoothing purposes. However, we perceive the proposed limit of 5% of the relevant issue as being insufficient, especially if considering the initial phase of an issuance. Therefore, we suggest either that the 5% limit refers to the overall amount of outstanding hybrids (not for an individual issuance), or that the limit applied to an individual issuance be increased up to 10%.

Also, we deem that such a limit should be applied as a general rule and not at the discretion of the competent authorities, in order to ensure fair competitive conditions.

B. Flexibility of payments

I. Supervisory request for the cancellation of payments

In paragraph 78, the meaning of “distributable items” should be clearly specified. Our understanding is that coupons may be paid out of “retained earnings” or “disclosed reserves”.

From the wording of paragraphs 79 and 81, it is not clear where the information needed for the supervisory assessment is coming from. Different from paragraph 64, it cannot be envisaged to oblige the institutions to provide the necessary information – especially those implied for paragraph 81 letter b). Our understanding is that this information is already available to the supervisors from their review of the individual ICAAPs.

Notwithstanding this, it is definitely questionable if, on the basis of estimations it is possible for competent authorities to decide on the cancellation of coupons/ dividends. A precipitated cancellation of payments may lead to critical developments at individual institutions and trigger supervisory liability.

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)

> 3. Are the guidelines in relation to dividend pusher or stopper 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 pusher and stopper? Please provide evidence.

The paragraphs 82 to 85 on “dividend pushers and stoppers” are in principle intelligible.

There should be no restrictions on the use of dividend pushers and stoppers. Any limitations would create confusion among investors and market participants and would render the market intransparent. Hybrid holders might be worse off than equity holders. This risks rendering hybrids non-disposable instruments or at least instruments which can only be placed at high costs.

III. Alternative Coupon Satisfaction Mechanisms (ACSM)

4.1 Are the guidelines in relation to ACSM sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals on how the text could be amended.

4.2 What would be the impact of implementing these guidelines on ACSM mechanisms? Would you propose any other options?

ESBG considers that the definition of "without delay" should be clarified.

C. Loss absorbency

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.

Paragraph 94 requires that loss absorbency on a going concern basis is dependent on the viability of an institution. However, in our view "viable" is not clearly defined and therefore not adequate for capital definition purposes. On the contrary, if it were suggested that the definition of viability in paragraph 111 counts as a legal definition ("viability measured as ability to raise funds…"), the application of such definition during the current crisis would have resulted in almost all banks being considered as being not viable. Therefore, we advocate that the reference to the concepts of "viability" and "viable" be abandoned.

The use of the concept "winding-up" in paragraph 100 is from our point of view not clear and would require more specification.

5.2 Do you agree with the definition of loss absorbency in going concern? If not why and what alternative would you propose?

We agree with the definition of ability to absorb losses in going concern as given in paragraph 105.

5.3 Do the guidelines provide sufficient flexibility for institutions to design mechanisms that fulfill the objective of loss absorbency in going concern? What alternative would you propose? Does this flexibility raise level playing field issues?

As regards the mechanism described in paragraph 114 letter a) – i.e. writing down permanently the nominal amount of the principal at a trigger point – we consider that this would disadvantage hybrid holders as compared to equity holders. Whereas equity holders could benefit from the improvement of market conditions through the increase in the share price or the payment of dividends in case of profit, hybrid holders will not. This would discourage investments in hybrid instruments, as it would be difficult to explain why undated hybrids could not be written back up again to their nominal value. It would be very difficult and costly to place on the market hybrids endowed with this kind of mechanism.

In paragraph 114 letter b) sentence 2, on the one hand, and sentences 4 and 5, on the other hand, seem contradictory. It is proposed to delete sentence 2.

The requirement in paragraph 117 that the mechanisms be "disclosed and transparent to the market" is considered too extensive and unreasonable. It would lead to an information overflow of interested market participants and risks obscuring important information. On the contrary, it is important that such mechanisms be disclosed to the investor. Therefore, we suggest to replace the expression “to the market” with “to the investor” and to delete the reference “for example as part of the pillar 3 requirements/ disclosures”.

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 completely preclude different ranking between hybrids?

ESBG welcomes different levels of ranking between hybrid capital instruments, as long as they are properly disclosed and investors are adequately informed about them.

D. Limits

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 how the text could be amended.

In general, the guidelines relating to the assignment of hybrid instruments to one of the three limits appear to be sufficiently clear. It would be welcomed if the functioning of the conversion ratio referred to in paragraph 135 would be specified through an example, in view of facilitating the application of the norm.

Hybrid instruments falling under the 50% bucket are convertible in shares either at the call date or before in case of the occurrence of a trigger event or at the discretion of the supervisory authority. Therefore, it is legitimate to ask why these instruments are not eligible as core capital (simply Tier 1 capital without any limits).

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

The reference to Pillar 2 in paragraph 130 is not appropriate and should be deleted. The requirements for the assessment of risks under Pillar 2 are considerably wider than the risks covered by the regulatory capital (e.g. the interest rate risk in the banking book, liquidity risks, etc.).

Emergency situations as referred to in paragraphs 136 to 138 should be more clearly defined, if the objective of the guidelines is to ensure a harmonised application of common rules within the EU.

E. Hybrid instrument issued through an SPV

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.

ESBG agrees that, for prudential treatment purposes, hybrid instruments issued through an SPV should comply with the same conditions for qualification as original own funds.

The applicable accounting rules should be duly taken into account. Therefore, sentences such as “SPVs are consolidated within the accounts of their parent institution” (paragraph 139, second sentence) should be deleted to avoid any misunderstandings, as it is not necessary that the issuing SPV has to be included into the consolidated accounts of the credit institution.

Furthermore, it should be clarified how the issuer of the SPV could demonstrate that he minimised cross-border and legal risk (paragraph 144).

Other aspects

ESBG would like CEBS to supplement its guidelines by providing an interpretation of the grandfathering clauses in article 154 paragraphs 8 and 9. It would be for instance necessary to clarify whether there is a need to differentiate between the various types of hybrid instruments (especially innovative and non-innovative).

About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 6061 billion (1 January 2008). It represents the interest of its Members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG Members are typically savings and retail banks or associations thereof. They are often organized in decentralized networks and offer their services throughout their region. ESBG Member banks have reinvested responsibly in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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Published by ESBG. September 2009