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Comments on the CEBS "Draft Proposal for a Common EU Definition of Tier 1 Hybrids"

Japanese Bankers Association

We are an industry association that represents the Japanese banking sector. Our membership consists of 142 Japanese banks and 46 foreign banks active in Japan.

On December 7 of last year, the Committee of European Banking Supervisors (CEBS) sent out for market consultation a document entitled "Draft Proposal for a Common EU Definition of Tier 1 Hybrids."

We take this opportunity to comment on the draft proposal because some of our member banks have offices in Europe and this proposal is considered likely to impact the discussions on "the definition of capital (numerator)" in the context of the regulation on capital adequacy which may take place at the Basel Committee.

In light of the magnitude of the impact of this document, we hope that our comments below would assist the CEBS in its further work on this matter.

[General Comments]

This draft proposal states "...the objective of CEBS is not to create a brand new definition for Tier 1 hybrids" (paragraph 13) and is regarded as a proposal which intends to incorporate the 1998 Sydney Press Release (SPR) hybrid capital principles into the Capital Requirement Directive. However, CEBS's interpretation of SPR and the establishment of quantitative limits partially go beyond SPR and will rather become new requirements in effect.

We understand that CEBS's proposal considers how to regulate banks in terms of capital adequacy during normal periods to ensure that they can raise capital under distressed conditions. However, we are concerned that the proposed new quantitative limits of hybrid capital instruments including those continuously applicable after the time of issuance might lead to an increased pro-cyclicality effect due to the decline in bank lending arising from the decrease in capital of the banks under financial distress and the lower flexibility of capital raising by banks. Therefore, we suggest that it would be necessary for CEBS to carefully consider its proposal in terms of financial stability.

We are aware that the Basel Committee on Banking Supervision (BCBS) is working on the definition of regulatory capital through the research of current practices and that it is likely to further review the definition of eligible regulatory capital in the years to come. In light of the circumstances where the international level playing field of capital adequacy rules is indispensable, we would like to request CEBS to align with BCBS and take appropriate and careful steps toward implementing this proposal, considering the impact on various countries, not only in Europe, but also around the world.

[Specific Points]

We are concerned that the following specific points will go beyond SPR and will rather become new requirements in effect. So we request that CEBS take appropriate and careful steps toward implementing this proposal in line with the international discussions at BCBS.

1. *Concept of "Loss Absorption"*

   - We understand that CEBS is concerned about whether "hybrid instruments are able to absorb losses within the bank on a going-concern basis" (Paragraph 4, third indent in SPR) or not. However, concerning the CEBS's statement "In the case that the Tier 1 ratio falls below 2%, the instrument must be able to absorb losses either by ensuring that the principal of the instrument can be partially or fully written down; or the instrument can be converted into ordinary shares" (Paragraphs 45, 98-102), a prudential examination based on further assessments from a practical perspective would be necessary, because product development and business practice regarding capital instruments vary between countries due to difference in legal and accounting systems.

2. *Concept of "Flexibility of Payment"*

   - The draft proposal states "Issuers must be able to waive payments at any time" (Paragraph 51) and "...supervisors can require banks to waive payments at any time" (Paragraph 53): These requirements may conflict with the contents of SPR that state "the bank must have discretion over the amount and timing of distributions, subject only to prior waiver of distributions on the bank's common stock…" (Paragraph 5, third indent in SPR). In addition, they might drive investors to question the possibility of dividend payment of such hybrid capital instruments, which could shrink the relevant capital markets. In light of such negative consequences, we think that careful deliberations would be necessary.

     Especially, we are afraid that the requirement: "...supervisors can require banks to waive payments at any time" might not prove adequate. It is hard for supervisors, who are aware of the financial positions of a distressed bank, to order it to waive payments since such an order could in turn preclude additional capital raising by the bank. We are not certain whether this requirement is valid and feasible. We would appreciate it if CEBS would revisit this issue.

3. *Establishment of quantitative limits on Tier 1 hybrids*

   Regarding the following points on the quantitative limits, we would like to repeat the comment we made under "General Comments" above, i.e. the proposed limits might lead to an increased pro-cyclicality effect due to the decrease in capital of the banks under financial distress. We believe that these quantitative limits need to be reconsidered carefully after examining the practices in each jurisdiction and their possible impact on banks.

- The proposed limit that requires "...Common shares...must represent at least...70% of the required Tier 1 capital...and at all times 50% of total Tier 1..." (Paragraphs 60 and 61). This issue should be approached with caution also from the viewpoint of the scope of eligible instruments to which this limit is applied.
- The proposed limit that requires "Instruments with incentives to redeem...must not exceed 15% of total Tier 1 after deductions at any time..." (Paragraph 61).

In addition, this limit is applied not only to common shares but also other capital instruments (for example, convertible preferred shares). We are concerned that this could lead to reduced flexibility for banks in raising capital under distressed conditions, hence instability of the financial system. We would be most grateful if CEBS would carefully reconsider this issue.