

Disclaimer:

Please find hereafter a proposal for the eligibility of hybrid capital instruments into original own funds (« tier 1 ») as presented at the public hearing on 22 November 2007.

Please note that the presentation so far only reflects the proposal as discussed and agreed by the CEBS Working Group on Own Funds and its Expert Group on Capital Requirements but is **not yet the final CEBS advice to the Commission.**

CEBS proposals for a common EU definition of Tier 1 hybrids

CEBS open hearing

Sylvie Matherat | 22 November
2007

CEBS

Committee of European
Banking Supervisors

Outline

- The process
 - CEBS work in the context of the European Commission's Call for advice on own funds
 - CEBS mandated to focus on convergence in the area of Tier 1 Hybrids
- Towards a common EU definition
 - The starting point
 - The eligibility criteria
 - The limits
 - The grandfathering

CEBS work on own funds

Call for advice from the European Commission issued in June 2005

- A survey of eligible capital instruments in Europe published in June 2006
- A survey of the latest market trends published in June 2006
- A quantitative analysis of hybrid capital instruments eligible as original own funds in Europe, at year end 2006 – published in March 2007
- A quantitative analysis of all types of eligible own funds in Europe, at year end 2006 –published in June 2007

Transparency: CEBS reports available at <http://www.cebs.org/Advice/advice.htm>

Key findings: A lot of core commonalities...but a wide dispersion on the treatment of hybrids as original own funds ('Tier 1')

CEBS mandate on Tier 1 Hybrids: the scope

In April 2007, CEBS has been asked to

- develop general principles with regard to the three criteria of permanence, loss absorption and flexibility of payments
- explore convergence in the limits to inclusion of Tier 1 hybrids
- Underlying principles:
 - Substance over form
 - Concern in crisis situation
 - Limit the impact on the markets

.... With a view to improving the quality of regulatory capital

CEBS mandate on Tier 1 Hybrids: the timeline

April 2007: Mandate to be fulfilled by end 2007

June 2007: Public hearing : what a more consistent definition of Tier 1 hybrids could look like according to market participants?

July 2007: Technical meetings with internationally active rating agencies

October 2007: Technical meetings with investment banks and investors

November 2007: Public hearing to present preliminary proposals, prior to the formal consultation scheduled to start in December 2007.

CEBS mandate on Tier 1 Hybrids : the objective

Objective: Incorporate the Basel Committee's 1998 Press release ('the Sydney Press release') into EU legislation

Methodology: build on the convergence already achieved and clarify more precisely the areas where different interpretations have arisen

Impediments: differences in bankruptcy and company laws, differences in tax and accounting rules. Few instruments have been tested in practice.

CEBS mandate on Tier 1 Hybrids: the principles

- ‘Equity’ as the benchmark;
- Substance over form;
- Applicable to all hybrid instruments (innovative, non innovative, non cumulative perpetual preference shares), all types of institutions, all types of structures (direct or indirect);
- Respect the capital structure and the rank of subordination of the capital instruments;
- Adopt a pragmatic approach.

Tier 1 hybrids in Europe: the starting point

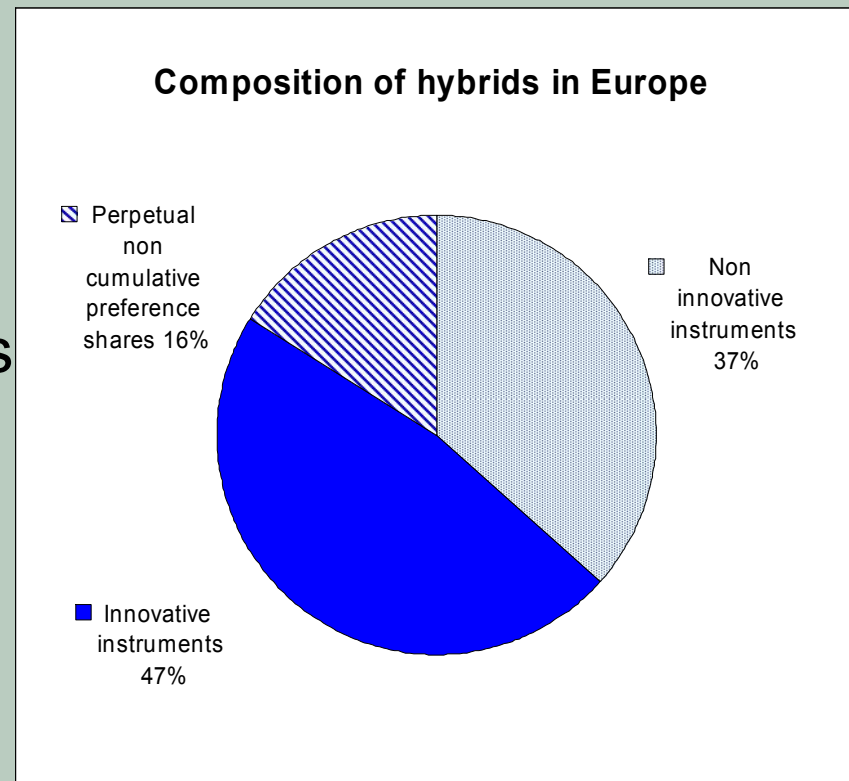
Size: 213 Bio EUR

11,5% of total own funds

- Innovative instruments (i.e. instruments with incentive to redeem such as step-ups)
- Non-innovative instruments (i.e. instruments without incentives to redeem)
- Non-cumulative perpetual preference shares

77% reported by

UK, DE, ES, FR, NL



Tier 1 hybrids in Europe: the starting point (ctd)

•When assessing whether hybrids can be eligible to Tier 1, EU supervisors subject hybrids to **three eligibility tests**:

- permanence;
- loss absorption; and
- flexibility of payments

•In June 2007, overall the industry was supportive of the approach of basing convergence on these three eligibility criteria

Tier 1 hybrids in Europe: the starting point (ct)

- The inclusion of Hybrids in Tier 1 is limited
 - Up to 15% for innovative instruments (hybrids with incentives to redeem)
 - From 15% and up to 50% for the other categories
- In June 2006, market participants
 - acknowledged the convergence already achieved with regard to the 15% limit;
 - proposed a trade off between the eligibility criteria and the limits.

Towards a common definition of Tier 1 hybrids

- Issued and fully paid up
 - Publicly disclosed and easily understood
 - Undated
 - Able to absorb losses
 - Able to suspend payment
 - Included in Tier 1 up to a certain limit
- => Must meet all aspects of the criteria altogether
- The grandfathering

Permanence

- The Sydney press release requires hybrids to be 'permanent' and sets out conditions in case of calls for early redemption
- In Europe, 95% of hybrids are explicitly undated and the conditions for early redemption are consistent with Basel:
 - in most cases the issuer has the option to call the issue after a minimum period; always subject to prior supervisory approval;
 - 58% of hybrids do not have any step-up. When they have one, the level of step-up is moderate.

Permanence: the proposal

- The instrument meets the permanence test if it is **undated**.
- The instrument can be **callable** under the same conditions as the Sydney Press release
- Step ups and principal stock settlements, when combined with a call option, are considered as incentives to redeem
- Instruments with incentives to redeem cannot exceed 15% of total Tier 1 after deductions

Loss absorbency

- The Sydney press release requires hybrids to be junior to depositors, general creditors and subordinated debt of the bank and to be loss absorbent on a going concern basis.
- In Europe, the vast majority of hybrids are deeply subordinated: pari passu with ordinary share capital (5%), senior only to ordinary share capital (74%) or senior to other hybrids (21%);
- Wide dispersion on other loss absorbency characteristics:
 - for 61% of hybrids, the principal cannot be written down
 - 1% are convertible into ordinary shares and 18% into non-cumulative perpetual preference shares

Loss absorbency: the proposal

The instrument must be able to absorb losses on a going concern basis, in liquidation and in stressed situation

- **On a going concern basis:** flexibility of payments (see below)
- **In stressed situation:** In case the Tier 1 ratio falls below at least 2%, the instrument must be able to absorb losses via
 - Temporary write down or
 - Conversion into ordinary shares

The mechanism must be transparent to the market and legally certain

- **In liquidation:** Rank of subordination

Loss absorbency: proposal (ctd)

The temporary write down:

Write down:

- Future coupons are cancelled while the principal amount is written down
- The use of dividend pushers and dividend stoppers will be restricted whilst the principal is written down

Write up:

- The principal of the instrument can be reinstated only out of future profits
 - Pari passu with shareholders
- If the bank wants to redeem the instrument whilst the principal is written down, it can only redeem at the written down amount. Redemption at par will not be possible until the principal is completely written up.
- In liquidation, the claim is at par

Flexibility of payments

- The Sydney press release requires hybrids to be non cumulative and the issuer must have discretion over the amount and timing of distributions
- In Europe, 93% of hybrids are non-cumulative and the issuer has maximum flexibility over the amount and the timing of coupon payments.

Flexibility of payments: the proposal

Issuers must have the contractual option to waive payments at any time, at the management's discretion (e.g. without pre-set conditions), on a non-cumulative basis and for an unlimited period of time

- Non-cumulative in kind or in cash
- Alternative Coupon Settlements mechanisms are permitted under strict conditions. These instruments are limited up to 15% of total Tier 1 after deductions.
- Supervisors can require that institutions waive payments at any time
- Institutions must waive payments when there is a breach of capital requirements
- Dividend pushers are acceptable but must be waived in case of supervisory event

The limits to inclusion in Tier 1

15% to hybrids
with incentives
to redeem in most
countries

Wider differences
for the limit on the
total
of hybrids
which can
reach 50%

Country	Supervisory limit on innovative instruments (hybrids with an incentive to redeem, e.g. a step-up)	Supervisory limit on hybrids excluding non cumulative preference shares (includes the limit of the first column unless otherwise stated)	Limit on perpetual non cumulative preference shares defined under National Law (in % of ordinary shares)	Maximum supervisory limit on hybrids (including the limits of all the preceding columns, unless otherwise stated)
AT	15%	30%	33%	30%
BE	15%	33%	33% (1)	33%
BG	Not eligible as original own funds		Does not exist in the legislation	
CY	15%	15%	No limit	15%(9)
CZ	Not eligible as original own funds		Does not exist in the legislation	
DE	15%	50%	does not exist(8)	50%
DK	15%	15%	No limit	15%(9)
EE	Not eligible as original own funds		No limit	Not eligible
EL	10%(7)	25%(7)	No limit (1)	25%(9)
ES	15%	30%	50%	30%
FI	15%	15%	No limit	50%
FR	15%	25%	25% (1) (2)	50%
HU	Not eligible as original own funds	15%	No limit	
IC	15%	33%	No defined	33%
IE	15%	49%	No limit	49%
IT	15%	20%(3)	50%	20% (4)
LI	Not eligible as original own funds		Does not exist(8)	Not eligible
LT	Not eligible as own funds		33% (5)	No limit (5)
LU	15%	15%	Does not exist	15%
LV	Not eligible as original own funds		No limit(1)	Not eligible
MT	15%	Not eligible as original own funds	No limit(10)	15%(9)
NL	15%	50%	No limit	50%
NO	15%	15% (1)	No limit (1)	15%
PL	Not eligible as original own funds		Does not exist in the legislation	
PT	20%	20%	50%(6)	20% (4)
RO	Not eligible as original own funds			
SK	Does not exist in the legislation			
SL	15%	15%	No limit	49%
SW	15%	15%	No limit(6)	15%(9)
UK	15%	15%	No limit	50 %

The limits to inclusion in Tier 1

Regulatory capital ratios should be met without undue reliance on hybrids. Core Tier 1 is the key element of regulatory capital.

- Common shares and disclosed reserves or retained earnings must represent at least and at all times 70% of the required Tier 1 capital.
- For excess capital, the proposal is: Common shares and disclosed reserves or retained earnings must represent at least and at all times 50% of total Tier 1 after deductions. 4 countries want the limit to be 30%.
- Instruments with incentives to redeem and instruments with ACSM features must not exceed 15% of total Tier 1 after deductions at any time (limit included in the limit on Tier 1 mentioned above).

Grandfathering

- Instruments with incentives to redeem which do not fulfil all the criteria set out previously can remain eligible to count as Tier 1 up to the first call date.
- All other instruments which do not fulfil all the criteria set out previously (including those with incentives to redeem which will not be redeemed) must not exceed 20% of the total Tier 1 after deductions in 10 years time, 10% in 20 years time and will stop counting as Tier 1 at year 30.
- Any redemption must be requested at the initiative of the issuer and is subject to prior supervisory approval.

The floor is yours....

- . Preliminary views on the overall package
- . Detailed discussion item by item
- . Formal consultation scheduled to start soon: check CEBS website.

The logo consists of two five-pointed stars, one in the upper left and one in the center. A vertical orange bar runs down the right side of the star area. The background is a gradient of blue and green with a pattern of wavy lines.

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