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via Mail: cp17@c-ebs.org

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ZKA position paper on own funds – recognition of hybrid capital as Tier 1 as proposed by CEBS CP17

Dear Mr Enria,

On 7 December 2007 CEBS published a paper on a common EU definition of Tier 1 hybrid instruments (CP17) and opened a public consultation period scheduled to run until 22 February 2008.

We welcome the opportunity to respond to the document and hereby submit the comments of the German banking industry.

Before commenting on CP17 in detail, we should like to begin with a few general observations and explanations.

CP17 offers a valuable basis for further discussion, in our view. The overall objective is to harmonise diverging rules in the EU on the eligibility of hybrids as Tier 1 capital within the meaning of the Basel Committee's guidelines as set out in the 1998 Sydney Press Release (SPR). CEBS has been given the difficult task of finding a compromise which takes equal account of various instruments that differ strongly due to the diverging insolvency, company law and tax regimes across member states. CEBS has made good progress in this regard and is a significant step ahead of the discussions in other members of the Basel Committee on Banking Supervision. In future, however, even greater consideration should be given to appropriate consultation practices. It must be ensured that all relevant market participants, especially the banks in their capacity as issuers of hybrid instruments, are heard separately by CEBS.

The starting point for CEBS's work is the principles enshrined in the SPR on recognising innovative capital instruments as Tier 1 capital. The Basel Committee is currently considering and analysing possible changes to the regulatory definition of "own funds" as a whole. This work at Basel level consequently goes beyond CEBS's mandate.

The ZKA firmly believes that **CEBS's work should confine itself** exclusively – as mandated – **to the issue of recognising hybrid capital instruments as regulatory Tier 1 capital and that the principle of "substance over form" should be observed**. In other words, only the SPR should be implemented. There is otherwise a danger of banks in the EU having to follow more stringent rules on the eligibility of hybrids as Tier 1 capital than those followed by their international competitors. This would make issuing conditions in the market more difficult and increase funding costs.[1] In addition, the possibility cannot be ruled out that EU banks would be subject to a double burden if the Basel rules necessitated a new implementation process.

For these reasons, all proposals concerning a future definition of own funds that go beyond the eligibility of hybrid instruments should first be discussed by the Basel Committee.

[1] Given that negotiations in the Basel Committee have yet to begin and that the final conclusions will take some considerable time (years) to emerge, such competitive distortions risk persisting for a prolonged period.

We would also like to stress that the **regulatory definition of own funds** must be drawn up **independently** of the current rules in IAS 32. The main purpose of this **accounting standard** is to supply information to the capital market and thus differs significantly from prudential objectives. What is more, IAS 32 is now undergoing a fundamental overhaul.

The criteria loss absorption, permanence and flexibility of payment are a suitable basis, in our view, for determining the eligibility of a hybrid instrument as Tier 1 capital. We believe, however, that **insufficient account has been taken of the overlaps between the key criterion of loss absorption and the other two principles. In the final analysis, permanence and flexibility of payment serve to absorb loss**.

As well as avoiding prejudging the future negotiations in Basel, it is also important to consider the practicalities of transposing the rules into national law. Many of CEBS's proposals are highly detailed. This will inevitably result in their coming into conflict with the differing legal regimes in the 27 member states of the European Union.

Until at least tax, company and insolvency law have been harmonised, detailed rules will translate into widely diverging results in individual member states and thus run counter to the objective of harmonising the definition of capital across the EU. It is very difficult to predict in advance exactly what effects detailed provisions in a European directive will have since the interplay of tax, company and insolvency law in each jurisdiction is highly complex.

The ZKA therefore advocates **including detailed rules in a directive only if their impact is clear in advance and if the details are essential to harmonisation**. This is mainly the case with the rules on limits. Other areas, especially application of the above **criteria, should be kept as abstract as possible so that the rules can be implemented at national level in an appropriate and flexible manner**. To ensure a level playing field, however, they should be **complemented by transparency criteria** such as supervisory disclosure.

In addition, harmonisation with the insurance sector, which is advocated among others by the joint CEBS/CEIOPS Interim Working Committee on Financial Conglomerates, should not be lost sight of and made even more difficult by excessively detailed requirements.

We would welcome it if our comments were taken into account when the consultation paper is revised and would naturally be pleased to supply any further information you may require about the issues raised.

Yours sincerely
for the Zentraler Kreditausschuss,
Bundesverband deutscher Banken

Dr. Hans-Joachim Massenberg   Jörg Ortgies

Enclosure

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Comments
of the German banking industry
(Zentraler Kreditausschuss)
on CEBS's draft proposals on criteria
for the eligibility of hybrid instruments as Tier 1 capital,
on the level of regulatory limits
and on grandfathering arrangements

18 February 2008

I. Summary

The position of the ZKA may be summarised as follows:

1. Permanence
   a. Life of the instrument:
      The definition of permanence should be revised so that dated instruments with long times to maturity are also covered if certain conditions are met.
   b. Issuer's call right:
      The proposals reflect the SPR guidelines and are supported by the ZKA on condition that common European rules on supervisory approval procedures are agreed.
   c. Definition of incentives to redeem (innovative instruments):
      The SPR guidelines were formulated ten years ago. To take account of the significant development of the market since then, we are in favour of dropping the current distinction between hybrid and so-called innovative instruments. The corresponding proposals concerning the definition of incentives to redeem would then be superfluous.

2. Loss absorption
   Loss absorption, permanence and flexibility of payment are closely interwoven with one another. We believe the criterion of loss absorption is adequately fulfilled in the presence of flexibility of payments and permanence. We are not in favour of a mandatory write-down mechanism or of alternative mechanisms.

3. Flexibility of payment
   The ZKA rejects the proposal that issuers should have unlimited discretion over coupon payments for an unlimited period of time. This is not necessary to enable hybrid instruments absorb losses adequately and goes much further than the SPR guidelines on suspending payments.

4. Level of regulatory limits
   Here too, we believe it is essential not to diverge from the SPR's well established guidelines:
   – It should be possible for hybrids to account for up to 50% of Tier 1 capital without having to meet complicated rules regarding the composition of Tier 1.
   – As a result of our above proposal in 1c, the 15% threshold for innovative instruments should be dropped.

- The SPR guidelines on the basis for calculating limits should not be diverged from. The percentage of hybrid instruments should continue to be measured at the time of issuance, not at any time.

5. Grandfathering rules

We welcome the proposed 30-year “amortisation plan” for the grandfathering of instruments which are currently eligible but will cease to be so under the new rules. This arrangement should apply to all hybrid instruments, however, without making a distinction between instruments with and without incentives to redeem.

II. Detailed comments on CEBS's proposals in CP17

1. Permanence

(i) <u>Maturity of the instrument</u> (first paragraph of the proposal on page 14)

The SPR established the criterion of "permanence", which is interpreted as "permanently available". This is the approach which has been adopted by CEBS (see CP17, page 11, para. 68).

The ZKA takes the view that **permanent does not necessarily mean undated**. Instruments with a long maturity are also permanently available to the issuing bank. It is already the case in the US, for example, that instruments with a 30-year maturity are recognised as Tier 1 capital. With this in mind, we do not consider it advisable to decide at this stage that permanence presupposes an undated maturity without awaiting the results of the Basel Committee's discussions.

We therefore urge CEBS to revise its definition of permanence so that instruments with long maturities are also covered. **The permanence required to make a dated instrument eligible for recognition as Tier 1 capital can be achieved by means of lock-in clauses**. Under such a clause, dated instruments are not recognised as Tier 1 capital for the final phase of their life (e.g. the last ten years), thus ensuring that the cash is permanently available to the bank during the period of regulatory recognition. In Germany this is already tried and tested current practice with silent partnerships, for instance.

(i) <u>Issuer's call right</u> (second and third paragraphs of the proposal on page 14 f.)

CEBS proposes adopting the SPR guidelines, under which an instrument

- may only be called by the issuer and
- with prior supervisory approval, which will only be granted if
  - the replacement capital is of the same or better quality or
  - the supervisor determines that the bank has capital which is more than adequate for its risks.

To implement these rules, **European supervisors should agree on a common and effective approval process for repayment**. This is the only way to achieve the desired level playing field across member states and establish planning security for the banks.

The ZKA therefore calls on CEBS to work towards an agreement whereby national supervisors

- establish a standardised process determining
  - how supervisory approval is to be sought and
  - how much time supervisors will have to consider the request (a reasonable period would be two weeks, or four weeks at most); and
- define a list of criteria, which
  - if met, will result in supervisors approving repayment or even rendering approval unnecessary,
  - if the issuer falls somewhat short of meeting, will result in closer scrutiny of the request and
  - if the issuer falls far short of meeting, can be expected to result in rejection.

CEBS also proposes, along the lines of the SPR guidelines, that the instruments can be called

(1) after five years if they contain a pure call option or
(2) after ten years if the call option is combined with an incentive to redeem.

But the volatility on the assets side brought about by Basel II makes it necessary for the banks to manage capital more flexibly and adjust their use of cost-intensive regulatory capital to a changing risk environment. The ZKA therefore considers it too restrictive to permit issuers to call their hybrids only after five or ten years. We would welcome it if the **Basel Committee addressed the issue of these minimum periods** so that the banks could better adapt to the new framework conditions brought by the implementation of Basel II. **Given the supervisory approval requirement**, we see **no need for mandatory minimum periods**. In our view, the approval requirement offers sufficient protection against untimely capital outflows.

(i) <u>Incentives to redeem</u> (paragraphs four to ten of the proposal on page 14 f.)

CEBS defines step-up clauses and principal stock settlements as incentives to redeem with the result that instruments carrying these mechanisms are classified as "innovative instruments". We take the view that **this approach and thus the category of so-called "innovative instruments" should be dropped**.

Though the SPR guidelines also envisage this procedure with respect to step-up clauses, we believe that the rule is now obsolete. It was formulated ten years ago at a time when hybrid instruments were new in the market. Owing to the experience of these instruments gained by market participants and supervisors since then, we consider that it is no longer necessary to have this separate category.

This applies all the more when it comes to principal stock settlements since these are not even covered by the SPR guidelines. A rule along the lines envisaged by CEBS could therefore lead to the competitive distortions already referred to above. In order not to place European banks at a competitive disadvantage, CEBS should in any event refrain from proposing rules that go beyond the SPR unless these are first adopted at the level of the Basel Committee.

2. Loss absorption

CP17 explores the loss absorption criterion at length. The ZKA warmly welcomes and supports this since it considers the criterion of loss absorption the central basis for evaluating the eligibility of an instrument as Tier 1 capital. CEBS appears, however, to have lost sight of the critical fact – specifically emphasised by the banking industry at the hearing in London in June 2007 – that loss absorption, permanence and flexibility of payment are closely interwoven with one another.

We take the view that the **loss absorption criterion is sufficiently satisfied by the principles of flexibility of payment (see 3) and permanence (see 1). We** therefore **argue strongly against both a mandatory write-down mechanism and the proposed alternative mechanisms.**[1] They would not end up placing the bank, its shareholders or creditors (including holders of hybrid instruments) in either a better or a worse position.

All in all, CEBS's proposals go much further than the SPR guidelines and this should be rejected in our view. The proposals nevertheless offer a valuable basis for later discussion, particularly in the context of Basel. At this stage, however, they are in need of further refinement. The paper stresses, for example, that loss absorption is a decisive criterion, but provides no definition of the term "loss absorption". And though CEBS tries to compensate for the lack of a clear definition by using a number of paraphrases, this frequently results in overlaps and ambiguities.

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[1] We would, however, draw attention to a special feature of silent partnerships in Germany. This instrument provides for a temporary write-down mechanism which is triggered at an earlier stage than that proposed by CEBS, is normally limited to the nominal amount and is pari passu with the amount contributed.

The first step should be to establish a standard definition of the term "loss". This could be based on the net loss for the year recorded in the profit and loss account or the accumulated loss reported in the balance sheet.

It is also unclear for banks subject to a consolidation requirement whether CEBS means the loss in individual or in group accounts. An argument in favour of the former is the fact that dividend payments are based on the individual accounts. On the other hand, only group accounts are harmonised across in the EU with no provision for national options (Article 4 of Regulation (EC) No. 1606/2002) and individual accounts often have little relevance for supervisory purposes (Article 69 of Directive 2006/48/EC). CEBS needs to clarify these two issues as a matter of urgency.

The ZKA believes that an instrument must meet the following **conditions to fulfil the criterion of loss absorption**:

(1) *In the event of the bank's insolvency or **liquidation**, the instrument must help to **satisfy the claims of all non-subordinated creditors**.*

(2) *A hybrid Tier 1 instrument must help the bank to **continue operations as a going concern**.*

In para. 107 CEBS sets out these conditions in the form of scenarios, supplemented by a third scenario, that of **stressed situations**. In our view, however, this third case is **covered by support of the bank as a going concern** and should be deleted as a scenario in its own right.

Re. (1) – Assistance in satisfying the claims of all non-subordinated creditors

In the first two paragraphs of its proposal on page 20, CEBS sets out two characteristics which an instrument must have in order to meet this requirement. These are (i) subordination to other types of debt capital including Tier II capital (deep subordination) and (ii) the absence of security or an arrangement by the issuer or related entities that would enhance the seniority of the instrument's creditors. The ZKA supports these principles, which are also enshrined in the SPR.

CEBS adds a phrase to the wording used in the SPR.[2] We understand this simply as clarification that *every* hybrid instrument is senior to ordinary share capital. In particular, we assume that the final phrase of the first paragraph of the proposal on page 20 is not meant to

[2] (...) meaning that hybrids are senior only to ordinary share capital.

introduce an order of priority within the hybrid category. Hybrid capital must be considered a homogenous category for prudential purposes and any internal ranking due to company law rules, for example, should not affect its eligibility as regulatory capital. Should our assumption be incorrect and the introduction of such an order of priority be intended, however, this would impose severe restrictions on the issuability of hybrid instruments and cause international competitive distortions. A bank could not, for instance, designate perpetual non-cumulative subordinated bonds as Tier 1 capital if it had already issued perpetual non-cumulative preference shares. This is because the latter would be senior to the bonds. Further complications could arise if, for example, an instrument were issued which, though deeply subordinate, provided for cumulative coupons. The bank would no longer be able to issue this instrument because less subordinate non-cumulative instruments might otherwise no longer be eligible as Tier 1 capital.

It is neither necessary nor appropriate, in our view, to tighten the existing rules in this way. To avoid misunderstandings, we would welcome clarification of what is meant by the final phrase of the first paragraph of the proposal on page 20.

Re. (2) – Support of the bank as a going concern

In its proposed definition of loss absorption (page 20 of the paper) CEBS does not explicitly refer to support of the bank as a going concern. The first sentence of para. 103 makes clear, however, that the objective of loss absorption is to maintain the going concern. We fully support this.

We believe that a **bank is supported as a going concern if**

a) its **insolvency is prevented and**
b) **recapitalisation** is **not hindered**, especially in stress situations.

These aspects should be included as prerequisites of eligibility.

Re. a) – Prevention of insolvency

The ZKA supports CEBS's view in para. 104 that **continuation as a going concern is supported** (and insolvency consequently prevented) **if** the instrument **helps the bank** to

- **meet its obligations**,
- **avoid its liabilities exceeding its assets**,

and also fulfils further conditions. Unfortunately, CEBS fails to make clear what these further conditions might be. It would be adequate and appropriate, in the view of the ZKA, to **add one single further requirement**, namely that

- the **hybrid investor** (holder of the hybrid instrument) **should not be in a position to initiate insolvency proceedings**.

Instruments satisfy these requirements if – as CEBS is correct to indicate in the first indent of para. 107 – **coupons can be waived**. The ZKA agrees with CEBS that the requirements are met by satisfaction of the flexibility of payment criterion (see also our comments below in section II 3).

But to ensure, **in addition**, that no payments leave the bank, the ZKA believes that it **should not be possible for instruments to be repaid in stress situations**. This condition is fulfilled if instruments are permanently available; no further rules are required since the instruments can only be repaid with the approval of the bank's regulators (see section II 1, **permanence criterion**).

Furthermore, **hybrid investors** will be unable to bring about the bank's insolvency on the basis of their creditor status because they **have no legally enforceable claim to coupon payments or the repayment of the principal**.

<u>Re. b) – Support of recapitalisation</u>

With regard to the scenario described in para. 107, third indent it is not necessary, in our view, to require a mandatory temporary write-down of the nominal amount of hybrid instruments. **Write-downs would not achieve the desired objective and are very difficult if not impossible to implement in practice, especially if the instruments have been issued through subsidiary companies.** Furthermore, the requirements set out in the proposal on page 20 and in paras. 108 to 114 once again go far beyond the SPR guidelines.

We outline below why we consider a mandatory write-down mechanism inappropriate and how we think recapitalisation should be supported instead.

(i) Support of fresh capital injections

The ZKA understands **recapitalisation to mean an injection of fresh Tier 1 capital**. Old or new investors thus need to be motivated to provide the bank with fresh funds. As we see it, the main **obstacle to this posed by existing instruments would be if the new capital was going to be used to settle existing liabilities** arising from these instruments **before the bank has completely recovered.**

The CEBS proposal fails to clarify what must be done to avoid hybrid instruments hindering recapitalisation. This means it is also not clear what write-downs of hybrid instruments or their conversion into traditional share capital would achieve.

(ii) Prevention of fresh capital leaving the bank before it has recovered

We believe the key means of **preventing the outflow of fresh capital and thus of supporting recapitalisation are already set out and adequately dealt with by the permanence and flexibility of payment criteria** of the CEBS proposal (see our comments in II 1 and II 3):

(1) Repayment is only permitted with the prior approval of the bank's regulators. They will not approve repayment until the bank has completely recovered. Nor will management consider repayment before the bank has recovered unless the funds are replaced with capital of at least the same value.

(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.[3]

(iii) Rejection of CEBS proposals on supporting recapitalisation that go beyond the SPR guidelines

We are firmly convinced that rules going beyond the mechanisms for preventing the outflow of fresh capital outlined above will do nothing to support recapitalisation.

What is more, CEBS's proposals for loss absorption through write-downs in paras. 108 a-d are impracticable and in part inappropriate for the following reasons:

[3] The FSA notes in its discussion paper 07-06: "From an economic perspective, coupon cancellation absorbs losses by reducing the present value of future payments. Depending on the duration of the coupon cancellation, it also reduces the economic value of the instrument. The more coupons cancelled, the more loss is absorbed by the instrument itself. If an issuer cancels all future coupon payments on a perpetual instrument, the economic value of the instrument to the investor would approach zero, as there would be no return either in the form of interest or principal. From the perspective of the issuer the instrument would have absorbed losses equal to its par value."

- Different company and tax law regimes in member states mean the proposed write-down mechanism would have widely diverging effects; this would obstruct harmonisation.

- If instruments have been issued by subsidiary companies, it is totally unclear how the write-down mechanism is supposed to function. This shows that it is absolutely essential to define the term "loss".

- The **suspension of coupon payments as a result of a temporary write-down** described in sentence 1 of para. 110 and sentence 1 of para. 111 **can be achieved on the basis 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** described in para. 111, sentence 2 **produces the same result, once the bank has been restored to its "normal situation", as suspending payments and not repaying the nominal amount**. This is basically no more than a different accounting exercise and would have no effect on the bank's regulatory capital situation or amount of available cash.

- In the interests of fairness to investors, it is possible to write principal back up using future profits. This **interferes with the rights of shareholders to distribute profits**, however, and in many member states a shareholders' meeting would have to approve the issue of the instrument. This would reduce the inherent flexibility of hybrid capital which is essential to effective capital management.

- In the final paragraph on page 20 CEBS proposes that it should only be possible to **redeem a written-down instrument at the written-down amount**. The ZKA believes this rule is **superfluous** in light of the permanence criterion because
  - the bank has no obligation to redeem the instrument and
  - 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 alone will discourage a bank from redeeming an instrument at the written-down amount because this would severely hamper its chances of attracting future investors.

- The German banking industry also rejects the **alternative** to temporary write-downs proposed in para. 112, namely the **conversion of the hybrid into ordinary shares**. This mechanism **cannot be applied in Germany or most other members of the EU**. It is only permissible in a minority of member states and thus unsuitable as a general proposal for absorbing loss.

- Furthermore, the mechanism would merely change the composition of the bank's capital on the balance sheet. Cash and regulatory capital would be unaffected, as CEBS itself points out in para. 112, sentence 4.

- **Given that we reject the idea** of a write-down or conversion mechanism for the reasons outlined above, **detailed discussion of the possible triggers** for these mechanisms outlined in paras 113 and 114 **is superfluous** in our view.

3. Flexibility of payment/discretion over distributions

In part 3 CEBS discusses the issuer's discretion over distributions ("dividend criterion"). It proposes that banks should have complete discretion over distributions and that payments may not be waived on a cumulative basis. To ensure full discretion over distributions, CEBS requires in the first sentence of its proposal on page 25 that issuers of hybrid instruments should have discretion and thus control over coupon payments at all times and for an unlimited period of time.

In our view, CEBS's proposal clearly goes beyond the SPR guidelines in this respect. According to the SPR:

> "the bank must have discretion over the amount and timing of distributions, subject only to a prior waiver of distributions on the bank's common stock and banks must have full access to the waived payments;" (see para. 115).

Discretion at all times and for an unlimited period of time is, in contrast, **to be rejected** as unnecessary for the purposes of ensuring that hybrid instruments can absorb losses adequately. The objective should be to ensure that the bank has sufficient funds to be able to guarantee payments to hybrid investors as well as dividend payments without significantly weakening the bank in the process. We believe that **suspending payments** is therefore **only necessary in a crisis** and **that the ability to stop payments at an earlier stage** (e.g. even if the bank is in profit) **would** in practice **make these instruments** more expensive and so **less marketable**. Hybrid capital is generally marketed as a bond with a fixed coupon and investors expect a corresponding margin to compensate for the higher risk of suspended payments and the deep subordination. They also expect that under normal circumstances coupon payments will be made on time and in the agreed amount. Given that the **investors**, unlike shareholders, have no possibility of influencing management decisions directly, they are right to **assume a certain degree of security with respect to payments**. The **complete flexibility** at all times and for an unlimited period of time envisaged by CEBS **flies totally in the face of these expectations** and is unrealistic. The ZKA is therefore in favour of revising this sentence.

At the same time, the ZKA agrees that payments need to be waived in a timely manner if the desired objectives are to be achieved (loss absorption/prevention of insolvency and prevention of cash leaving the bank). The proposed **trigger for waiving coupon payments** (second paragraph of the CEBS proposal on page 25), namely the breach of minimum capital requirements, **is well chosen** in our view.

The **insertion in brackets allowing national supervisors to define their own trigger**, on the other hand, **is to be rejected**. A national option of this kind would undermine the key objective of the new directive, namely establishing a level playing field in Europe, and constitute gold-plating.

The proposed **requirement** in the fourth paragraph **concerning dividend pushers contravenes the order of priority**, in our view. If payments were stopped despite having been paid dividends, higher-ranked **hybrid investors would be worse off than shareholders**. It would be very difficult sell such a complicated contractual arrangement to potential investors, which, in turn, would **make placing the instruments** costlier and **more difficult**, if not impossible.

Moreover, if the bank were in a crisis, i.e. in breach of capital requirements, it may be assumed that it would already have been under severe stress for some time. This would have prompted the management to suggest waiving dividend payments. And finally the competent authority would have stepped in to stop cash leaving the bank by ordering dividend payments to be suspended. CEBS addresses just this situation in the third paragraph of its proposal on page 25. The proposed rules already apply in Germany and have proved their worth. The ZKA therefore strongly supports this requirement. But rules going beyond it, such as that proposed in the fourth paragraph, should be avoided in the interests of not undermining the markets.

We are not clear on what is meant or intended by the sixth paragraph of the proposal ("distributions can only be [...]"). This point should either be explained in more detail or, even better, deleted. It is our understanding that **flexibility of payment exists if no money is able to leave the bank in stress situations**.

4. Limits on the inclusion of hybrid capital in Tier 1

The 15% limit for so-called "innovative instruments" is already enshrined in the SPR guidelines and is normal practice in the international markets. We would nevertheless like to suggest **reappraising this 15% limit** since we believe the need for it has become obsolete. At the latest, the case should be argued for a revision of the relevant Basel rules in upcoming discussions.

We also advocate **following the SPR guidelines on overall limits** and requiring at least **50% of Tier 1 capital to be made up of traditional core capital**. This is in line with the most widespread current practice. In the interests of a level playing field, any discussions about tighter limits should be conducted by the Basel Committee. What is more, Pillars 2 and 3 of the revised capital framework (Basel II) offer sufficient possibilities to counteract any isolated instances of excessive reliance on hybrid instruments. Divergence from this rule risks placing European banks at a competitive disadvantage compared to banks in the US, for example, where a high proportion of hybrid instruments is permitted in Tier 1 capital.

In para. 146 CEBS suggests making a trade-off **between clearly defined eligibility criteria for hybrid instruments and limits** for their inclusion in Tier 1 capital. We are firmly convinced that **no link can or should be established** between these factors. It is essential for CEBS to clearly define what requirements hybrid instruments must satisfy to be recognised as Tier 1 capital and fulfil the function of this category of capital. If CEBS does this and all parties involved agree that the result represents a definition of eligible Tier 1 capital, there is no reason for restrictions that go beyond the prevailing limits.

Furthermore, the proposed **compromise in the form of a continuum permitting hybrids to account for between 30% and 50% of Tier 1 capital** (first and second paragraphs of CEBS's proposal on page 29) **is excessively complex** in our view. The suggested mechanism would give rise to "cliff effects" at the edges of the continuum. This would make capital management very difficult for banks operating at these edges since there would be a constant danger of exceeding certain limits.

Although very few banks would generally operate at the edge of a lower limit, banks which found themselves **in a stress situation** would be in **danger** of approaching these limits. Owing to their associated "**cliff effects**", the proposed limits would probably plunge such banks into **an even deeper crisis**.

The situation is made worse by the fact that CEBS, unlike the SPR, which only requires the limits to be observed at the time of issuance, proposes that the limits should apply at all times (first and second paragraphs of the proposal). This would necessitate a continuous monitoring of the eligibility of a bank's hybrid instruments and could exacerbate a crisis because a stress-induced reduction in traditional core capital would trigger a parallel reduction in the amount of eligible normal and innovative hybrid capital.

The greater volatility of capital requirements under Basel II would heighten these effects still further, making capital management all but impossible.

We advocate **discussing, at Basel level at the latest**, how to deal with instruments that meet the loss absorption, permanence, and flexibility of payment criteria to differing extents because of their differing design or national specificities (e.g. silent partnerships in Germany). With investments by silent partners, for instance, the trigger for loss absorption through temporary write-downs is set at a point far earlier than that proposed by CEBS. In the areas of permanence and flexibility of payment, on the other hand, the proposed requirements would not always be met. We are in favour of examining eligibility on a case-by-case basis in such circumstances to **enable a trade-off to be made between the three criteria**.

5. Grandfathering arrangements

We support CEBS's intention to soften the impact of the new rules on the market and avoid disruption by means of grandfathering arrangements (paras 154 to 156).

Nevertheless, we feel that the proposed **special treatment for instruments with an incentive to redeem is superfluous** at best and, under certain interpretations, could cause market disruption and tip banks in difficulty into crisis:

- We believe the rule is **superfluous because** under normal market conditions and **if the bank is sound**, the **market expects an instrument to be redeemed** at the first call date. The vast majority of these instruments will therefore be repaid by the bank to protect its market image.

- **Only a crisis at the bank** or problems in the capital markets **will** normally **lead to the instrument not being redeemed**. If repayment does not or is unable to take place, CEBS's proposal could be interpreted as meaning that the instrument is no longer eligible as Tier 1 capital. This would plunge the bank into an even deeper crisis than before.

The ZKA therefore argues in favour of **treating all hybrid instruments equally** and deleting the first paragraph of the proposal on page 31 and the text in brackets in the second paragraph.

It is not clear from the amortisation table on page 31 exactly what the percentage figures refer to. In the interests of avoiding different interpretations, we would appreciate it if CEBS could provide an example calculation showing how the limits function and how they are to be calculated.