Committee of European Banking Supervisors - CEBS

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BPCE comments on CEBS consultation Paper 27 regarding Hybrid Capital Instruments

BPCE welcomes the opportunity to comment on the implementation guidelines regarding hybrid capital instruments released by the Committee of European Banking Supervisors (”CEBS”), further to the European Parliament’s vote of the amendments to the Capital Requirements Directive (“CRD”).

BPCE is the central body of the Group BPCE, the second largest banking group in France in terms of 2008 retail net banking income.

We support the process followed by CEBS and consider it is useful and important that there exists a public consultation on this topic with interested stakeholders to ensure convergence and stability of the framework.

BPCE supports the objective of CEBS to provide guidelines on criteria that hybrids must meet to achieve harmonisation.

We would like to stress however that we consider that some of the guidelines regarding loss absorbency in going concern and comments made during the public hearing held on September 8th could very possibly result in the complete disappearance of this market, a critical source of capital for banks. If, as a consequence of guidelines not sufficiently thought over or overly prescriptive, the fixed income investors were deterred to invest in bank hybrid securities, it would have adverse consequences for banks in general, but even more so for the cooperative and mutual banks, such as BPCE, which have no access to the stock market to raise capital.

Banks require altogether more flexibility on some points and stable rules to be able to manage their capital in an efficient way in volatile markets. Overly prescriptive rules will also limit the flexibility for supervisors to address exceptional circumstances of individual institutions while maintaining the robustness of the hybrid capital regime. We believe that a more principle based, substance over form approach should be considered for the oversight of hybrid instruments.

Moreover, we do not share the view taken in the Consultation Paper that, in economical and prudential terms, buy-backs would be equivalent to a call or a redemption. The process applying to buy-back of a hybrid instrument should therefore be reviewed.

You will find our detailed comments in the attached annex.

<u>Question 1: Incentive to redeem</u>

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.

Guidelines in relation to “incentive to redeem” are sufficiently clear and principle based.

Instruments with incentive to redeem are classified in the 15% limit, but should be allowed in the 35% limit if they are not called.

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

CEBS takes the view in article 56 that a principal stock settlement in conjunction with a call option must contain a cap limiting the number of shares that may be issued under a principal stock settlement provision to a number of shares that has a value equal to 150% of the principal amount of the hybrid capital instrument on its issue date.

Stock settlement is relatively rare feature amongst existing securities. Rather than the above measure, we would favour a cap on potential dilution to be introduced.

<u>Question 2: Buy back</u>

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.

We find these guidelines to be clear; however we believe that inclusion of guidelines with respect to buybacks is unnecessary and should not be removed (cf. paragraphs 61 to 67). We do not believe that buybacks are equivalent to the exercise of call or redemption at par, especially as many buybacks take place below par.

We strongly recommend removing any reference in paragraphs 71 and 72 to a five-year restriction and to a mandatory replacement. Appropriateness of timing and replacement should be left at the discretion of the issuer and of its supervisor, depending on the specific situation justifying the economic and prudential rationale of a buyback. We are of the opinion that an alignment for consistency between treatment of ordinary shares and hybrid instruments in respect of timing should be considered.

We would suggest introducing a time limit of one month after the application to receive the prior consent of the supervisor.

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.

Buy-backs can for instance be justified in cases where the institution has taken actions to shrink its balance sheet to reduce RWA or experience a significant increase in profitability. Institution may also have to manage their capital structure after a merger or an acquisition. It is wrong to assume that banks should never alter the mix and level of regulatory capital. Incentive for buybacks is to add economic value to the institution.

Therefore, we believe it is most unhelpful for banks to be restricted from repurchasing hybrid instrument in the first five years; it would unduly limit the flexibility of an institution to efficiently manage its capital structure and may persuade banks to instead repurchase even higher quality of capital.

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?

We believe that the appropriate regulatory architecture already exists to ensure that prudent capital levels are maintained.

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.

The 5% restriction discussed in point 73 is too restrictive. Many banks sell subordinated instruments into their own networks. Clients expect to have some liquidity on such investments. Often, only the issuing bank is able to provide such liquidity. The previous allowance was 10%, and we believe this should be maintained.

Question 3: Dividend

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.

Regarding the dividend pusher, we note that the guidelines are less investor-friendly than the rules applied today on the following point: currently interest payment on hybrids is compulsory if a dividend is paid either in cash or shares, except if it is only paid in shares. We do not wish to introduce the notion of "major part". It could represent an additional uncertainty discouraging investors.

Regarding the guidelines related to flexibility of payment, we note the requirement for dividends and Coupons to be cancelled under supervisory request. We dispute such requirement to be on a fully discretionary basis. We strongly suggest clarifying the following, in order to avoid such an overwhelming and unfettered discretion impacting too severely the cost of hybrid capital. It is critical to precise in the guidelines that such regulatory intervention would remain an exceptional situation and to refer to a clearly identified risk that the institution will breach its capital requirements set according to Article 75 of the CRD.

Question 4: 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.

Yes.

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

Paragraph 90 requires deferred coupons in the form of article 57 (a) instruments to be issued "without delay". The requirement to subscribe immediately reduces the element of flexibility that banks look for so that they can avoid issuing their shares when market conditions are unfavorable. The bank should be able to defer equity issuance until it has emerged from the other side of the stress it is experiencing, if that would be the most prudential approach.

Financial issues: most structures currently provide for issuer flexibility to decide when ACSM should be enacted. We see tremendous value in leaving the choice for the issuer to decide when it should be enacted. Banks may be forced to sell shares when the share price is depressed.

Practical problems: Fixed income investors cannot in most cases hold equity instruments. As a practical matter, direct delivery of shares would not work and there would need to be an intermediary step where equity instruments are monetised.

As a result of the above, we believe the ACSM will become less attractive for banks and investors alike. This should lead to a reduction in direct Tier 1 issuance.

Question 5: Loss absorption

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.

The text is clear.

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

CEBS takes the view in its guidelines that the definition of loss absorbency in going concern is to be assessed both from a capacity (1) to prevent insolvency and (2) to not hinder the recapitalisation / make the capitalisation more likely.

(1) Loss absorbency – Prevent insolvency

We agree with the definition of loss absorbency in going concern for what relates to the capacity to prevent insolvency as defined in paragraphs 106 to 109 taken from Paragraph 57(a) to (d) of the CRD;.

- (a) Permanence
- (b) Flexibility of payments
- (c) Investors are not in a position to petition for insolvency
- (d) Instruments are not taken into account for the purpose of determining insolvency

In some jurisdictions, it is noted that the preconditions (c) and (d) of paragraph 106 can not be met by the instruments issued by banks that embed the features of permanence, flexibility of payments and subordination. Only in these circumstances, we agree that alternative features, such as write-downs or conversions, may be required to achieve the criteria of paragraph 106.

This being said, as we agree that such alternative mechanisms like write-downs and conversions do not either increase the loss absorption capacity of hybrids or improve the situation of the institution or the one of more senior creditors and depositors. It should be confirmed that the use of such mechanisms should be restricted to insolvency purposes exclusively to satisfy the criteria of paragraph 106. There is therefore no need to define a trigger in the terms and conditions as long as the contractual conditions of such mechanism properly address the requirements of paragraph 106.

(2) Loss absorbency – Not taken into account for the purposes of determining insolvency

We suggest modifying the wording of paragraph 109 which is too direct in its formulation implying clearly a transformation into equity which has the potential to deter many fixed income investors.

109. To make sure that the instrument would not be taken into account for insolvency purposes – notably if the instrument qualifies as a debt under insolvency, company or accounting law –, the competent authorities may require that the instrument ***has*** ~~is transformed into~~ equity ***features*** for the purpose of the application of the insolvency law. This may be achieved using different mechanisms such as a conversion into an equity instrument, or, if applicable for insolvency purposes, a write down mechanism. Depending on the relevant insolvency and accounting system the write down can be permanent or temporary.

(3) Loss absorbency – Not hinder the recapitalisation / make the recapitalisation more likely

As hybrids do help to prevent insolvency because they meet the four preconditions in paragraph 106, we do not believe that it is any further needed to elaborate on the loss absorption capacity on a going concern basis. We suggest therefore modifying the wording of paragraph 112 as follows:

112. The simple fact that the principal of hybrid instruments is available to the institution and the terms provide the flexibility to stop the payment of coupons may not be sufficient to restore the financial situation of the institution or attract new shareholders; notably because hybrid holders in general are being granted some form of preferential rights such as coupon/dividend payments. Due to these preferential rights, after a recapitalization hybrid holders might profit from it by immediately recovering the right to the full principal amount as well as to full coupon/dividend payments. ~~In this sense, hybrid instruments may hinder the recapitalization. It is much easier to attract new capital suppliers/owners/shareholders if they will benefit to a good extent from the return of their investment after the firm becomes profitable again due to their intervention. Hence, the new capital provided to recapitalise the institution should not be used directly or indirectly to benefit existing hybrid holders.~~

We are also of the opinion that it is going beyond CEBS's remit to request that hybrids should contain mechanisms such as permanent / temporary write-down or conversion into equity at a trigger point to demonstrate that they do not hinder recapitalisation and make it more likely. Consequently, we strongly suggest CEBS to remove paragraphs 114 and 115 from the guidelines.

Should CEBS decide to maintain paragraphs 114 and 115, we then advocate against the introduction and definition of a particular trigger point at which the hybrid Tier-1 capital instruments would be written down or converted, we strongly disagree with the use of both mechanisms. In the event CEBS decides to maintain this proposal we recommend that it be kept at the discretion of the institution and of its competent authority. This will maximise the flexibility to manage exceptional situations such as recapitalisations. We thus strongly recommend the removal of paragraphs 116 and 117.

We remind that hybrid capital satisfying eligibility criteria (other than those 114-117 disputed here) already prevent insolvency. CEBS is concerned, as described in the paragraph 113, that a balance between new shareholders and hybrid holders' rights is likely to be necessary for a recapitalisation. The hybrid instruments features derived from the CEBS guidelines, excluding paragraphs 114 to 117, already make it possible to achieve such balance. Payment of dividends or coupons is at the full discretion of the institution and of the competent authority. As long as required, the equity holders will have full ownership on the value creation while distributions on hybrid capital instruments can be cancelled on a non cumulative basis. This flexibility answers the need for tools allowing building up a balance, or an incentive as the case may be, for a required recapitalisation.

This being said, the idea that new capital coming into the firm and subsequent profits could be used for distribution to ordinary shares while they should not be used "directly or indirectly" to benefit existing hybrid holders would effectively subordinate the rights of existing hybrid holders to holders of ordinary shares. We can't see how this would be acceptable, especially as "old" ordinary shareholders will not be able to be distinguished from new ordinary shareholders due to corporate law. As a result, existing hybrid holders would not only be worse off than new ordinary shareholders, but would also effectively be worse off than existing ordinary shareholders. We consider that this requirement would be hardly acceptable to fixed income investors, who represent the main available investor base for hybrid capital.

Similarly, should CEBS decide to maintain paragraphs 114 and 115, and the mandatory use of mechanisms such as write-downs, it should be confirmed that such mechanisms would stop to be in effect when the company would resume paying dividends, in order to respect the fundamental seniority of hybrid capital above ordinary shareholders.

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?

We consider that the guidelines in paragraphs related to loss absorbency in going concern for what relates to preventing the liquidation is sufficiently clear and principles-based.

To the contrary, guidance for what relates to making a recapitalisation more likely is over prescriptive and for reasons presented in answer 5.2, we recommend the removal of paragraphs 114 to 117.

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?

We do not object to the possibility to have several types of hybrids with different ranks in case of liquidation, for instance preference shares with calls (pari passu with ordinary shares in liquidation) and deeply subordinated notes which are senior in liquidation to all shares.

Question 6: limits

6.1 Are the guidelines relating to the assignment of hybrids 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.

The text provided in Article 66(1a) of the CRD is clear with respect to hybrid limits. We do not see a need for CEBS effort to provide a more detailed and prescriptive guidelines for such limitations.

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

Hybrids of the 50% bucket are convertible into shares (with certainty), either at the call date, either before in case of trigger event or at the discretion of the supervisory authority. Therefore it can be questioned why those instruments are not eligible as core Tier one rather than tier One hybrids.

We do not support paragraph 125 requiring the definition of “emergency situation” in the contractual terms of the instrument. To do so might limit the ability of institutions and competent authorities to act with sufficient flexibility and may create unintended consequences which could increase volatility in distressed situations. It should be sufficient that such conversion may occur in case of a breach of capital requirements or regulatory discretionary intervention. Moreover such definition is quite subjective and should be interpreted on a case by case basis.

Similarly, we caution against the requirement that any higher regulatory limit than the 4% Tier-1 and the 8% total capital ratio must be identified in the terms and conditions. This to avoid disclosing discussions between institutions and regulators that should be treated confidentially as they are on forward looking assessments of profitability and business strategy.

Question 7: SPV

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.

We agree that hybrids issued through a SPV should be classified the same way as a direct issue for prudential treatment.