FEDERATION
BANCAIRE
FRANCAISE

The Deputy Director General

Paris, February 22, 2008

CP 17 - Tier 1 Hybrids

Dear Madam,

The French Banking Federation (FBF) welcomes the opportunity to comment on the CEBS consultation paper CP 17 on the proposal for a common European definition of Tier 1 hybrids. In our opinion, hybrid instruments provide a flexible tool for capital management and a large source of funding for banks. They will give them access to different types of investors and may increase financial stability.

FBF supports the objectives of CEBS to "provide guidelines for a common and clear interpretation across the EU of the eligibility criteria that hybrids must meet". We believe a full harmonization is required all over the European Union in order to avoid competitive distortions and to reduce the cost of capital for European banks. As far as the definition of capital is concerned, Member States should not be allowed to impose additional and/or stricter requirements as legal, tax and insolvency laws may already cause competitive disadvantages between different Member States.

We deem this document highlights the main conditions to be fulfilled (permanence, flexibility of payments and subordination) but fails to bring sufficient clarity especially for the loss absorption clause. We think the grandfathering clause should also be reviewed.

We feel the propositions made by CEBS are much more restrictive than the Sydney Press Release of 1998 and thus can lead to competitive distortions with international competitors. In fact, the proposal which is supposed to be rule-based is overly detailed and restrictive.

More generally, it would have been more consistent to wait for the common definition by the Basel Committee on Banking Supervision before modifying the EU legislation. Otherwise, it would be damaging to the European Banking Industry and the hybrid market especially if the conditions are more restrictive for new issuances and if the grandfathering clause is applied earlier and on a more restrictive basis.

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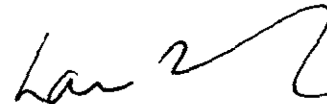
We think the major challenge should be to fully harmonize the definition of the capital (different categories of shares, question of dividends, deductions, etc.) when Tier one hybrids only represent a part of it. Other discussions are in progress to reach a clear definition of capital and it could be an opportunity to wait until the outcome of the consultations before modifying the EU legislation.

That is the reason why regulatory changes have to be really well-thought and made by following a staged approach. For the time being, pending the outcome of the forthcoming discussions within the Basel Committee on Banking Supervision, the EU should satisfy itself with resolving only those differences amongst Member states which truly matter from a competitive point of view. In the longer term, it should take part in the BCBS discussions before implementing a harmonized definition of hybrids and capital in the banking and in the insurance sectors.

The French Banking Federation is committed to building a level playing field in Europe that a better regulation can contribute to create. FBF is at CEBS's disposal for any further discussion on these issues.

Please find attached our detailed comments on CP 17.

Yours faithfully,



Pierre de Lauzun

FEDERATION
BANCAIRE
FRANCAISE

Le Directeur Général Adjoint

Paris, le 22 février 2008

Consultation CP 17 - Titres hybrides

Madame,

Je vous remercie de votre invitation à commenter la consultation CP 17 émanant du CEBS et concernant la proposition d'une définition européenne commune des titres hybrides pouvant être inclus dans les fonds propres de base. De notre point de vue, les titres hybrides constituent une source de fonds propres utile pour gérer les contraintes banques en matière de solvabilité en raison de leur flexibilité et de leurs caractéristiques puisqu'ils leur donnent accès à d'autres types d'investisseurs et peuvent ainsi accroître la stabilité financière.

La Fédération Bancaire Française soutient les objectifs du CEBS visant à établir des recommandations pour une interprétation claire et identique dans tous les pays des critères d'éligibilité que doivent remplir les titres hybrides. Nous considérons qu'une harmonisation totale est nécessaire dans l'Union Européenne pour éviter des distorsions de concurrence et réduire le coût du capital pour les banques européennes. Dans la mesure où il s'agit de la définition des fonds propres, les états membres ne devraient pas pouvoir imposer, de leur propre initiative, des exigences supplémentaires ou plus strictes, alors que les textes fiscaux, légaux et en matière de faillite peuvent déjà entrainer des divergences significatives entre pays.

De notre point de vue, les propositions du CEBS mettent à juste titre l'accent sur les conditions que doivent remplir les titres hybrides (permanence, flexibilité des paiements et subordination) mais n'apportent pas de précisions suffisantes sur la clause d'absorption des pertes. Nous pensons également que la clause de grand père devrait être revue.

De plus, les propositions du CEBS, qui auraient dû être basées sur de grands principes, s'avèrent dans la réalité beaucoup trop détaillées et plus restrictives que celles contenues dans l'accord de Sydney de 1998. Elles pourraient ainsi entrainer des distorsions de concurrence en défaveur des banques européennes.

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Plus généralement, il aurait été logique d'attendre que le Comité de Bâle sur la Supervision Bancaire parvienne à une définition commune avant de modifier la législation européenne. Dans le cas contraire, la profession bancaire européenne se trouverait inutilement pénalisée et le marché des titres hybrides ne se développerait pas en Europe, notamment si les conditions mises par les régulateurs sont plus restrictives pour les nouvelles émissions et si la clause de grand-père est appliquée plus tôt et de façon plus sévère que dans d'autres pays.

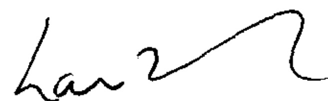
Nous pensons que la première tâche devrait être de parvenir à une définition totalement harmonisée des fonds propres (différentes catégories d'actions, question des dividendes, déductions à pratiquer, etc.) dont les titres hybrides ne représentent qu'une fraction. Différents travaux sont en cours pour y parvenir et il nous aurait paru opportun d'attendre le résultat de ces discussions avant de traiter la question des titres hybrides. C'est la raison pour laquelle les changements envisagés dans l'Union Européenne doivent être bien pesés avant d'être effectués selon une approche par étape.

Pour le moment, et dans l'attente des résultats des discussions à venir au sein du Comité de Bâle, l'Union Européenne devrait s'attacher à résoudre les différences qui ont réellement de l'importance du point de l'égalité des conditions de concurrence entre Etats membres. A plus long terme, elle devra participer aux discussions au sein du Comité de Bâle avant de légiférer sur une définition harmonisée des fonds propres et des titres hybrides commune au secteur de la banque et de l'assurance.

La Fédération Bancaire Française est attachée à la mise en place de saines conditions de concurrence et juge qu'une réglementation appropriée permet d'y parvenir. Elle est à la disposition du CEBS pour toute discussion complémentaire sur ces questions.

Vous trouverez nos commentaires détaillés sur le CP 17 dans l'annexe jointe.

Je vous prie d'agréer, Madame, l'expression de ma considération respectueuse.



Pierre de Lauzun

Fédération Bancaire Française
Answer to CEBS CP 17

Introduction

The French banking Industry welcomes the proposal made by CEBS to achieve a common understanding of the interpretation of the 1998 Sydney Press Release (SPR) of the Basel Committee on Banking Supervision.

European and international convergence in achieving a level playing field in terms of competition, and to the possible extent in terms of cost of capital. This is of course limited by national legal, tax, etc... framework which is far from being harmonized.
It would seem appropriate to adopt a staged approach: for the time being: pending the outcome of the forthcoming discussions within the Basel Committee, the EU should satisfy itself with resolving only those differences amongst Member States which truly matter from a competitive point of view:

1) All EU banks should be authorized as a matter of principle to issue hybrids to strengthen their capital base.
2) The total limit for inclusion of hybrids into Tier 1 capital - which currently vary considerably across the EU - should be harmonized as this creates substantial distortions of competition which need to be addressed. Our proposal would be that the EU would impose a 50 % maximum limit.

To avoid competitive distortions between Member States, those common rules must be construed as a full harmonization: Member States should not be allowed to impose additional and/or stricter requirements.

We believe that hybrid instruments may increase financial stability – and should, therefore, more readily be accepted as Tier 1 - because:

- (i) they provide an additional cushion protecting depositors and senior bond holders;
- (ii) they diversify and broaden the investor base, which can be crucial to maintain access to funding and capital in times of economic downturn;
- (iii) they may provide cheaper funding;
- (iv) whilst equity tends to be highly volatile, fixed-income instruments are much more stable;
- (v) hybrid instruments can be denominated in foreign currency whilst subscribed capital and reserves are mandatorily denominated in the reporting currency - which is important from a foreign exchange risk point of view;

II – Reaching a common definition of hybrid capital and its underlying principles

FBF supports the objective of CEBS to "provide guidelines for a common and clear interpretation across the EU of the eligibility criteria that hybrids must meet" (cf paragraph 13). FBF notes that implementation of specific common mechanisms in each Member State can hardly be harmonized as it depends on specific diverging rules in the area of bankruptcy law, company law and tax law.

It has been agreed that a principle-based approach of the eligibility criteria should be developed. Those key economic features, commonly agreed as being permanence, flexibility of payments and loss absorbency, are clearly inter-related and should not be taken and analysed in isolation from each other, being accepted that, in fact, loss absorption is the underlying key objective.

In terms of definition, FBF mainly agrees with the CEBS definitions of permanence and flexibility of payments but highly argues against the loss absorption proposal (including the questionable definition of subordination).

FBF suggest that CEBS adopts a wider approach, recognizing that the eligibility criteria are strictly interwoven and to develop a real "substance-over-form" principle.

A. ***Permanence***: FBF agrees that hybrids must be available at all times and therefore on CEBS definition, which, consistently with the SPR, states that Tier 1 hybrids must be undated and that call options are acceptable under conditions and subject to supervisory approval. Tier 1 hybrids must also be fully paid-up.

A consequence of this feature that need to be highlighted is that the call initiative remains at the initiative of the issuer only and hybrid investors never have enforceable claim to the repayment of the principal and therefore are not in a position to force bankruptcy. Hybrid capital then remains available in time of financial stress.

At the same time, the possibility to include a call option in all types of hybrid instruments including preference shares has to be recognized by CEBS since it is an important feature that is required to attract fixed income investors which are the usual investors in hybrid instruments.

B. ***Flexibility of payments:*** FBF agrees with the principle that issuers must be able to stop payments on a non-cumulative basis, and that this opportunity becomes an obligation when the issuer is in breach of the minimum capital requirement. In terms of other triggers, FBF advocates for a non-overly prescriptive approach avoiding the insertion into the regulation of potential national discretion, already foreseen by Basel Pillar 2 which ensures an in-depth regulatory supervision.

In addition, FBF supports the view that payments must be commensurate with the ranking of the instrument and that therefore, in accordance with Member State legislation, dividend pushers have to be allowed.

FBF considers that the fact that the distributions can only be paid out of distributable items is in line with the SPR.

In conclusion, through flexibility of payments feature, it has to be noted that the coupon payment decision remains with the issuer in case of optional and mandatory coupon cancellation and that hybrid investors never have enforceable claim to the payment of the coupon (therefore, they are not in a position to force bankruptcy) unless a dividend pusher is active. The consequence is that the firm is allowed to keep, with undefined term, free financial resources in time of stress, providing financial flexibility until recovery.

C. ***Subordination***: FBF agrees with the fact that hybrid instruments must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids rank senior to ordinary share capital (and does not rank senior only to ordinary share capital as stated by CEBS in its proposal page 7 and 20[1]).

D. ***Loss absorbency:*** FBF clearly recognizes that this criterion is the key feature and is, therefore, deeply concerned about the lack of precise definition of loss absorption feature.

[1] FBF however understands that this wording, much stricter than the SPR and excluding potential intermediary instruments that would be junior to Hybrid Tier 1 instruments, was not the intention of CEBS and that the word "only" will be ultimately removed from the document's wording, thus confirming that it should be sufficient for hybrid instrument to always rank junior to depositors, general creditors and subordinated debt of the institution and senior to ordinary share capital.

FBF would like to clarify what can be understood by loss absorbency. First of all, it is understood that the concept of loss absorbency applies in case of extraordinary loss.
Loss appeared to be considered mainly as an operational and accounting loss with a direct impact on the profit and loss account. It can also be an accumulation of past and current losses. It can be added that, from a prudential point of view, a loss could also be defined as a negative impact on own funds[2], that can be for instance a direct record into equity or an additional goodwill to be deducted from own funds.

Loss absorption feature is defined as enabling a bank to continue operations on a going concern basis (cf. paragraph 103). FBF deplores that no further precision is given on this requirement while prescriptive answers are detailed.

FBF believes that loss absorption is determined through the ability of the instrument:
- to satisfy the claims of all non-subordinated creditors in the event of a bank's insolvency or liquidation,
- to help the bank to continue its operations on a going concern – which means that (i) it should help preventing its insolvency and (ii) not hinder its recapitalisation, particularly in stress situations.

FBF agrees with the principles established in paragraph 105 of CEBS proposal[3] and with the scenarios of loss absorbency mechanisms detailed in paragraph 107:
- "on a going concern basis, losses can be absorbed by waiving the coupons,
- in case of liquidation, losses are absorbed in accordance with the degree of subordination; and
- in stressed situations, where a bank make significant losses, especially if it is in breach of its minimum capital requirement and is likely to need new capital either by issuing new capital or through future earnings (or alternatively it could try to reduce its capital requirements), Tier 1 hybrid should not hinder recapitalisation."

However, FBF believes that hybrid instruments fulfil these requirements by their defintion as:
- they rank subordinated to all depositors, general creditors and subordinated debt of the issuer, which enable to satisfy the claims of all non-subordinated creditors in case of bank's insolvency or liquidation (as defined in C.).
- they are permanent (as defined in A.),
- they provide the issuer with the ability to cancel payments at any time (subject however to a dividend pusher not being active) on a non-cumulative basis and for an unlimited period of time without triggering a default and give the issuer thereby full access to the waived payments (as defined in B.). Moreover the supervisor can require the issuer to waive payments at its discretion based on the financial situation of the issuer.

In addition, FBF would like to discuss the options of CEBS to address stress situations:

- **coupons are written down on a permanent basis:** from an economic perspective, this reduces the present value of the undated instrument to zero, even if it might be redeemed at par when the institution recovers, at the option of the issuer. This would limit the financial flexibility given to the issuer that can decide when stopping and when resuming those payments. The fact that coupons are cancelled for a temporary period

[2] For instance, in the IFRS accounting framework, this can be linked to movements in exchange rates, to transactions carried out with minority interests, to changes in the fair value of financial instruments. FBF acknowledges that, in certain cases, prudential filters minimize the potential impact.
[3] Ie, regulation of hybrids should not be more onerous than the rules on ordinary share capital and ranking of subordination of different Tier 1 capital instruments should be respected so that the ordinary shareholders should suffer the first losses.

of time is enough to allow the bank to pursue its activity and to avoid hindering a future recapitalisation (in comparison to coupon deferral for instance). Furthermore, in terms of comparison to equity, this would discriminate hybrid instruments as dividends cannot be stopped on a permanent basis.

- **the principal amount of the instrument is written-down but is written back-up**: FBF does not understand at all why this characteristic would increase the loss absorbency feature of hybrid instruments, or even, consistently with the principle applied by CEBS[4], how it would bring the feature closer to the equity benchmark. Indeed, a temporary write-down of the principal amount does not improve the situation of the bank and the cancellation of coupons gives the required flexibility. It is sufficient to ensure that no cash leaves the bank.
  FBF wonders whether this write-down feature is required by CEBS in order to avoid displaying an accounting loss on the issuer's annual accounts. This is not our understanding either of hybrid instrument objective or of loss absorbency feature:

  - From a legal point of view, hybrid holders never waive their claim for the full principal amount[5], as otherwise they would rank junior to ordinary shares, which would not be acceptable.
  In fact, (i) in liquidation, the investors have the right to claim for the full principal of the instrument and (ii) in going-concern situations, hybrids can never be totally redeemed at an amount different from the full principal amount. This is why we understand the comment made in page 20 of CEBS proposal[6] as a possibility (quite impracticable from an issuer point of view) of a partial, but not definitive, redemption as total redemption will always be on the full principal amount (coherent with the rank of subordination). As a result of the fact that from economic and legal point of view, hybrid holders never waive contractually their claim, the write-down accounting entry would not be possible whether hybrid instruments are accounted for as equity or debt.

  - Even if this could be achieved, from a regulatory point of view, it is not obvious that there would be an advantage to pass the write-down into P&L as there may not be impact on the total Tier 1 capital of the issuer and as it does not improve the protection of the more senior debt holders.

  - Finally, it has to be noticed that, if the hybrid holders were to waive their claim on a portion of the principle amount, this would give rise to a [potentially] taxable gain in the hands of the issuer.
  In addition, in the event this write-down ends to be possible (highly improbable in the FBF view), a necessary write-up out of future profits is likely to severely hinder a potential recapitalisation. Indeed, a potential investor would invest after the write-down (and would not have benefit from its "theoretical" positive impact) and before the write-up and therefore would suffer the accounting loss because of the reinstatement of the hybrid instrument principal.

- **the principal amount of the instrument is permanently written-down on a mandatory basis:** this would be inconsistent with the ranking of hybrid instruments which are senior to ordinary shares. Therefore, FBF agrees with CEBS that it does not constitute an option.

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[4] FBF already indicated that hybrid instruments have advantageous characteristics distinct from equity.
[5] Unless approved at a Hybrid holders general meeting
[6] "If the bank wants to redeem the instrument whilst the principle is written down, it can only redeem it at the written down amount. Redemption at par will not be possible until the principal is completely written up".

- **the instrument mandatorily converts into ordinary shares**: FBF agrees that this would make hybrid instruments pari passu with ordinary shares and that the conversion itself does not of itself absorb losses.
  - FBF disagrees on the fact that the conversion improves the quality of the remaining capital of the bank to absorb future loss, as hybrid instruments are designed for this purpose, as explained before.
  - A conversion into ordinary shares would not improve the status of the general depositors and subordinated debt holders (already senior to hybrid investors before conversion) on an ongoing basis, in important financial distress or in liquidation.
  - In addition, FBF believes that this mechanism will have several negative consequences:
    * CEBS proposal would introduce rules going beyond established practice applied by companies in difficulty in all sectors of the economy. The write-down and conversion mechanisms proposed by CEBS would actually be less effective than the customary market practice[7] in case of over-indebtedness circumstances, in which creditors holding hybrid instruments would agree to waive a portion of their claims (a permanent write-down) because, if the bank would succeed in recovering and continuing operations on a going concern, they would obtain much more of their investment than if the bank would become insolvent (gone concern), where their claim would be deeply subordinate.
    * from a market point of view, this feature might considerably reduce the hybrid investors base, mainly composed of fixed income investors as of today, which is considered as having the advantage to diversify and broaden the investors base of an issuer, which can be crucial to maintain access to funding and capital in times of economic downturn,
    * also from a market point of view, the equity conversion might also worsen the bank shareholders situation as the fixed-income investors would be required to sell the shares they received, probably creating a market turmoil which would hinder a recapitalisation,
    * from a legal point of view: it might be very difficult to obtain the necessary approval from ordinary shareholders that might refuse the principle of being (a priori) extremely diluted (principle amount of hybrid instrument to be converted at a conversion ratio based on fair market value).
    * from a tax point of view, the conversion into ordinary shares might severely affect the tax deductibility of coupon payments. It is reminded that this issue is critical to issuers and that FBF supports the creation of a European, and even wider, level playing field in this area and recommends that CEBS proposals do not discriminate Member State, in a context where tax law harmonisation will be long to achieve.
    * finally, this mechanism is very difficult if not impossible to implement in mutual or cooperative organisations.

On the principle that hybrid instrument should help preventing the issuer's insolvency, FBF believes that hybrid instruments should not be liabilities for insolvency purpose, but this is mainly within the competence of Member State bankruptcy law, which we understand is far from being harmonized.

As a conclusion, FBF does not understand how the CEBS proposal would reinforce the loss absorbency feature of hybrid capital. Indeed, FBF believes that the features of permanence, flexibility of payments and subordination make hybrid instruments fulfil the objective of what the SPR call "loss absorption". Any other additional requirements would alter the first three features and reduce the issuer's flexibility. In this context, FBF considers that there is no reason to

[7] This point is also clearly described in the European Banking Federation answer.

discuss triggers issues but highlight the fact that making a reference to an absolute threshold (2% for instance) does not seem appropriate for non dated instruments in a context of moving regulations. However, FBF would be ready to consider a clear and acceptable mechanism that would, in times of financial stress, make compulsory the reduction in the capital base for interest calculations on hybrid instruments.

II – Limits, deductions and "at issuance" issue

In so far as the main objective is to reach a level playing field in Europe along the lines of the SPR, the FBF generally agrees with the CEBS proposal to maintain unchanged the SPR limits of 15% of Tier 1 for innovative instruments and for a minimum level of 50% of core Tier 1. The FBF also agrees that low capitalised banks should have a higher proportion of core Tier 1. However, the FBF would like to suggest some improvements in the way these limits should be implemented. A tentative wording for amendments to the CRD is proposed in annex 1 to this letter.

Over a longer term, the FBF is of the opinion that at the time the 15% limit has been set in the SPR, the market for hybrids was less developed than it is today and that the level of this limit should be revisited in the upcoming discussions to be held at the BCBS level.

A. Full harmonisation across Europe

As the main goal of the Commission is to achieve a level playing field in Europe through the incorporation of the SPR principles in the CRD, the 15% limit for innovative Tier 1 and the 50% or 70% minimum level for core Tier 1 should be applied on a uniform basis across Europe and local regulators should not have any national discretion in order to impose different levels in their country.

B. Implementation of the 70% minimum level of core Tier 1 for low capitalised banks

The numerical examples used by the CEBS has brought some confusion as to the way the 70% minimum level of core Tier 1 for low capitalised banks should be computed. The CEBS proposal can be read as a first 70% minimum level of core Tier 1 for the minimum required Tier 1 amount plus a second 50% minimum level of core Tier 1 for any amount of Tier 1 in excess or the minimum required Tier 1 amount. We think that such a dual mechanism is not a workable solution. We rather suggest that core Tier 1 should be greater than the lower of the two following amounts:

i. 70% of the minimum Tier 1 requirement (i.e. 2.8 % of risk weighted assets, without taking into account any additional Tier 1 requirement under pillar 2)
ii. 50% of the actual Tier 1 amount

C. Limits to be applied to Tier 1 before deductions

The CRD consistently applies limits to own funds before deductions that have to be applied 50% to Tier 1 and 50% to Tier 2.[8] The rationale for this treatment is that a deduction requires additional own funds to reach the same level of targeted own funds before deduction and that these additional own funds can be of the same composition as the original own funds before deduction. By way of example, assume a bank had 100 of required Tier 1, divided in 70 of core Tier 1 and 30 of hybrids and no deduction. Subsequently, this bank buys a material participation and has to make a deduction in an amount of 10 from its Tier 1. It has to raise an additional amount of Tier 1 that should be allowed to be funded through 7 of core Tier 1 and 3 from hybrids. If the 30% limit were to be applied to Tier 1 after deduction, the additional own funds should be funded by core Tier 1 only.

[8] Reference is made to the limits for total Tier 2 and lower Tier 2 as defined in Articles 66-a) and 66-b) and to the 10% threshold for non material participations in other credit institutions as defined in Article 57-n)

D. 15% limit for innovative hybrids at all times (versus at issuance)

Although the SPR has stated that the 15% limit is measured at issuance, the FBF recognises that there are some merits in requiring that the 15% limit be observed at all times. In particular, under a sound capital planning exercise, any foreseeable event that would reduce the Tier 1 amount (such as a share buyback or the goodwill resulting from a planned acquisition) should not permit the 15% limit to be exceeded. However losses brought forward also reduce the amount of Tier 1. In this circumstance, limiting the innovative hybrids to 15% of a reduced Tier 1 amount will accelerate the decline of the Tier 1 ratio. This would be an unnecessarily bad signal sent to the market as the depositors will still benefit from the subordination of the total amount of the hybrid issuances. The FBF therefore suggests that the 15% limit could be exceeded in the sole case where it would result from a net loss and a reduction of the reserves.

III- Grandfathering and transitional provisions

Grandfathering of existing instruments would be essential as the volume of outstanding hybrids instruments which may cease to qualify under the proposed rules could be substantial.

No distinction should be made between hybrid instruments with incentives to redeem and other hybrid instruments

The general approach adopted in the CEBS document in this regard is puzzling. It proposes to discriminate between hybrid instruments with incentives to redeem and other hybrid instruments – without providing any explanation as to why such a distinction should be relevant and appropriate from a grandfathering perspective. We question whether such a distinction is indeed relevant on the basis that both types of instruments are all eligible as "original own funds" under the current rules. In addition, once the step-up has occurred, if the instrument is not redeemed (for example because it provides the issuer with a funding source which is more favourable under the market conditions which are prevailing), it will turn into an instrument without incentive to redeem.

Uncertainties remain on the exact meaning of the proposed grandfathering mechanism. We understand the CEBS proposals as follows:

a) instruments with incentives to redeem are eligible to count as Tier 1 up to the first call date (whenever the call date is, even if in 30 years ahead);
b) instruments with no incentive to redeem and instruments with incentives to redeem which first call date has already occurred and that have not been redeemed must not exceed 20% of total Tier 1 in 10 years time, 10% in 20 years time and will stop counting as Tier 1 capital at year 30.

Another interpretation of the CEBS proposals according to which instruments with incentives to redeem would no longer qualify as regulatory capital after the first call date could have adverse consequences as it would make the instrument becoming regulatory-wise dated. This would create a strong additional incentive to exercise the call (because, otherwise, the instrument will no longer qualify as Tier 1) in a context where the issuer is not always in a position to redeem because of:

- difficulties to replace the called issuance with hybrid instruments which qualify under the new regulatory framework :
  - linked to the marketability of such hybrid instruments (investors base might be dramatically reduced);
  - linked to the pricing of such instruments (terms and conditions might increase the investors' requirements);

- linked to the legal and tax environment constraints with which the issuer is faced (write-down obligation might lead to adverse tax consequence, coupons could become non deductible);
- a refusal from the regulator to allow the call of the instrument to be called.

Therefore, under any interpretation, it would seem more appropriate to apply the grandfathering equally to all instruments, so that the call exercise decision remains at the discretion of the issuer (subject, of course, to prior supervisory approval).

It also needs to be observed that we do not understand what is meant by *"hybrids with incentives to redeem which are not callable"*, to which paragraph 62, b refers.

In any case, FBF considers that unlimited grandfathering would be appropriate until an agreement is reached within the Basel Committee

From an economic perspective, hybrid instruments created under the current regulatory framework are still equity-like items which remain worthwhile to both shareholders and regulators. Even if some new specific provisions make the major part of current hybrid instruments allowed today in Tier 1 capital ineligible, this does not mean that they would no longer meet regulatory needs and would not constitute a useful and diversified source of "own funds".

Once the new European rules will have come into force, new hybrid instruments issuances will need to bear the characteristics finally defined. As a consequence, those instruments which were created under the previous regulatory framework will naturally be called and will need to be replaced with new issuances. This, in addition to the banking sector growth, will lead to a decrease of the proportion of own funds composed by historical hybrid instruments. However, the replacement of hybrids can take place only if a deep liquid market for hybrid instruments corresponding to the new regulatory framework exists. If market forces fail to deliver such a market, the issuer will face a deadlock where he cannot replace the current instruments with new one complying with the new regulation and where those instruments do no longer qualify as regulatory capital, putting therefore the solvency ratios into unnecessary pressure.

Should the Basel Committee adopt in the future a wider grandfathering clause on existing hybrid instruments, this would create a competitive distortion between European and non-European players. It needs to be reminded in this context that the SPR advocated for an unlimited grandfathering.

On the basis of the arguments mentioned above, an unlimited grandfathering of existing instruments is definitely the right choice, at least until the Basel Committee defines a new framework and gives grandfathering indications. All pre-dated instruments which qualified as Tier 1 capital under the rules-that are currently in place in that jurisdiction should continue to qualify.