ABI Associazione Bancaria Italiana

ABI COMMENTS ON THE CEBS DRAFT PROPOSAL FOR A COMMON EU DEFINITION OF TIER I HYBRIDS

POSITION PAPER

2/2008

1. GENERAL OUTLOOK

ABI welcomes the opportunity to comment on the CEBS draft proposal (the **"Draft Proposal"**) which is being discussed throughout Europe to align the treatment of hybrid instruments as eligible capital among the Member States.

ABI generally shares and supports the analysis and comments that have been made by the European Banking Federation. In addition, there are a number of aspects of the Draft Proposal where we consider our input to be useful and will illustrate hereunder our precise concerns.

In general, we suggest that the CEBS proposal create a principle-based framework which would allow Member States the flexibility to interpret the spirit of the principles in line with any specific concerns they may have with their domestic legal and regulatory regime. In our view, the current draft proposal is essentially rules-based, containing a level of detail that raises a number of concerns in certain jurisdictions and, despite the general aim to align and facilitate the issue of hybrid securities, as currently drafted, could even hinder the issue.

The content of this paper follows the order of the CEBS draft proposals.

2. PERMANENCE

2.1 Undated

The Draft Proposal suggests that an instrument meets the "permanence test" if it is contractually undated. In our view, there is no need to introduce a further concept of securities having to be "undated" as well as the general principle of an instrument meeting the permanence test.

In line with our suggestion to adopt a more principle-based approach, we suggest that the concept of permanence should be viewed in a wide context in order to allow flexibility of interpretation and that, rather than tying this concept to contractual dating of an instrument (the word "undated" seems to suggest that this has been the approach), the fact that there is no obligation for a company to redeem the security should be the test. This can be key for taxation analysis.

By way of example to support our view that permanence as a general principal is sufficient without adding the additional requirement of "undated" the followings are two existing hybrid structures which would be difficult to classify as "undated", (i) recent hybrid securities directly issued by Italian

banks have a maturity linked to the end date of the issuer's life or to the date of issuer's liquidation, with a provision that in the event the date of the issuer is extended, the maturity of the security will also be accordingly extended, and (ii) mandatorily convertible securities are dated but consistent with the permanence concept as these securities convert mandatorily into shares at a specified date and there is no possibility for a company to redeem the securities in cash.

In our view, the aim should be to create a security that is as "permanent" as the issuer's share capital (for example, if a security would mature on the winding up of the issuer and be paid out according to, among others, its subordination clauses, or if a security would mandatorily convert into the issuer's share capital). In this way, the instrument is permanent as it may not be redeemed by the company for as long as the company exists (subject to any permitted call options), but in our view this is not the same as stating a security is "undated".

This approach is, after all, in line with the concept "substance-over-form" which the CEBS draft proposal recommends.

2.2 Callable

The Draft Proposal refers to call options for issuers (subject to prior consent of the supervisory authority) with a first call date, without an incentive, falling at least five years from the issue date of the security, and a first call date, with incentive (subject to certain limitations), falling at least ten years from the issue date, which is largely in line with the Italian position.

In addition, the Draft Proposal discusses other early redemption options (subject to prior consent of the supervisory authority) which are not considered incentives to redeem, including as examples call options triggered by a change in regulatory recognition or a change in the tax treatment of the securities.

We suggest two issues that need to be clarified in relation to the latter category of early redemption options:

- firstly, that such early redemption options may be exercised at any time (including prior to the first call date);
- secondly, that there is flexibility to allow for early redemption for other trigger events - this is implied in the Draft Proposal as the examples of regulatory/tax change given are not qualified as exhaustive *("Early redemption triggered by an event* ***SUCH AS*** *a change in regulatory recognition [...] or a change in the tax treatment...")*.

In any event, any early redemption would be subject to the prior consent of the supervisory authority, which would ensure the stability of the issuer.

Our concerns to allow for flexibility of early redemption triggers is due to the fact that issues of hybrid securities may be sensitive to changes other than merely regulatory and tax treatment.

For example, some structures on the market may be driven by specific rating agency, accounting or other concerns, without which the security would no longer be efficient. We believe that, considering that any call would nonetheless be subject to prior consent, each supervisory authority should be able to decide appropriate triggers with issuers on a case-by-case basis.

3. LOSS ABSORPTION

3.1 Ranking

In terms of ranking, the Draft Proposal states "*The instrument must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids are senior only to ordinary share capital*".

We suggest that this point needs to be further clarified as the key feature is to ensure that hybrid securities rank sufficiently junior to other less subordinated securities (such as Upper Tier II and Lower Tier II securities), as well as senior to share capital.

We would therefore clarify that hybrid securities should rank no higher than senior to share capital (which in Italy includes ordinary shares, saving shares and privileged shares) and all other securities (other than share capital) ranking "pari passu" with any such share capital.

In addition, the Draft Proposal should take into account the fact that in certain jurisdictions, share capital is composed of not only ordinary shares, but also of other types of share that are "true" share capital. In Italy there are three classes of share capital: ordinary shares, savings shares and privileged shares.

It should also be recalled that in Italy, savings shares and privileged shares (also in certain other jurisdictions) are in fact share capital and, in this way, are not comparable to securities which are known in the Anglo-Saxon world as "preference shares".

3.2 Write-down

The Draft Proposal discusses aspects of loss absorption relating to the writing down of principal and how this should be dealt with on redemption.

Our first objection on this point, driven by some tension in the tax analysis, would be to clarify that an issuer should be able to redeem hybrid securities at their full nominal amount at any time, as there is never any obligation to

redeem (a call option is by its nature always at the discretion of the issuer) and also that any redemption would be subject to the prior consent of the supervisory authority.

If repayment of principal would result in the insolvency of an issuer, it is hard to envisage that such discretion would be exercised and such consent obtained. In any event, should a call option be successfully exercised and result in an insolvency situation, claims of holders of hybrid securities would be subordinated to the majority of other creditors as per the ranking provisions discussed above.

Our second objection on the loss absorption discussion is the statement that *"If the bank wants to redeem the instrument whilst the principal is written down, it can only redeem it at the written down amount".*

This would result in an instrument that could be redeemed at an amount below par which could be key to the taxation analysis (for example, typical bond tax treatment in Italy could be affected by this type of instrument).

Furthermore, redeeming at the written down amount may leave open a possibility of future claims for the amount that had been written down, creating uncertainty and possible contingent liabilities.

Given the considerations above as to when an issuer could exercise its call option, we believe that this part of the Draft Proposal does not provide any meaningful protection to ensure the stability of the issuer but rather uncertainty both from a legal and tax perspective.

4. FLEXIBILITY OF PAYMENTS

4.1 Breach of Minimum Capital Requirements

The Draft Proposal contemplates that dividend pushers are permitted but must not "push" payments where certain supervisory events occur between the date of the dividend payment and the date of the coupon payment. This provision would theoretically allow for payment of a distribution to shareholders but then with no payment to hybrid investors shortly thereafter.

We believe that this is inconsistent with the market position where the underlying spirit is that share capital is junior to hybrid securities. As such, it is not realistic to allow hybrid investors to be treated significantly worse than shareholders.

From a practical perspective, a provision of this nature would have an impact on pricing and we risk reducing the efficiency of this type of instrument and in the reliability of the Tier 1 market.

A possible solution would be to limit the amount of time during which a dividend payment is able to "push" coupon payments, as currently hybrid securities tend to provide that coupons will be paid to the same extent a dividend was paid in the previous year.

For example, a proposal could be to provide that a coupon payment must be made to the same extent a dividend was paid in the 6-month period prior to the coupon payment date (a reduction from the current standard period of one year).

4.2 Payments only out of Distributable Profits

The Draft Proposal states that distributions on hybrid securities can only be paid out of distributable items. In our view, it must be clarified that it does not imply that distributions can only be paid out of distributable profits.

4.3. Payments While Principal is Written Down

The Draft Proposal contains a provision suggesting that ongoing payments be stopped while principal is "written down".

The position set out in the Draft Proposal is, in our view, overly conservative because the trigger event occurs when the minimum capital requirement (i.e. 8 per cent of risk weighted assets) is not respected. We suggest that the trigger event for mandatory deferral of interest be fixed here in the same way and at the same level as the loss absorption requirement, to avoid the risk of Member States applying this provision differently and putting institutions at an advantage/disadvantage with respect to their European competitors as a result.

5. LIMITS TO INCLUSION INTO TIER 1

The CEBS proposal introduces a link to required capital as the starting point to be able to count hybrid capital: "*only banks that have met 70% of their required Tier 1 with common shareholders' funds, disclosed reserves/retained earnings will be able to count additional hybrid capital…When an institution operates above the required Tier 1 capital, ordinary shares and disclosed reserves/retained earnings represent at least and at all times 50% of the total Tier 1 after deductions*".

We have a concerns with this mechanism and the existence of two levels to be applied depending on a bank's capital structure.

The proposed system creates a "cliff effect": although a bank would usually observe stricter capital requirements than those imposed by regulators, as soon as its Tier 1 ratio decreases, the amount of hybrids that the bank is allowed to include in its Tier I will also decrease. This would make it

difficult to issue new hybrid instruments and count previously issued instruments, which in turn would make it more difficult to overcome a crisis. This would accelerate any stress situation that a bank finds itself in, as it would go from a level where 50% of its Tier I could be composed of hybrid instruments towards the minimum where only 30% of its Tier I may be composed of hybrid instruments.

In our view, introducing a 70% limit "in all cases" is not useful to foster capital adequacy. This limit works only at a Tier 1 ratio above the required capital and would therefore introduce a competitive disadvantage for well capitalised banks compared to other European banks.

In addition when a bank operates in a stress situation (i.e. where it is under the required capital level) it has limited commercial possibilities to pursue and raise capital on the markets other than through issuing new equity.

CEBS proposes to broaden the range of instruments to which the limit would apply. It proposes, in particular, to include both principal stock settlement and instruments with ACSM features within the 15% limit. With this new definition, most of the current hybrid instruments would fall under the 15% limit of Tier 1 after deductions.

We believe that it would not be appropriate to go beyond the Sydney Press Release: the 15% limit should apply only to true innovative instruments, i.e. with a principal incentive to redeem which gives the instrument a dated nature.

We believe that a "one-off" limit should be introduced for the amount of hybrid capital that can be counted for a bank's Tier I capital (i.e. 50%). Setting this limit, CEBS should also bear in mind that banks would in normal circumstances remain below this level in the light of rating agency concerns, and also the opinion of financial analysts as well as a prudential concern to retain a residual issuing capacity of capital instruments to face stress situations.

We believe that "ACSM" should not be allowed only for fiscal reasons as we do not consider it to be an incentive to redeem but rather a possibility to access markets which are sensitive to the payment of a coupon. ACSM gives an issuer the possibility to pay coupons only after raising funds from the equity market (or from an issue of similar securities) within certain limits. We believe that this mechanism should only be modified in the possible cumulative feature but not in the limited feature.

Both limits referred to above take "Tier 1 after deductions" and "ordinary shares and disclosed reserves / retained earnings" as benchmarks.

Such an approach is not likely to contribute to achieving a level playing field within the EU as harmonised rules are currently lacking in regard to (i) the

composition of Tier 1, (ii) items which need to be deducted and (iii) risk weightings. The definition of limits in the absence of rules should refer to "Hybrid" and to "Tier 1 net of Hybrid" (after deductions if differences among Member States' definitions are not material). The two categories will be complementary.

6. GRANDFATHERING

On this point we agree with the EBF position paper.