CEBS Working Group on Own Funds
Committee of European Banking Supervisors
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12 February 2008

To the CEBS Working Group on Own Funds:

Citigroup Global Markets Limited (Citi) welcomes the opportunity to comment on the Committee of European Banking Supervisors' (CEBS) proposal to provide guidelines for a common definition of innovative and non-innovative Tier 1-qualifiying instruments and non-cumulative preference shares (together, Hybrid Instruments) outlined in its report entitled, "Draft proposal for a common EU definition of Tier 1 hybrids," dated 7 December 2007 (the CEBS Report).

Hybrid Instruments are an important capital management tool for most banks, as evidenced by their extensive use over time, as well as their prominence (relative even to common equity) in the recent recapitalisations undertaken by several large international banks. Citi is supportive of an initiative that, where appropriate, promotes the convergence of criteria for Tier 1-qualifying Hybrid Instruments and the establishment of a level-playing field across jurisdictions. We welcome in particular CEBS' recommendation to standardise capacity limitations and grandfather outstanding Hybrid Instruments. However, Citi is of the opinion that, while many of the proposals in the CEBS Report advance this agenda, the proposed loss absorption and alternative coupon satisfaction mechanisms would be counterproductive to the realization of convergence and parity. Citi observes that CEBS' stated objectives may best be realized by introducing principles-based guidelines that may be incorporated into the distinct national regulatory, legal, and tax frameworks of jurisdictions within the European Union.

Principal Write-Down

Citi believes that the principal write-down requirement is neither necessary nor helpful in promoting the convergence of criteria for Tier 1-qualifying Hybrid Instruments or the establishment of a level-playing field across jurisdictions because a) a principal write-down provision does not enhance an issuer's ability to absorb losses on an ongoing basis or in liquidation, b) it is unclear that the provision would aid the recapitalization of an issuer under extreme financial stress, and c) the implementation of the provision in certain jurisdictions may have adverse consequences for the issuer, and, even within the same jurisdiction, it may have adverse consequences for one type of borrower but not another.

Loss Absorption

A Hybrid Instrument absorbs ongoing losses by providing the issuer with the ability to cancel periodic payments indefinitely on a non-cumulative (or non-cash-cumulative) basis and in liquidation by subordinating holders' claims for the principal amount of the Hybrid Instrument to the claims of all depositors. CEBS has proposed in addition that, if the issuer's Tier 1 capital ratio falls below 2%, the principal amount of the Hybrid Instrument could potentially be written-down and, once written-down, may be reinstated only out of future profits. However, the holder would have a claim for the full original principal amount upon a liquidation of the issuer.

Citi submits that the proposed principal write-down provision does not enhance a Hybrid Instrument's loss absorption characteristics for the following reasons:

- The institution has full control over the cash raised from the date of issuance.
- In many jurisdictions, an issuer has full discretion over periodic payments; in such jurisdictions, Hybrid Instruments are often excluded from the calculation of liabilities

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for legal insolvency purposes, thus providing economic support for the institution while also providing its board the necessary flexibility to continue trading in the interests of depositors and senior creditors.

- In liquidation, the holder has a claim for the full principal amount of the Hybrid Instrument.
- On an ongoing basis, a principal write-down provision would not enhance the loss absorption qualities of the Hybrid Instrument. It may be argued that ongoing loss absorption would be enhanced because periodic payments would be reduced for as long as the principal amount is written-down. However, prior to the occurrence of a principal write-down (i.e. a time when the issuer's Tier 1 ratio has fallen below 2%), the issuer, in all likelihood, would have elected to suspend periodic payments, and, in any event, at the point at which a principal write-down occurs, would have been required to suspend periodic payments under the Hybrid Instrument's terms.
- A principal write-down would not increase the issuer's total Tier 1 capital because the write-down would have the affect of reducing an issuer's innovative or non-innovative Tier 1 capital and increasing the issuer's core Tier 1 capital by equivalent amounts.
- A principal write-down may thus be viewed as reflecting an improvement in the quality of the issuer's capital under regulatory accounting principles (as the amount of Core Tier 1 would have increased). Yet, the actual quality of capital would remain unchanged (for the reasons described above). Indeed, under IFRS, such a write-down would be very unlikely to be reflected on the issuer's balance sheet.[1] Thus, the representation of an actual write-down under regulatory accounting principles would be at odds both with economic reality and with the relevant disclosure under IFRS.

Recapitalisation

Furthermore, it is unclear that a principal write-down provision would aid a recapitalisation of the issuer. One might argue that the provision would aid a recapitalisation because the issuer may redeem the Hybrid Instrument at its written-down amount, thereby removing a layer of capital that would otherwise have ranked senior to new ordinary shareholders. However, such an argument is spurious for five reasons:

1. The issuer would be unlikely to reduce its capital during a time of financial distress.
2. Even if the issuer were so inclined, the issuer's regulator would be unlikely to permit a redemption of the Hybrid Instrument during a period of financial distress.
3. Even if the issuer were inclined to redeem the Hybrid Instrument *and* the issuer's regulator were to approve a redemption, the issuer's cash balance would be reduced by the amount of the outstanding principal amount of the Hybrid Instrument, reducing the ability of the issuer to make investments and grow the business for the benefit of shareholders.
4. New equity investors would not welcome a redemption of the Hybrid Instrument because it would represent a capital outflow precisely at a time when capital is needed most, thus triggering a need for yet more capital.
5. In any case, "new" owners of a bank would very likely wish to introduce a layer of hybrid Tier 1 capital into the capital structure of the institution. Given the distress events leading up to a recapitalisation, it is unlikely that this could be achieved at more favourable terms than those of the institution's original Hybrid Instruments.

[1] Note that an issuer may elect to account for a Hybrid Instrument at fair value, in which case, the carrying amount of the Hybrid Instrument may be reduced for a variety of reasons, including among others, a principal write-down.

One might also argue that potential new equity investors would view a principal write-down provision positively because the principal amount of securities ranking senior to ordinary shareholders would be reduced while the issuer is under financial stress. However, the write-down provision is unlikely to be meaningful for new equity investors because the dividend stopper in the Hybrid Instrument would apply for at least as long as the period during which the Hybrid Instrument has been written down and the principal amount of the Hybrid Instrument would be reinstated upon the issuer's liquidation.

Implementation Considerations

In many jurisdictions, a principal write-down provision in a Hybrid Tier 1 instrument may give rise to adverse tax, regulatory, and/or legal consequences for the issuer. We list below Citi's understanding of some, but not all, of these considerations:

- Belgium – There are no publicly available precedents for a directly-issued instrument that includes a write-down provision. The inclusion of such a provision in a Hybrid Instrument potentially would create tax and regulatory complications for an issuer. From a tax perspective, the principal write-down provision is likely to be viewed as an equity-like feature that causes the holder to share in the profits and losses of the issuer. As a result, it is uncertain that the Hybrid Instrument would qualify as debt for tax purposes.

  From a regulatory perspective, in the past, the *Commission Bancaire, Financiere, et des Assurances* (CBFA) has taken the position that a principal write-down provision would cause the amount of Tier 1 capital treatment afforded to the instrument to be reduced by the principal amount multiplied by the Belgium corporate tax rate. The reason for this adjustment would be to reflect the contingent tax liability borne by the issuer (a write-down would be treated as a taxable gain for the issuer).

- Germany – A principal write-down raises the possibility that a Hybrid Instrument would be deemed to participate in the profits of the issuer, in which case periodic payments would be subject to German withholding tax and would not be deductible by the issuer.

- Italy – If a Hybrid Instrument may be redeemed by the issuer at its written-down amount, the Hybrid Instruments may be classified as an "atypical security", in which case periodic payments would be subject to Italian withholding tax.

- Netherlands – A principal write-down raises the question of whether the consideration for the use of principal by the issuer is "results-dependent" for tax purposes, in which case periodic payments would not be deductible. Although, in the context of securitisation transactions, the Dutch tax authorities have confirmed that a write-down prior to a winding-up would not be regarded as being results-dependent, it is not certain that this conclusion may be extended to Hybrid Instruments.

- Spain – Hybrid Instruments issued by Spanish banks take the form of "*participaciones preferentes*" (Preference Shares) provided for under Law 19/2003 (Law 19). Provided that the terms of Preference Share issue comply with Law 19, the Preference Share issue will qualify as Tier 1 capital according to the Bank of Spain and dividends will be deductible for corporate tax purposes. As a principal write-down is not provided for in Law 19, the inclusion of such a provision in a Preference Share issue raises a question as to whether the issue would qualify as Tier 1 capital and also whether dividends would be deductible by the issuer for tax purposes.

- United Kingdom – A principal write-down (and cancellation of periodic payments while the Hybrid Instrument is written down) raises the question of whether the consideration for the use of principal by a bank issuer is "results-dependent" for tax

purposes, in which case periodic payments would not be deductible. The provision also may cause the interest payable on the Hybrid Instrument to be "abnormal", and therefore not deductible, if the Hybrid Instrument may be redeemed at the written down amount. In addition to jeopardizing the deductibility of periodic payments, a principal write-down provision might have an impact on the issuer's tax group because the issuer could be "de-grouped".

Investors could also be adversely affected as the Hybrid Instrument potentially would be subject to transfer and stamp duty upon transfer.

Corporate law complications exist as well. For example, it is not legally possible for the liquidation preference of a preference share to be written down.

Finally, even within the same jurisdiction, a principal write-down requirement may give rise to adverse consequences for issuers of a certain corporate type, but not for rivals of a differing corporate type. For example, in the UK, as stated above, a bank may not be able to issue a Hybrid Instrument with a principal write-down provision. However, a building society may be able to issue tax-efficient permanent interest bearing shares (PIBS – a form of Hybrid Instrument) that feature a principal write-down.

Equity Conversion

The CEBS report also proposes that a Hybrid Instrument may convert into ordinary shares, in lieu of being subject to a principal write-down, when the issuer becomes undercapitalised. Citi believes that, while an equity conversion feature would render a Hybrid Instrument more equity-like, it would not improve the status of depositors and senior creditors and would have a significant negative impact on the Tier 1 hybrid capital market. Furthermore, a large new class of ordinary shareholders, each enjoying a vote as a member of the issuer, may be off-putting to anyone seeking to recapitalise the ordinary share base.

Effect on Depositors and Senior Creditors

An equity conversion feature would not improve the status of depositors and senior creditors because they would rank senior to holders of the Hybrid Instrument *even before* a conversion of the Hybrid Instrument into ordinary shares and therefore would be indifferent to its actualisation. In a financial stress scenario, depositors and senior creditors would have first priority on cash flows on an ongoing basis - because periodic payments on the Hybrid Instrument would have been suspended - and in liquidation - because claims of depositors and senior creditors would rank senior to those of the Hybrid Instrument holders (irrespective of whether or not the Hybrid Instrument has converted).[2]

Effect on Tier 1 Hybrid Capital Market

More importantly perhaps, an equity conversion requirement likely would have a significant negative effect on the Tier 1 hybrid capital market because it would a) give rise to complications relating to the tax, accounting and legal treatment of Hybrid Instruments, b) diminish investors' receptivity to the asset class, and c) be unpalatable to most issuers.

- Tax Complications – In many jurisdictions, an equity conversion provision may cause the relevant authorities to view the Hybrid Instrument as being "results dependent" and, accordingly, as not being deductible by the issuer. Such jurisdictions include Germany (with respect to silent participations), the Netherlands, and the UK.

- Accounting Complications – Auditors may conclude that an equity conversion should be presumed to have occurred for the purpose of calculating an issuer's fully-diluted

[2] Although unlikely, it is conceivable that an equity conversion feature may actually *disadvantage* depositors and senior creditors on an ongoing basis because the dividend stopper constraint would cease to exist, and theoretically the issuer would be free to pay an ordinary dividend to the detriment of depositors and senior creditors.

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earnings per share under International Accounting Standard 33, potentially causing the Hybrid Instrument to be significantly dilutive from an EPS perspective.

- Legal Complications – In many jurisdictions, the necessary corporate authorisations may be difficult, or even impossible, to procure. For example, in Germany, silent participations may not convert into ordinary shares. Resolutions authorising the use of conditional capital in many jurisdictions often are subject to expiration dates and therefore may not be suitable for a perpetual obligation.

- Investor Receptivity – A fundamental underpinning of the global Tier 1 hybrid capital markets is that Hybrid Instruments are, or are the functional equivalent of, perpetual, non-cumulative preference shares, as envisaged under Basel I, the banking directives, and the innovative Tier 1 capital criteria promulgated by the Basel Committee on Banking Supervision in the Sydney Press Release of 27 October 1998 (the Sydney Press Release). As such, they rank senior to ordinary shares on an ongoing basis and in liquidation. An equity conversion feature would violate this basic tenet because Hybrid Instrument holders and ordinary shareholders would rank equally in liquidation. As a result, the size of the market likely would decline and the cost of issuing Hybrid Instruments likely would rise to compensate investors for greater subordination risk.

  The feature would also produce an arbitrary outcome if the issuer were to experience a slow deterioration that results in the 2% trigger being breached and Hybrid Instrument holders receiving ordinary shares, whereas if the bank were to suffer overnight failure, holders would have a preferred claim at par in the issuer's liquidation.

  The US institutional hybrid capital market would be particularly vulnerable if Hybrid Instruments were to include an equity conversion feature because the National Association of Insurance Commissioners (NAIC) could conclude that Hybrid Instruments should be classified as common equity for the purpose of determining the risk-based capital (RBC) charge for insurance company investors. Insurance companies comprise a significant subset of the US institutional hybrid capital market, and a common equity designation implies an RBC charge of 30% of the principal amount of the investment, which is generally prohibitive for many insurance company investors.[3]

- Issuer Receptivity – Most companies would be loathe to issue a Hybrid Instrument with a mandatory equity conversion feature because, in a financial distress scenario, the provision could result in massive dilution that would undermine the company's ability to recover. Indeed, dilution is highlighted as a concern of CEBS in its comments on principal stock-settlement and ACSM.

Alternative Coupon Satisfaction Mechanism (ACSM)

The CEBS Report suggests that an ACSM is acceptable if it is implemented solely for tax purposes and if any share issuance under the ACSM i) is made out of existing authorized and un-issued shares, ii) is subscribed for by the Hybrid Instrument holders and iii) is affected immediately to avoid the accumulation of unpaid periodic payments. Citi submits that the proposed ACSM requirements are overly prescriptive and potentially restrict an issuer's financial flexibility without strengthening the loss absorption qualities of a Hybrid Instrument. There are also well-established methods for ACSMs that have the same economic effect and which are well understood and accepted.

[3] During the period from March 2006 until September 2006, when the NAIC's Securities Valuation Office (SVO) designated numerous Hybrid Instrument issues as common equity, secondary spreads for US$ Hybrid Instruments increased significantly and very few European financial institutions executed US institutionally-targeted Hybrid Instrument offerings.

Generally, the inclusion of an ACSM strengthens the tax analysis of Hybrid Instruments in most jurisdictions because holders do not lose their claims for scheduled periodic payments.[4] Nonetheless, it seems overly constraining to restrict the use of an ACSM to those issuers in jurisdictions where an ACSM is critical to the tax analysis. Even if not necessary for tax purposes, an ACSM may be used by issuers to balance the competing objectives of i) enhancing the marketability of a Hybrid Instrument offering (by reducing the holder's non-payment risk), and ii) ensuring that the loss absorption qualities of the Hybrid Instrument are characteristic of Tier 1 capital (by requiring shareholders effectively to recapitalise the issuer by financing any deferred payments on the Hybrid Instrument).

Similarly, the requirement that Hybrid Instrument holders subscribe for any shares issued under an ACSM seems counterproductive. Hybrid Instrument investors tend to be fixed income investors that prefer not to take possession of equity investments, even if only for a short period of time.[5] Therefore, many traditional Hybrid Instrument investors may not be willing, or able, to invest in a Hybrid Instrument with an ACSM that forces the holder to take delivery of shares instead of cash. Nor does the proposed requirement improve the position of depositors and senior creditors because they should be indifferent to the identity of the equity subscriber as long as the ACSM results in the preservation of cash. It is difficult to see the policy objective of Hybrid Instrument holders receiving the shares as they are not bound to hold them. The financial position of the issuer would be the same if it were to (A) deliver shares having a specified value to Hybrid Instrument holders in lieu of payment or (B) sell shares having the same specified value to other investors and deliver the proceeds thereof to Hybrid Instrument holders in lieu of payment.

Finally, an obligation to effect the immediate issuance of shares may be detrimental to an issuer because it curtails the issuer's ability to take actions that it deems to be in its best interests by depriving the issuer of valuable flexibility at the point that it most needs it. There are various reasons why an issuer may wish to avoid issuing shares at a time of financial distress. For one, the issuer's share price is likely to be severely depressed, so the forced issuance may result in excessive dilution. In addition, the obligation to issue shares may represent an unwelcome distraction to a management board that instead should be focusing on restoring financial health to the issuer.

One might argue that, in the absence of a requirement for immediate share settlement, an issuer's ability to recapitalise might be impaired because potential new equity investors would be reluctant to invest if proceeds from the equity issuance were used to settle deferred periodic payments on a Hybrid Instrument, rather than improving the issuer's financial profile. However, an ACSM does not require the issuer to use the proceeds from any equity issuance to settle deferred periodic payments; an issuer may obtain new equity capital and continue to defer periodic payments on a Hybrid Instrument indefinitely. In any case, most structures provide the issuer with the ability to use the ACSM immediately if it is in their best interests to do so.

Principles-Based Guidelines

Due to the aforementioned implementation complications, in some jurisdictions, issuers would be forced to resort to more complicated, indirect hybrid structures that would give rise to reduced harmonisation across Europe, problems for issuers who require solo Tier 1 capital, and problems for insurers if insurance and bank capital regulations were ever to be harmonised.

Citi suggests that the convergence of criteria for Tier 1-qualifying Hybrid Instruments and the establishment of a level-playing field across jurisdictions may best be realised though the formulation of principles-based Tier 1 guidelines that national bank regulators may interpret

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[4] Hybrid capital transactions featuring an ACSM have been executed by banks domiciled in Belgium, the Netherlands, and the UK.

[5] Many fixed income investors are prohibited by their governing articles from investing in equity instruments.

and implement in the context of varying regulatory, legal, and tax frameworks. Citi agrees with CEBS that the principles should relate to the permanence, payment flexibility, and subordination of Hybrid Instruments, and that the principles should follow from the innovative Tier 1 capital criteria promulgated by the Sydney Press Release. However, Tier 1 capital criteria that are overly prescriptive and focus on specific features rather than principles may actually create an uneven playing field by creating inefficiencies or impediments for certain issuers merely by virtue of their geography or legal form.

Finally, while the CEBS Report applies to banks, one overarching objective of many European financial sector regulators and companies is convergence between forms of hybrid capital in the bank and insurance sectors.[6] In many European jurisdictions, rules for insurance Tier 1 hybrids have not yet been promulgated, although a number of insurance issuers have taken a "best practice" approach to structuring securities with a view to potentially receiving Tier 1 credit in the future under Solvency II. In other jurisdictions, convergence has already been achieved and insurers have taken advantage of these frameworks to raise significant amounts of hybrid Tier 1 capital. We think that it is important for insurance companies and their regulators to have the opportunity to participate in the finalisation of any proposals and to ensure that:

- there is a level playing field between banks and insurers in terms of the forms of Tier 1 capital available to them; and
- the relative timing of these proposals and Solvency II does not unfairly leave insurers in a position of uncertainty with regard to their ability to issue hybrid Tier 1 capital.

As you will appreciate, this letter represents our view as to certain technical matters within our area of expertise and should not and cannot be construed as containing legal, tax, accounting or any other form of advice. Other lenders, investors or financial services firms may have differing or opposing views to ours.

Citi appreciates the opportunity to provide the CEBS with comments regarding its proposal to provide guidelines for a common definition of Hybrid Instruments. We would be happy to discuss these comments with you further at your convenience.

Sincerely,
Citigroup Global Markets Limited

[6] For example, most recently, CEBS/CEIOPS stated such an objective in "Recommendations to address the consequences of the differences in sectoral rules on the calculation of own funds of financial conglomerates," January 2008.