Febelfin

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Mr Giovanni Carosio
Chairman
CEBS
Committee of European Banking Supervisors
Floor 18, Tower 42
25, Old Broad Street
London EC 2N 1HQ

By email: cp27@c-ebs.org

Implementation Guidelines regarding Hybrid Capital Instruments, CP 27, unofficial Febelfin comment

Brussels, 16/09/2009,

Dear Sir,

Febelfin, i.e. the Federation which regroups four trade associations from the Belgian financial industry[1], welcomes the opportunity to express its views on the consultation document mentioned above. We send you our comments in an unofficial way, as they still have to be evaluated by the Febelfin Board.

In our general comments we would like to focus on the proposed rules for Alternative Coupon Satisfaction Mechanisms (ACSM) as these are of high importance for Belgian banks.

We fear that the proposed guidelines on ACSM reverse the seniority order between shareholders and investors in hybrid instruments.

In our opinion, the condition to have full discretion over the payment of the coupons is, by its nature, not applicable to dividend pushers. For this reason we propose to adapt the guidance accordingly.

We also draw the attention to the situation where an issuer has tried to enhance its authorized capital with the goal to satisfy the deferred coupons, but received no approval from the meeting of shareholders. In that case we believe the ACSM should be recognized as valid.

Our other, more detailed comments, can be found in the annex to this letter.

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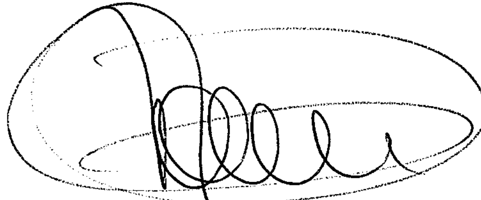
[1] The following trade associations are part of Febelfin: the Belgian Bankers' and Stockbroking Firms' Association (ABB/BVB); the Professional Union of Credit Providers (UPC/BVK); the Belgian Asset Management Association (BEAMA); the Belgian Leasing Association (BLA).

Belgian Financial Sector Federation | rue d'Arlon, 82 • B-1040 Brussels | http://www.febelfin.be
T +32 2 507 68 11 | F +32 2 888 68 11

We hope these remarks will be taken into account. Please do not hesitate to contact our services and our working group, should you want any further information.

Yours sincerely,



Michel Vermaerke
Chief Executive Officer

Daniel Mareels
Director Taxation & Prudential, Legal & Compliance

Cc. Mr Jean-Paul Servais, Chairman, Banking, Finance and Insurance Commission

Implementation Guidelines regarding Hybrid Capital Instruments, CP 27, unofficial Febelfin comment, annex

Question 1:

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.

Yes, the guidelines in relation to "incentive to redeem" are sufficiently clear. However, we believe that, in contrast to what is mentioned under § 49, that instruments with an incentive to redeem 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.

While we understand the use of it, the proposed cap reduces the efficiency and value of the stock settlement to a substantial extent. In order to keep the impact on the capital structure as neutral as possible we propose to introduce a cap on potential dilution.

Paragraph 73 states the following :The guidance above does not prevent competent authorities from permitting limited activities for market making or market smoothing purposes (in those cases, usually the amount of hybrids remain outstanding). Institutions shall in this case have in place adequate policies for these transactions in order to avoid material holdings in own hybrid instruments. Therefore, it is proposed that at any time repurchased instruments held by the institution shall not account for more than 5% of the relevant issuance.

While we agree with an exception for market making or market smoothing purposes, we feel that the limit of 5% is too low and should be brought in line with the 10% limit for holding of own shares.

Question 2:

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.

In order to allow a sound liability management with a direct impact on solvency and profitability management, we feel that a "buy back" within the first 5 years should be allowed, subject to the same rules governing calls and redemptions with respect to application, regulatory consent, including possible replacement if appropriate.

Our understanding is that the application process for call or redemption is also applicable for of the buy-backs (§§ 61 to 67)? This implies a large quantity of information and analyses to provide to the regulator, which is really demanding. We wonder if it is possible to clarify in which extent the articles 61 to 67 apply in case of buy-backs?

We would suggest to introduce a time delay to receive the prior consent of the regulator. (1 month?)

Paragraph 64 to provide the estimated solvency data for the 3 to 5 years is in our opinion very demanding.

Paragraph 67 mentions that in case the hybrid instrument has already be replaced, the regulator may require less information. We propose to define "less information" in a way which is as reduced as possible.

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.

We agree that a buy-back should take place at the initiative of the issuer (paragraph 72, a). However, we feel that the replacement (paragraph 72, c) should not be mandatory in any situation where the bank has the choice between repurchasing shares and hybrid instruments to reduce the amount of Tier 1 Capital. In our opinion, it is not useful to oblige a bank to lower the quality of Tier 1 Capital by allowing a repurchase of core Tier 1 instruments but not of hybrids. See also our response to question 2.2.2.

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.

Situations like that may arise after a reduction in risk (RWA) and after a period of large profits. It may also arise if a bank holding company sells part of its business at a substantial gain thereby realizing the market value of the operations, facing a large excess equity and being economically incentivized to restructure the different capital components. It may also arise after a period of stress and uncertainty when the bank has issued hybrid tier 1 instruments to provide a capital buffer. When the situation normalizes, the bank may rightly want to reduce the buffers to normal levels. It would then not be sensible for the regulators to prefer repurchase of shares rather than repurchase of the hybrid instruments issued as a buffer as this would lead to a reduced quality of the tier 1 capital. Subject to the issuance structure of hybrid tier 1 a buy back at an earlier stage makes sense and it is justifiable from a prudence perspective.

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?

Buybacks and exchanges are not driven by an incentive to deplete capital but by a sound liability management which has a direct impact on solvency and profitability management. Liability

management transactions should be subject to rules governing capital ratios, calls and redemptions with respect to application and regulatory consent, including possible replacement if appropriate and in case of credit quality deterioration.

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.

Major Banks or Bank Holding Companies are at the same time issuer and lead manager / underwriter in a syndicate for placing hybrid tier-1 instruments in the capital market. The lead manager of a transaction is expected to be able to make a market in instruments which are placed. Should the market making exception go away the investors would be subject to a potential substantial bid ask spread volatility and therefore not reliable pricing. This is particularly the case as in tendency the capital instruments have been placed with large funds which can take up 10-15 % of an issue. If such a fund needs to unwind it increases the volatility in the capital markets.

Question 3

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?

Yes, the guidelines are sufficiently clear.

What would be the impact of the restriction on the use of dividend pusher and stopper? Please provide evidence.

No comment.

Question 4:

Paragraph 83 mentions that the coupons should be waived if the major part of the dividend to shareholders is note paid in cash, but in shares. We propose to add: "*except if the coupon is to be paid by ACSM*".

In paragraphs 90 and 91 we propose to complete the text of the following paragraphs as follows:

90. *Therefore an ACSM is only acceptable if it achieves the same economic result as a cancellation of the coupon (i.e. there is no decrease in capital) and when the issuer has full discretion over the payment of the coupons or dividends at all times,* ***except for rules applicable to dividend pushers.*** *To meet this condition, the deferred coupons should be satisfied ~~without delay~~ using newly issued instruments, referred to in Article 57(a) that have an aggregate fair value as a maximum equal to the amount for the coupon/dividend. For this purpose, the issuer must* ***on a best effort basis*** *already have authorised but un-issued instruments. The obligation of the institution is limited to the issue of those instruments but the institution must not be committed to find new investors for these instruments. The instruments may be, afterwards, sold in the market by the hybrids holders but if the sales proceeds are less than the coupon, the issuer must not be obliged to issue further new instruments to cover the loss incurred by the hybrid holder.*

a) By its nature the condition to have full discretion over the payment of the coupons is not applicable to dividend pushers.

b) In the situation where an issuer has tried to enhance its authorized capital with the goal to satisfy the deferred coupons, but received no approval from the meeting of shareholders, the ACSM should be recognized as valid.

c) In deleting the words 'without delay' a more flexible timing for the ACSM could be achieved.

91. ***Subject to postponement events***, *if circumstances arise preventing the ACSM to work as originally envisaged the payment of coupon or dividend shall be cancelled.*

We believe this should be subject to postponement events, including not having enough authorized capital. We also believe that the beneficial tax treatment may be negated by cancellation of the coupon if new shares are not issued and placed immediately. We also believe that it is not optimal to force the use of ACSM immediately rather than allowing a company's discretion over the timing. Companies should have discretion to defer dividends / interests to be paid with 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.

With exception for our comments related to paragraphs 90 and 91, the guidelines are sufficiently clear.

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

With exception for our comments related to paragraphs 90 and 91, we agree with the proposed guidelines.

Question 5:

Comments to paragraphs 112 till 116:

§§ 112 and following: We fear the proposed guidelines reverse the seniority order between shareholders and investors in hybrid instruments.

The proposed guideline effectively subordinates hybrid capital to any new capital coming into the institution, even if such capital is in the form of ordinary shares. We can't see how this would be acceptable when "old" ordinary shareholders will not be able to be distinguished from new ordinary shareholders because of corporate law. As mentioned earlier, dividend / interest pusher and stopper must be applicable and should not be affected by loss absorption to ensure ranking and marketability of hybrid capital instruments.

We believe that the features of permanence, flexibility of payments and subordination make hybrid instruments fulfill the objective of the so-called "loss absorption". Any additional requirement would alter the first three features and reduce the issuer's flexibility.

The temporary write down does not increase the loss absorbency of hybrids instruments. It does not increase the total Tier-1 capital and it does not improve the protection of the more senior creditors and depositors. Besides several drawbacks, it creates a taxable gain, hence Tier-1 destruction. This being said, such feature may be necessary to prevent insolvency in some countries where hybrid instruments are from a legal perspective considered as liability for insolvency purpose : the use of temporary write down should therefore be restricted to a possible mechanism to prevent insolvency in these countries.

Conversion into ordinary shares does not increase the loss absorbency of hybrids instruments and would considerably reduce the available hybrid investor base, mainly composed of fixed income investors, not mentioning the market turmoil due to fixed-income investors immediately disposing of these shares which could hinder the recapitalization.

We propose to remove paragraphs 112 to 116.

§ 114: It is not clear how to define "recapitalization" in this context, when it has to be facilitated and to what extent ? Besides, it is not clear what is meant by "pari passu with the shareholders". The language in the case of a temporary write-down suggests that this would override any dividend pusher mechanisms contractually included in the terms of the securities. We do not believe that this would be acceptable to the market. In distress situations, the company, the supervisor and the state / finance ministry should dispose of flexibility to apply appropriate measures, rather than being tied by detailed rules.

The same paragraph includes the possibility to have a permanent write-down. This is more restrictive than the position of shareholders, because their position will get better when the situation improves, which would not be the case for hybrid holders. This is not coherent with the ranking according to us.

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.

Yes, the proposed guidelines are sufficiently clear.

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

With exception for our comments related to paragraphs 112 till 116, we agree with the proposed guidelines.

5.3 Do the guidelines provide sufficient flexibility for institutions to design mechanisms that fulfil the objective of loss absorbency in going concern? What alternative would you propose? Does this flexibility raise level playing field issues?

The proposed guidelines are not flexible at all. We refer to our comments related to paragraphs 112 till 116.

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?
No comment.

Question 6:

Comments to paragraphs 128 till 129.

We are concerned with paragraph 128 which suggests that the regulator can trigger a conversion of hybrid Tier 1 into equity instruments when necessary. We do not believe that the regulator should be able to mandate a conversion into equity, nor do we believe this is a responsibility that most regulators would be willing to accept.

Regulatory intervention should be formally triggered by an assessment of the supervisor that the company will no longer be able to satisfy Art. 75 in the short to long term. It should not be used if management is able to remedy this situation otherwise.

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 howthe text could be amended.

With exception for our comments related to paragraphs 128 till 129, the guidelines are sufficiently clear.

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

Yes, we believe the conditions proposed are proportionate and balanced.

Question 7:

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.

No comment.