

CEBS

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**EAPB comments on the
draft proposal for a common EU definition of Tier 1 hybrids**

We thank CEBS for the possibility to submit our comments on CEBS' proposal for a common EU definition of Tier 1 hybrid capital instruments. We would very much appreciate CEBS taking our remarks into account.

Before going into detail on the five main issues dealt with in the consultation paper, we would like to make some general comments.

1. General Remarks

We welcome the Commission's and CEBS' attempts to harmonise the very diverging rules in the EU on the eligibility of hybrids as Tier 1 capital given the need for more convergence in this respect. The current initiative takes account of the increasing importance of hybrids as an instrument to cover economic capital needs.

As set out in CEBS' draft proposal, the objective of CEBS is not to create a brand new definition of Tier 1 hybrids but to provide guidelines for a common and clear interpretation of the "Sydney Press Release (SPR)" issued by the Basel Committee on Banking Supervision in 1998. We very much welcome CEBS' self-limitation in this regard. We would like to underline that it is **very important that no additional rules, beyond the SPR, are introduced** in EU legislation. Otherwise, EU banks would face competitive disadvantages vis-à-vis their international competitors. Due to more stringent rules on the eligibility of hybrids as Tier 1 issuance conditions would degrade implying an increase in funding costs. In addition, the possibility cannot be ruled out that EU banks would be subject to a double burden due to diverging (new) Basel rules, which would necessitated a new implementation process.

Anyway, all proposals concerning a future definition of own funds that go beyond the eligibility of hybrid instruments should first be discussed by the Basel Committee.

In general, we think that the approach taken by CEBS to determine the eligibility of a hybrid instrument as Tier 1 capital on the basis of the criteria loss absorption, permanence and flexibility of payment is very sensible. However, we feel that the **overlaps between the key criterion of loss absorption and the other two principles** are not sufficiently taken into account. Permanence and flexibility of payments eventually suit the purpose of loss absorption.

Finally, we think that **too detailed rules should be avoided**. Given the prevailing differences in tax, company and insolvency law, excessively detailed rules will translate into widely diverging results in individual Member States, thus running counter to the objective of harmonising the definition of capital across the EU.

In general, detailed rules should only be included if their impact is clear in advance and if the details are essential to harmonisation. This holds in particular true for the rules on limits.

Other areas, on the contrary, should be kept as abstract as possible so that the rules can be implemented at national level in an appropriate and flexible manner. This is especially the case for the three criteria loss absorption, flexibility of payments and permanence.

In order to guarantee a level playing field, **transparency requirements** should be introduced, e.g. by way of supervisory disclosure.

2. Comments on the proposal in detail

2.1. Permanence

(a) Maturity of the instrument

According to para 68 of the consultation paper, the “permanence” criterion is interpreted in such a way that the instrument must be permanently available.

In our view, “permanent” does not necessarily mean undated and CEBS’ proposal in this regard goes beyond the permanence requirement in the SPR. The interpretation of the criterion of permanence is also wider in other non-EU countries where hybrid instruments with a long maturity are recognised as Tier 1 capital (e.g. the US which accepts instruments with a 30 year maturity).

Instruments with a long maturity are also permanently available to the issuing bank. Hybrids would still have the same quality if dated instruments would have a “lock-in” feature that would be triggered at a predetermined point in time or at a predetermined point of stress in relation to the issuer’s regulatory capital resources. Dated instruments could, e.g. not be recognised as Tier 1 capital for the final phase of their life (e.g. the last ten years). This

would ensure that capital is permanently available to the bank during the period of regulatory recognition.

Against this background, we urge CEBS to revise its definition of permanence in order to cover also instruments with long maturities. In the end, it is up to the Basel Committee to specify the permanence criterion set out in the SPR. It would, however, not be sensible to anticipate the result of this discussion.

(b) Call right of the issuer

According to CEBS, hybrids may be callable but only at the initiative of the issuer, always subject to prior supervisory approval and under the condition that they will be replaced with capital of the same or better quality unless the supervisor determines that the bank has capital that is more than adequate for its risks.

In order to provide for a level playing field following the implementation of these rules, we advocate that European supervisors should agree on a **common and effective approval process for repayment**. We therefore ask CEBS to develop an agreement establishing a standardised approval process and to define a list of criteria including capital limits. The standardised approval process should determine how supervisory approval is to be sought and how much time supervisors will have to consider the request (a reasonable period would be two weeks, or four weeks at most). The list of criteria should establish which criteria will result in supervisors approving repayment, which criteria will result in closer scrutiny of the request and which criteria can be expected to result in rejection.

As regards the **timeframe for the call right of the issuer**, we take the view that the proposed five years / ten years are too restrictive. We acknowledge, however, that these minimum periods are determined by the SPR. Nevertheless, we would like to note the following:

The Basel II framework makes it necessary for the banks to manage capital more flexibly and adjust their use of cost-intensive regulatory capital to a changing risk environment. We see no need for mandatory minimum periods as the approval requirement offers sufficient protection against untimely capital outflows. We would therefore welcome if the Basel Committee addressed the issue.

(c) Incentives to redeem

The draft proposal further considers step ups and principal stock settlements in conjunction with a call option as incentives to redeem. Such instruments are classified as “innovative instruments”.

We think, however, that the approach to differentiate between hybrid and innovative instruments is outdated. Experience in the past years has shown that incentives to redeem do not automatically weaken the permanence of the instrument. Rather, it enhances the financial flexibility and improves investor diversification. An instrument will not be called if the issuer is not able to refinance cheaper or when the capital is redundant.

What is more, the principal stock settlements are not even covered by the SPR. This could lead to competitive distortions, as set out in our general remarks.

2.2. Loss absorption

We think that the loss absorption feature is the central criterion for evaluation of the eligibility of hybrid instruments.

We think, however, that the **loss absorption criterion is sufficiently met by the principles of flexibility of payment and permanence**. We therefore **strongly argue against both, a mandatory write-down mechanism and the proposed alternative mechanisms**.

In particular, we do neither see any tangible regulatory benefit of a temporary write-down or a conversion into ordinary shares. Nor do we see any benefit for banks, its shareholders or creditors.

All in all, CEBS' proposals go much beyond the SPR guidelines and should be rejected in our view.

If, however, CEBS would like to uphold its approach in this regard, we strongly suggest to review the definition of "loss". It is particular not clear whether CEBS refers to the net loss for the year recorded in the profit and loss account, the accumulated loss reported in the balance sheet, loss in individual or in group accounts.

2.3. Flexibility of payments

In part 3 CEBS sets out that the issuers must be able to stop payments on a non-cumulative basis. According to CEBS, this comprises that the issuer must be able to waive payments *at any time* and for an unlimited period of time.

The EAPB takes the view that CEBS' proposal clearly goes beyond the SPR in this respect. The latter only requires the ability at issuance.

Apart from that, discretion at any time and for an unlimited period of time is not necessary to ensure that hybrid instruments can absorb losses adequately. We rather think that waving payments is only necessary in a crisis situation. The possibility to stop payments at an earlier stage (e.g. even if the bank is in profit) would in practice make these instruments more expensive and therefore more difficult to market.

With regard to the triggering events listed by CEBS, we fully agree that payments must be waived if the institution is in breach of the minimum capital requirements. However, we can not support the discretion left to supervisory authorities in this regard to determine another level. This would lead to different rules in the various Member States which would be contrary to the goal of harmonisation of the rules on hybrids.

2.4. Limits to inclusion into Tier 1

- *50 % limit*

The EAPB takes the view that the limits set out in the SPR, i.e. a minimum of 50 % of Tier 1 capital to be made up of traditional core capital, should be followed.

Any discussions about tighter limits should be conducted on Basel level but should not be subject to the EU level discussions. We would like to underline again, that any specific tighter EU rules would hamper the EU institutions competitiveness.

Diverging from the simple 50 % rule in the SPR, CEBS proposes a continuum permitting hybrids to account for between 30% and 50% of Tier 1 capital. The proposed compromise is in our view excessively complex. Also, it would give rise to “cliff effects” which could cause severe additional problems in times of stress. Especially for banks in stress situations, there would be a constant danger of exceeding certain limits and the proposed limits would provoke an even deeper crisis.

The situation is aggravated as CEBS requires the limits to be observed at any times and not just at the time of issuance. This would necessitate a continuous monitoring of the eligibility of a bank’s hybrid instruments and could deepen a crisis because a stress-induced reduction in traditional core capital would trigger a parallel reduction in the amount of eligible hybrid capital. The greater volatility of capital requirements under Basel II would heighten these effects still further.

- *15 % limit for innovative instruments*

The 15% limit for so-called “innovative instruments” should in our view be reconsidered since we believe the need for it has become obsolete (see our remarks above). It would also reduce the available solvency capital in those cases when banks are experiencing losses. We acknowledge that the 15 % limit is also set out in the SPR. Therefore, it might be most appropriate to launch discussions on this issue at the level of the Basel Committee.

2.5. Grandfathering

The EAPB fully supports CEBS’ proposal to limit the impact of the proposed common regulatory approach by introducing a grandfathering clause.

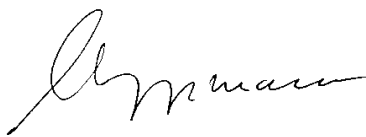
In particular, we are supportive of the proposed gradual reduction over a period of 30 years, as set out in CEBS’ consultation paper.

The table setting out the continuous reduction of instruments that do not fulfil all criteria for eligible hybrids is, however, in our view not sufficiently clear. In order to leave no room for diverging interpretations we would therefore kindly ask CEBS to provide some examples.

Finally, we feel that the proposed special treatment for **instruments with an incentive to redeem** is not adequate and could even cause market disruption. Under normal market conditions the market expects an instrument to be redeemed at the first call date. The vast majority of these instruments will therefore be repaid by the bank. Only a crisis situation will normally lead to the instrument not being redeemed. If repayment does not or is unable to take place, CEBS’ proposal could be interpreted as meaning that the instrument is no longer eligible as Tier 1 capital. This would plunge the bank into an even deeper crisis than before. The EAPB therefore suggests to treat all hybrid instruments equally.

Please do not hesitate to contact us if you have any questions.

Kind regards,



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European Association of Public Banks

– European Association of Public Banks and Funding Agencies AISBL –

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