European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

Committee of European
Banking Supervisors

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cp27@c-ebs.org

CONSULTATION PAPER ON CEBS'S GUIDELINES ON HYBRID CAPITAL INSTRUMENTS (CP 27)

Dear Sir/Madam,

The European Association of Co-operative Banks (EACB) welcomes the opportunity to comment on the consultation paper on CEBS's guidelines on hybrid capital instruments.

Please find our remarks on the following pages. Do not hesitate to contact us should you have any questions.

Yours sincerely,

Hervé Guider	Volker Heegemann
General Manager	Head of Legal Department

Rue de l'Industrie 26-38 • B-1040 Brussels
Tel: (+32 2) 230 11 24 • Fax (+32 2) 230 06 49 • e-mail : secretariat@eurocoopbanks.coop
European Commission Register of Interest Representatives Identification Number 4172526951-19
www.eurocoopbanks.coop • e-mail : secretariat@eurocoopbanks.coop

General Remarks:

While its mandate obliges CEBS to proceed in such a way, we nevertheless think that it is not the most reasonable approach to first develop guidelines for hybrids and to create guidelines on core capital only at a later stage.

We therefore think that these guidelines, especially when more general definitions are established, should not prejudice guidelines on capital according to Article 57 (a) of the CRD.

While both convergence and equivalence regarding the treatment of different capital instruments is crucial, there should be enough room to take also other features into consideration.

<u>Permanence</u>

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.

We believe that the guidelines are sufficiently clear regarding that aspect.

1.2 Please describe the potential impact of a cap of 150% relating to stock settlement of the conversion ratio. Please provide evidence.

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.

We see a need for more clarification regarding the cancelation of instruments, which were issued, but which a bank still holds in its (bank- or trading-) books (ready for sale to the "second market"; still no generation of capital). It should be clarified in the guidelines that this is not a "buy back", since the issuing process has not been completed (it is rather a "take back", "roll back", "withdraw" or similar). Thus, the restrictions of the guidelines should not apply under those circumstances.

Furthermore, as regards the procedure for achieving supervisors' approval, we think that some more efforts should be taken to ensure a timely and rapid process. The current wording of Nr. 61 ss. gives the impression of a relatively heavy, lengthy process. However, this may not be question of wording alone.

- We would like to recall that the dialogue between banks and supervisors within the context of the SREP already allows supervisors to have a good knowledge of the situation of the bank.
- Furthermore, decisions may have to be taken quickly in order to ensure timely execution. While certainly a certain procedure will have to be respected, it will be crucial that supervisors can approve at short notice.

- The need to submit information on the planned development of the data under nr. 64 b for the coming 3-5 years seems to be too restrictive. We think that such a long-term perspective is rather a relevant for internal long-term planning and not a solid basis for conclusions on an adequate proportion of assets and own funds in the present. We therefore suggest a shorter time horizon (12 months), or at least a clear indication that such long-term projections may only be of a rather limited value within the context of the approval of a buy-back or cancellation.
- Especially, when banks intend to replace financial instruments by instruments of comparable or better quality the process should be speedy.
- Finally, with regard to a level-playing field, clear indications are required on when permission to cancel, redeem or buy-back definitely has to be granted (e.g. when there is a rather comfortable situation regarding own-funds).

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.

We are not convinced that negating any distinction between buying back and call or redemption, as pointed out under Nr. 72 is fully correct. While a call or redemption generally implies the cancellation of the hybrid as a financial instrument, a buy back does not have this effect. The bank may sell the instruments again and thereby also re-establish the required prudential effects; prudential treatment should consider this.

We do not see any reasons why banks should not call back or redeem instruments before five years – with the permission of their supervisor – when they replace those instruments by capital instruments of at least equal quality; here should be no obstacle whatsoever for maintaining or improving capital.

Furthermore, a fix five year period will create a considerable degree of inflexibility and probably create adverse incentives, since banks may be more hesitant regarding the issue of such instruments. Maintenance of capital would be more a question of "principle" than of prudential aspects.
It also negates the fact that finally supervisors have to decide on whether they approve a buy-back or redemption. One may expect that supervisors oppose any call, redemption or buy back, when they consider it inappropriate.

Finally, it has to be underlined that banks need flexibility for adapting to their business development in order to ensure an efficient capital management. Relevant circumstances can be changes regarding the regulatory treatment of certain assets, changes of the business profile of the bank as well as the effects of mergers, de-mergers etc. Under those circumstances a situation can easily arise that hybrids do no longer qualify as capital (e.g. since their amount passes the relevant limits). Under those circumstances we do not see any case for supervisory approval of a cancellation or pay-back.

Typically, a buy-back would take place when banks do not need the capital as prudential capital and when they can draw further advantages from that buy-back, especially if the market-price is under par. In such situation, profit can be generated that even improves the quality of the capital-base.

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.

The members of the EACB fear that these rules may be too restrictive and reduce flexibility, as explained above in 2.2.

In particular, the wording of nr 72 c) requires replacements even if changes in the business mix (risk situation) of the respective institution do not require a replacement at all.

Equally we think that options allowing to keep a certain percentage of own regulatory capital instruments (e.g. 10 %) on the balance sheet would be useful, since they would

- increase flexibility of capital management
- support orderly secondary markets by stabilization measures as used with certain issuance activities
- and thus reduces the risk that new issues fail.

Finally, we presume that tax calls should always be possible.

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.

There are many possible situations, in particular changes in the volume of assets, e.g. their sale or a significant decrease in value or caused by a change in business plans. Equally, when expectations regarding certain plans have not materialized, a reduction of capital may be appropriate.

Especially in the context of a restructuring of a bank or a group the own funds may significantly decrease so that it might no longer comply with the limits under Article 66 (1)(a) of the CRD. In such a situation the replacement of a hybrid instrument by an instrument of equal quality would not solve the problem. Under those circumstances a buy-back (redemption) should provide for faster and easier solutions than any issue of capital of higher quality.

Furthermore, all sorts of M&A activities (mergers, de-mergers etc.) can change the capital and asset structure in a way that buy backs without replacement become advisable.

Finally, we do not see any reasons why there should be any restrictions for institutions when they dispose of a “comfortable” capital situation.

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?

While banks managers seek solvency, profitability, and efficiency, supervisors are to ensure that solvency standards are respected and maintained. The CRD framework requires both an ICAAP and a SREP.

We think that these processes ensure that supervisors have a good insight into the actual prudential situation of a bank including the near future and can develop their own opinion on whether a buy-back is appropriate from a prudential perspective or not. Supervisors should therefore dispose of discretion in this respect.

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.

We equally wonder whether any such figure or proportion should not relate to total own funds or total original own funds rather than to an individual instrument

Furthermore, we believe that the proposed percentage of 5 % may be too low, particularly where small issues are concerned and at the beginning of issuances.

We, therefore, suggest setting a limit of:

- 10% of a relevant issue, which institutions should be allowed to redeem or buy-back without the prior approval of the competent authorities. Especially within 3 months of issuance to allow for market making.

B. Flexibility of payments

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

The guidelines seem appropriate in general

However, we wonder whether the circumstances, under which supervisors may demand offsetting coupon payments, should be described some more in detail. This would give more certainty, both to banks and investors.

With regard to the information to be provided to supervisors under nr. 81 c), we think that the major question is whether institutions will comply with capital requirements in the current year. Projections of the financial situation over the coming three to five years should not play a decisive role.

Question 4:
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.

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

C. Loss absorbency

Question 5:
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.

The guidelines are clear in general.

However, we are concerned about the fact that for the definition of loss-absorption as worded in the guidelines, especially under Nr. 105 and 106, the distinction between permanence and loss absorption is given up. We fear that defining loss-absorption by referring to permanence is a somewhat circular reasoning. It is finally the existence of loss-absorption or permanence of capital that is important for the classification of capital, but whether capital is loss-absorbing or not is a question on its own.

Furthermore, we would like to suggest that it should be clarified that the principles set out in the consultation are only applicable to hybrids. Therefore, the consultation paper should explicitly state that capital instruments issued by cooperative companies are outside the scope of the interpretation guidelines set out by the CEBS, since they are core tier 1 capital

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

While we agree to the definition in general, we think that the aspect of "not hindering recapitalization" requires modification.

They seem to make sense primarily in those Member States, where the hybrid is treated as a liability from the perspective of insolvency law. The examples therefore only seem to make sense in those Member States.

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

A permanent write-down of the principal of the hybrid capital should be avoided, since it would put investors in hybrid capital too much at a disadvantage. They would find themselves in a definitely weaker position than shareholders since the latter could participate in an improvement of the economic situation of the issuer. Therefore a temporary write-down seems preferable.

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?

Nr. 107 and Article 57 (a) provide for appropriate criteria.

Ranking between hybrids should be allowed. As explained in Nr. 108, different ranking in hybrids is more an aspect of information and transparency.

D. Limits

Question 6:
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 how the text could be amended.

The guidelines are sufficiently clear.

However, we would appreciate clarification on the fact that the”up to 50% bucket” will also include hybrids that can be converted into capital under other circumstances than emergency situations only.

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

The conversion mechanism seems extremely severe.

As regards the conversion rate (Nr. 134) we think that CEBS should not stipulate a formula for fixing the conversion rate. We see no reason why this conversion rate should not be in the discretion of the issuing bank.

E. Hybrid instrument issued through an SPV

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.

They are sufficiently clear.