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

Committee of European
Banking Supervisors

Brussels, 21 February 2008
VH/B2/08-035

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Consultation Paper (CP 17): Draft Proposals for a Common EU Definition of Tier 1 Hybrids

Ladies, Gentlemen,

The European Association of Cooperative Banks (EACB) welcomes opportunity to comment on CEBS's draft proposals for a common EU definition of Tier 1 hybrids. Please find our remarks on the following pages.

Already in our letter from September 25th, we had presented some reflections on the implementation of the Sydney Press Release and on principles regarding the definition of hybrids. Our members therefore regret that they were not given the opportunity to have an exchange of views with CEBS on these matter while, on the other hand, CEBS has been *"organising informal technical contacts with internationally active rating agencies, investment banks and investors".*

A due process would have required technical contacts with industry experts already prior to the publication of this consultation paper and hereby express our wish that CEBS will change its approach in the future.

The lack of such consultation is made evident by the concept for tier 1 hybrids laid down in CP 17. We consider it to be highly imperfect and hereby wish to urge CEBS to reflect on major improvements.

Yours sincerely,

Hervé Guider
Secretary General

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Head of Legal Department

- **GENERAL REMARKS**

- The main objective of CEBS's efforts should be to transpose the 1998 Sydney Press Release into EU legislation in order to achieve a reasonable degree of convergence within the EU, while taking in mind that a decade of evolution in hybrid financial instruments has passed since then.
- The new framework for solvency requirements under Basel II has not yet led to the necessary changes in the field of banks' capital. We see a strong need to henceforth establish an own funds regime which allows a more active approach to banks' capital management which is aligned to the fluctuation of capital requirements under the CRD along economic cycles. This is of specific relevance for co-operative banks.
- Today, there are some differences across the EU, in particular regarding the recognition of hybrids and there is a need for a reasonable degree of convergence.
- The achievement of a widespread use of hybrid capital is a key element for a level playing-field among banks and an integrated financial market in the EU member countries.
- This implies that member states should remove obstacles in company law that inhibits the use of hybrids for banks capital management.
- Furthermore tax aspects, where there is insufficient convergence today and insolvency law aspect will require appropriate consideration, if a level playing-field is to be achieved. We fear, in particular, that write-downs features together with subsequent write-ons could be highly detrimental from a tax perspective.
- The members of the EACB take the view, however, that CEBS's approach is too conservative. The criteria defined in CP 17 are both overly descriptive and restrictive, what could lead to problems in many member states and to disadvantages for EU banks on the global level. Instead, emphasis should be put on a modern, principle-based approach, which gives room to new developments (e.g. future economically based changes in the mechanics of instruments). Such approach should take into account differences in accounting, tax and legal requirements over EU countries and outside the EU.
- We therefore strongly advocate a more principle based approach, which
  - Ensures sufficient flexibility to comply with different tax and company laws, bankruptcy and financial regulation.
  - Facilitates the innovation and ensures the implementation of market developments
  - Enhances further convergence in different financial sectors, especially for conglomerates and
  - Looks at the functionalities of the instruments (substance-over-form), with capital available to cover losses as the ultimate yardstick.

- Finally, we fear that CEBS's criteria, as laid down in CP 17, are not convergent in itself and would overthrow the concept of hybrids as understood today. By consequence, we fear that hybrids as cost-effective capital instruments for European Banks would cease to exist.

- The designed write-off feature wipes away the conceptual borders between subscribed capital and tier 1 hybrids. Hybrids would have significant equity features. We think that wiping away these borders, in particular the write-off feature, will in many jurisdictions generate important obstacles for a liabilities-treatment of payments on hybrids under tax aspects.

  - The fact that tier 1 hybrids will conceptully eaqual equity, will most probably have an immediate impact on the market. Either the new instruments will not be accepted, or the market will demand higher compensation.

  - By consequence, we fear the CEBS proposals would not define tier 1 ***hybrids***, but a new category of minor tier 1 ***equity capital***. "Tier 1 hybrids would" would be regulated "away" into tier 2.

  - While the quality of the capital will be improved beyond the necessary, the capitalisation of banks will certainly become more difficult.

- Such consequence would imply serious competitive disadvantages for EU-banks in the global context, while also a broader economic impact on the (capital markets, lending side, etc.) can not be excluded. The members of the EACB therefore strongly disapprove the concept as described above and ask CEBS to reconsider and take a more prudent approach.

II. Specific Remarks

1. Loss-absorption

Write-off features

As we had pointed out already in our letter from September 2007, we think that financial instruments that dispose of write-off facilities should even qualify for a highest quality level of capital. For this reason we had suggested that hybrid instruments disposing of writing-off features should be admitted as tier 1 without any limits.

The reason behind this suggestion was that such capital, in particular when undated, would in fact equal equity regarding the relevant key aspects and accordingly lose its "hybrid character". Today's hybrid instruments would become tier 2 capital. We think that this trade-off between loss-absorption and regulatory limits is inappropriate.

We would like to remind that tier 1 hybrid instruments, as defined today, have so far very well served their purposes by allowing banks to defer or cancel any payment on these instruments. As we had underlined before, the structure and the quality of capital instruments that form credit institutions' capital base has not been the cause for the default of any European bank. Accordingly there is no indication of any "market failure", demanding important changes or a more restrictive approach to the matter.

The possibility to defer or cancel payments guarantees that no liquidity is leaving the banks in times of crisis and that huge amounts of money can be kept. This effect should by far be sufficient.

A write-down feature changing the character of "hybrids" into full risk capital would increase the risk of investors: the participation in the downside of capital would add to the risk of a deferral of payments. The treatment of liabilities in case of liquidation (claim for the full amount) is not decisive in this respect. By consequence, compensation on the upside would be necessary to establish a new balance between the features.

European banks will have to pay a higher price for hybrids in the future, under the presumption that markets will accept the new instruments at all.

We fear that such regulation will create disadvantages for the competition of European banks on the global level. We therefore think that any implementation beyond the Sydney Press release would require decisions at the level of the Basel Committee.

We are not convinced that a write-down feature would be the most effective means to avoid ***over-indebtedness*** of an institution and therefore help to avoid inevitable insolvency proceedings:

- When undated, hybrids could also be created as equity instruments so they would not be liabilities from an accounting perspective and, in some jurisdictions, not contribute to over-indebtedness: to the contrary, they would contribute to avoid it. Under such circumstances, a write-down feature would lead to some kind of window-dressing: on the balance sheet a lower amount of hybrids is exchanged for a higher amount of reserves/retained earnings.

- In other jurisdictions, it would be more important that rank equal to subscribed capital in insolvency, in order to be considered as capital.

Neither do we believe that the suggested terms for write-downs would contribute to facilitate a ***recapitalisation*** of an institution by external investors, when in a severe crisis: A presumption that external investors may be more attracted if there is less debt due to a write-down feature, seems to be inaccurate: the key aspect will be whether and to what extent the terms of the instrument imperatively require a ***write-on*** when the crisis has been overcome and profits are generated. Thus, the write-on element, not the write-down would be the key aspect. Once the instrument is issued a unilateral change of the terms of the instruments will not be possible. We furthermore would like to recall that the latter will be laid down in the terms of the instrument, which can not be changed unilaterally by the issuer.

For an instrument, whose terms would allow to simply cancel the write-on once written down, the market would demand an important premium: The investors would participate in the downside almost equal to equity instruments, while the chances on the upside are fairly limited. To compensate, either a more interesting coupon a lower issuing price would be the consequence.

Other aspects of loss-absorption

We agree to the proposals regarding the following aspects:

- 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.

- The instrument must neither be secured nor covered by a guarantee of the issuer, a related entity or any other arrangement in order to legally or economically enhance the seniority of the claim vis-à-vis the institution.

2. Permanence

Supervisory Approval

We suggest a more flexible approach on the requirement that *“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.”* These requirements seem too strict:

- In order to grant more flexibility, a waiver for supervisory approval should be established, if the bank, after redemption, maintains a capital level of more than 125% of required capital and provided that the quality of the capital remains the same.

- As regards the verification that “capital of the same of better quality”, we do not think that supervisory approval is required. In order to make the procedures less “bureaucratic”, banks should be allowed to settle these questions with their auditors.
- Due to the ICAAP processes, which determine the bank’s plan on shorter and longer run and allow to compare such plans with the finally resulting ratios, supervisors have already much information at hand. In particular, when there are hybrid programs, the replacement of some hybrids with others within the course of the program will ensure permanence.

Incentive to redeem

We do not think that an incentive to redeem automatically weakens 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 more efficient or when the capital is redundant.

The members of the EACB agree to the other “permanence” features.

3. Flexibility of Payments

We suggest that the wording of the CEBS proposals should me more in line with the Sydney Agreement: It seems too far-reaching to stipulate that *“issuers must be able to waive payments at any time on a non-cumulative basis and for an unlimited period of time”.* The wording of the Sydney Press Release *“the bank must have discretion over the amount and timing of distributions, subject only to prior waiver of distributions on the bank's common stock and banks must have full access to waived payments”*, seems to be more appropriate in this respect.

Furthermore, we suggest to allow that banks stipulate conditions/limits for the deferral of payments in the terms of the instruments. Such limits would have to be in line with the intended supervisory purposes. The well-founded probability of a shortfall in prudential capital requirements could be such a limit.

ACSMs

We do not support the idea to link the admission of Alternative Coupon Satisfaction Mechanisms (ACSM) to tax reasons. Such restriction could create distortions under level-playing field aspects.

The members of the EACB agree to the other “flexibility of payment” features.

4. Limits for Inclusion

Improved wording

Discussion among members and with the European Commission made evident that the current proposals, when to be applied in concrete examples, lead to serious misunderstandings. In particular, the application of the 70/30 or 50/50 rules around the 4% tier 1 limit are not clear[1]. We therefore urge CEBS to consider a redrafting of its advice, in particular with regard to the implementation of its proposals in the CRD.

"Cliff-effect": Required Capita/Operation above required capital

It could be that according to the suggested interference of the 50% limit and the 70% limit there could be a "cliff-effect" for companies operating above the required minimum capital level: An institution operating at 4% tier 1 would require 2.8% in capital, ordinary shares and disclosed reserves/retained earnings, while an institution operating at 5% tier 1 would only require 2.5%. We do not think that these results are desirable.

Instead we suggest to fix a minimum level for capital, ordinary shares and disclosed reserves/retained earnings of 2.8% in order to simplify and clarify this limit. Beyond this level, 50% of tier 1 hybrids should be allowed.

"Limit for Required Capital"

The members of the EACB seriously doubt that beyond the minimum level described above, a 70% limit for hybrids would be appropriate. It needs to be pointed out, in this context, that many countries oblige their banks to keep a ratio of capital, ordinary shares and disclosed reserves/retained earnings that goes far beyond the required minimum of 2.8% core tier 1. In such countries, a fix maximum level 30% of tier 1 hybrids would result in additional severe restrictions for these banks. We therefore think that the general application of a 50% level for hybrids for banks that operate beyond 2.8% core tier 1 is sufficient.

The fact alone that supervisors require a higher capital ratio for a bank is not by itself an indicator that the structure of tier 1 should be different. We suggest that any deviation from a general 50% rule regarding the portion of tier 1 hybrids, should rather be determined on an individual basis, like for the capital ratio. A general rule to require a level of 70% of a minimum capital ratio determined by supervisors in an individual case would rather reduce flexibility.

"70% limit"

We think that any 30% limit for tier 1 hybrids would be rather inappropriate. There is no evidence that there are problems regarding the capital structure in those countries, where there is a level of 50%. To the contrary, such countries seem to dispose of a highly dynamic industry.

[1] Is the minimum of 2.8% (70% of 4%) applicable at all times up to a ratio of 5.6% (50% of 5.6%), or is 50%, if core tier 1 > 2.8% the right approach?

Furthermore, we would like to recall that the eligibility criteria suggested by CEBS, in particular regarding loss absorption (write-off) make tier 1 hybrids equal to equity. Under these circumstances, we do not see any justification for a reduced 30% ratio for the suggested tier 1 hybrids.

Reference for the Limits

In order to ensure certainty and to avoid subsequent discussions on the substance on CEBS's advice, we suggest clarifying that the calculation of the limit for tier 1 hybrids is based on the amount of Tier 1 capital after deduction of goodwill but before the deductions of investments pursuant to this part on scope of application. Such wording would correspond to the Basel capital accord.

"At issuance"

It needs to be underlined that the Sydney Press Release, when referring to limits considers them "at issuance", while the current proposal requires the limits to be respected at all times. The members of the EACB consider this to be an additional restriction for banks that requires justification.

5. Grandfathering

Clarification

We think that the current text requires more clarification regarding the application of the suggested rules. Concrete examples would probably be helpful.

Time Horizon

The current proposal aims to cover all sorts of hybrid instruments. There are non--innovative hybrids that have been issued with perpetual maturity and call options starting in year 5. In the absence of redemption incentives these instruments were considered to be of a perpetual nature and were used for long dated swap agreements (40-50 years, sometimes even perpetual) against them. With the end of grandfathering after 30 years such instruments would have to be called - for economic reasons - while it may be impossible to call the corresponding swap agreement. As swaps exceeding a duration of 50 years are very uncommon we would suggest to expand the duration of the final grandfathering part from 30 to 50 years.

6. Minority Interest

We welcome the clarification on minority interest (Nr. 17), which we take also as an important step towards converging capital regulation. Recognition of the underlying consolidated instrument is a consistent concept. Minority interest provided via instruments regarded as hybrid capital under the Sydney Press Release should, as a general rule, fall under the suggested limitations on hybrid capital instruments, whereas common equity will remain common equity also at consolidated level.

7. Tax Aspects

While we certainly agree that it will be difficult for CEBS to consider tax aspects, we fear that it could be highly detrimental to ignore them. In fact, the tax deductibility of coupon payments is one of the key economic concepts of hybrids. Without proper consideration of tax aspects for the definition of tier 1 hybrids, there is a great danger that such instruments will be senseless to set up in a number of member states.

In particular we are very much concerned that the write-down feature and any subsequent write-on feature would very much hamper a “debt treatment” of hybrids under tax aspects.

8. Cross-border Consolidation and non-EU jurisdictions

Within the context of consolidation it becomes evident that a unilateral modification of the Sydney Press Release is not in the interest of the European banking industry. Capital instruments issued in compliance with the SPR in the US by a subsidiary domiciled in the US would not be recognized as hybrid instruments under the EU directive at the level of the EU mother company. The US subsidiary would have to use EU compliant structures which may be highly costly due to additional requirements like write down and/or unusual structural elements for a placement in the US market. Accordingly recognition has to be ensured.

We, therefore, think that any implementation beyond the Sydney Press release would require prior decisions at the level of the Basel Committee.

9. Authorisation/CEBS as single new Entry Point for new Instruments

We think that as regards the creation of any new hybrids, the first line responsibility for new hybrids lies with the issuing bank and its auditors. An authorisation by supervisory authority should only be necessary in cases of doubt.

When addressed, national supervisory authorities should be able to assess and deliver a decision regarding the eligibility of newly created hybrids in a short time frame (e.g. 8 weeks).

As to the idea to mandate CEBS with the role of entry point for new instruments that access the EU, we are of the opinion . that only when national supervisors do not feel in a position to take a well-founded decision, they should be able to address CEBS and ask for assessment and decision.

The decision of CEBS should have some kind of binding character. If the decision of CEBS is not binding at all, but member states keep the right to disregard the

CEBS decision, the process does not seem to make too much sense and even lead to important delays.

Moreover, we feel that in case a hybrid instrument has gained the approval of a national supervisory authority or CEBS, it has to be accepted in the EU (EU-passport).