

26 March 2008

Proposal for a common EU definition of Tier 1 hybrids

Background

1. In response to the European Commission's ('the Commission') Call for Advice on Own Funds CEBS provided technical advice in the form of:
 - a. a survey of the implementation of the current rules on own funds across CEBS members;
 - b. an analysis of the capital instruments recently created by the industry;
 - c. the development of guiding principles behind own funds; and
 - d. a quantitative analysis of the types of capital held by credit institutions within the CEBS members¹
2. One of the CEBS's key findings was the significant volume of 'hybrid' instruments (estimated at around 213 Billion EUR) which represents around 11.5% of total eligible own funds as of 31 December 2006 and the various regulatory treatments that these instruments are subject to:
3. Against the background of the CEBS's findings and the lack of EU legislation on the treatment of hybrid instruments, the Commission in its letter of 10 April 2007 invited CEBS to consider whether convergence in this area can be achieved, in particular it asked CEBS to
 - a. develop general principles that could guide supervisors in each of the three areas identified in the CEBS surveys (permanence, loss absorbency and flexibility of payments), and clarify detailed aspects of each of the principles (see below in the main report);
 - b. seek convergence on the current different quantitative limits to "innovative" and "non-innovative" hybrids; and

¹ The surveys answering Parts (a) and (b) were published on the CEBS website under <http://www.cebs.org/Advice/advice.htm> on 23 June 2006. The quantitative analysis of all types of eligible capital instruments in response to Part (d) followed on 15 June 2007, with a special subset - a quantitative analysis of hybrid capital instruments - published separately in March 2007. These pieces of work provide a full picture of the similarities and differences between eligible capital elements across the EU and their quantitative relevance

- c. consider possible ways to limit the impact on financial markets of any future common approach e.g. by grandfathering current instruments.
4. In addition, 'Consideration of the principle of 'substance' prevailing over the form and the importance of assessing any legal risk potentially embedded in hybrids in order to ensure that there is an actual transfer of the issuer's risk to the market should also be explored'.
5. Another aspect was to ensure that the overall prudential goal of improving the quality of capital could be achieved in a reasonable period of time.

Objective

6. The EU legislation, so far, does not address hybrid instruments. The Basel Committee on Banking Supervision, on the other hand, while also not formally addressing them in the Basel Accord, has set out the conditions for these instruments to be considered as Tier 1 capital in the Sydney Press Release (**'SPR'**) of 27 October 1998² as well as imposing limits on their inclusion.
7. The objective of these proposals is not to create a new definition for Tier 1 hybrids but to provide guidelines for a common and clear EU-wide interpretation and implementation of eligibility criteria that hybrids must meet.

Terminology

8. According to the Capital Requirements Directive (CRD) regulatory own funds are composed of two main layers³: 'original own funds' which are of the highest quality and permanence, and 'additional own funds', which are lower quality and may be less permanent. Article 57 of Directive 2006/48/EC sets out a list of eligible components. To cover market risks, institutions may also use 'ancillary own funds' (Article 13 of Directive 2006/49/EC).
9. There is no clear terminology for describing hybrid instruments which are considered to be eligible as Tier 1 capital. In that context, and without aiming to provide a general definition, the term "hybrids" has

² <http://www.bis.org/press/p981027.htm>

³ Terminology of Directives 2006/48/EC and 2006/49/EC. Subject to technical differences, these layers correspond to the Basel Accord terminology of Tier 1 and Tier 2. Capital instruments used to cover market risks (Ancillary own funds) are commonly referred to as Tier 3. For the sake of simplicity the draft proposals refer only to the more commonly-used Basel categories. Therefore, hereinafter every reference to "Tier 1 capital" should also be understood as a reference to "original own funds".

been used consistently in the CEBS surveys as well as in this report to encompass the following three broad categories:

- 1.1. innovative instruments (i.e. instruments with incentives to redeem such as step-ups);
- 1.2. non-innovative instruments (i.e. instruments which do not have incentives to redeem); and
- 1.3. non-cumulative perpetual preference shares, which some CEBS members treat as 'core Tier 1 capital'.

10. Minority interests can comprise common equity, hybrid Tier 1 instruments or non-Tier 1 items. For the purposes of the proposals in this report minority interests should be classified according to the underlying component. For example, common equity and reserves should be classified as common shareholders' funds, and hybrid instruments within minority interests should be subject to the permanence, loss absorbency and coupon flexibility features proposed in this report.

Scope and methodology

11. The proposals set out in this report are based on the SPR guidelines with regard to the key economic features of permanence, flexibility of on-going payments and loss absorbency and on the characteristics eligible hybrids bear across the EEA. The separate discussion of each economic feature in this paper serves mainly to provide a clear structure to the report. In practice, the features are more closely linked than this structure might suggest and must all be complied with at the same time. Cross references, or considerations of how a certain treatment of one feature may affect another feature, are therefore included where appropriate.

12. During the whole process CEBS maintained a dialogue with market participants in order to gain a better understanding of the range of concerns the current definition of own funds in the EU, and especially Tier 1 hybrid capital instruments, causes for market participants and their views on what a more consistent definition would look like.

13. For this purpose, CEBS organized public hearings in June and November 2007 as well as bilateral meetings with representatives of institutions, rating agencies and investors.

14. On 7 December 2007 the draft proposals were published for public consultation. CEBS received 31 responses. The comments and proposals provided have been incorporated, where appropriate. For details please see the feedback table (CEBS 2008 33).

15. The scope of the proposals encompasses:

- a. all hybrid instruments, regardless of the category they belong to;
- b. direct and indirect issuances of hybrid instruments (and in this respect minority interests); and
- c. all institutions subject to the CRD (i.e. credit institutions and investment firms).

16. CEBS members will endeavour to apply the prudential requirements set out in this paper independently of the legal form of the institution⁴.

17. In developing the proposals set out in this report, CEBS has applied the following principles:

- a. Instruments eligible for inclusion in Tier 1 capital have to be measured against the benchmark of 'equity'. Equity represents the highest quality of own funds. It can absorb losses that exceed current earnings, allowing the bank to continue its activities in times of poor performance. It is the most deeply subordinated claim (in liquidation) and is perpetual (no fixed maturity). In addition, the bank has full discretion over the amount and timing of the distribution of dividends.
- b. "Substance over form" - an instrument eligible for inclusion in Tier 1 capital should not only comply with the prudential requirements set out in this paper, regardless of its legal form, but also must result in the effective transfer of the issuer's risk to the market.
- c. Have regard to the capital structure and rank of subordination of the capital instruments, whilst recognising that in times of stress hybrid instruments must also be able to absorb losses on a going concern basis.
- d. Adopt a pragmatic approach, although there is a limited number of real cases where one can see how hybrids have performed in practice in stress situations, CEBS has tried to build on the experience and knowledge that market participants have gathered since 1998.

18. The issuance of hybrid instruments is usually guided not only by regulatory requirements but also by considerations outside the scope of supervision such as tax or company laws or accounting rules. These implications are highlighted as far as they form constraints on further convergence and cannot be resolved with amendments to supervisory regulation or practice alone.

⁴ Institutions are incorporated in various legal forms and alternative but equivalent solutions may be necessary.

19. Within the framework of the Joint Protocol between CESR, CEBS and CEIOPS and the 3L3 Work Programme for 2007, CEBS's and CEIOPS's experts have informed each other about their respective work.
20. The Basel Working group on the Definition of Capital, on which CEBS is an observer, has also regularly been kept informed.

Executive Summary

21. In recent years, EU banks have increasingly relied on the issuance of hybrid capital instruments, which may combine features of debt and equity. The market for such instruments has been growing fast both in terms of volume and in the diversity of instruments which has arisen mainly as a result of the particular features of local markets and differences in national tax and company laws.
22. These hybrids are specifically designed to raise funds in a cost-efficient and less dilutive way than equity and to be eligible for regulatory purposes.
23. EU legislation has so far been silent on the treatment of such instruments in regulatory capital.
24. On 27 October 1998, the Basel Committee issued guidelines (Sydney Press Release, hereinafter "SPR") setting out conditions for these instruments to be considered of adequate quality to qualify for the highest tier of regulatory capital ('Tier 1') while imposing limits on their inclusion.
25. CEBS members investigated whether a common EU approach to these instruments could be found without jeopardising the quality of regulatory capital, using as the starting point the SPR.
26. As a result, the 27 members of CEBS and the 3 EEA countries agreed on the conditions that any hybrid instrument must meet in order to be considered to be eligible Tier 1 capital in the EU. These conditions apply to all hybrid instruments, regardless of their denomination, the category (innovative, non-innovative instruments or non-cumulative perpetual preference shares) and the form of their issuance (direct or indirect). All the conditions must be fulfilled at the same time.

Issued and fully paid-up

27. The instrument must be issued and fully paid-up: any amount outstanding will not be included as eligible own funds as it is not yet available to support the on-going business of the institution.
28. The proceeds must be immediately available without limitation to the issuing institution, or if proceeds are immediately and fully available only to an issuing SPV, they must be made available to the institution (e.g. through conversion into a direct issuance of the institution that is of higher quality or of the same quality at the same terms) at a predetermined trigger point, well before serious deterioration in the institution's financial position.

Publicly disclosed and easily understood

29. The main features of the instrument (including whether it is grandfathered), the proportion of Tier 1 capital it accounts for must be periodically and publicly disclosed by the issuer. The main features of the instrument must be easily understood.
30. Moreover, the three economic characteristics must all be fulfilled at the same time - loss absorbency, permanence and ability of the issuer to cancel payments.

Able to absorb losses in liquidation

31. An instrument is able to absorb losses in liquidation if it always ranks junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids collectively are senior only to ordinary share capital.
32. The instrument must neither be secured nor covered by a guarantee of the issuer or a related entity, nor other arrangements that legally or economically enhance the seniority of the claim vis-à-vis the institution.

Able to absorb losses in going concern

33. On an ongoing basis and in particular in stress situations, the instrument must absorb losses to help the institution to continue operations as a going concern which means:
- that it should help to prevent its insolvency (deep subordination will not help to prevent insolvency and only absorbs losses in a winding up); and
 - that it would make the recapitalisation of the issuer more likely.
34. The instrument helps to prevent insolvency if the following conditions are met :
- the instrument is permanent;
 - the issuer has the flexibility to cancel coupon/dividend payment;
 - the instrument would not be taken into account for the purposes of determining whether the institution is insolvent; and
 - the holder of the instrument cannot be in a position to petition for insolvency.
35. When the issuer has incurred losses, notably when these losses cause a breach of capital requirements, it is likely that it will need to be recapitalised. The new capital provided to recapitalise the institution should not be used directly to benefit existing hybrid holders. Hence, the hybrid must include a meaningful mechanism that will make the recapitalisation more likely, by reducing the potential future outflows to the hybrids holders.
36. Possible mechanisms are a write-down of the principal, a conversion into ordinary shares or other mechanisms, provided that the issuer can

demonstrate to the satisfaction of the supervisor that the mechanism is capable of achieving the objective of facilitating a recapitalisation.

37. The mechanism must be disclosed and transparent to the market and in the case of a principal write-down must be on the issuer's balance sheet (assuming this is possible from an accounting perspective). In addition, the mechanism must be legally certain.

Permanent

38. The instrument meets the permanence test if it is undated.
39. It can however be callable but only at the initiative of the issuer and always with supervisory approval and under the condition that it will be replaced with capital instruments of the same or better quality, unless the supervisor determines that the institution has capital that is more than adequate for its risks.
40. Hybrids may be callable after a minimum of 5 years after the issue date; if they contain a pure call option. If the call option is associated with an incentive to redeem, it is only permitted after a minimum of 10 years.
41. Step ups and principal stock settlements, when combined with a call option, are considered as incentives to redeem.
42. Step ups are permitted, in conjunction with a call option, only if they are considered moderate. A step up is moderate if it results in an increase over the initial rate that is no greater than either (i) 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or (ii) 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis.
43. The terms of the instrument must provide for no more than one rate step-up over the life of the instrument. The swap spread is fixed at the pricing date and reflects the differential in pricing on that date between the initial reference security or rate and the stepped-up reference security or rate.
44. Principal stock settlement mechanisms must contain a cap on the conversion ratio in order to limit the potential dilution.
45. A term allowing early redemption triggered by an event such as a change in regulatory recognition of hybrids or a change in the tax treatment of these instruments, subject to prior consent of the supervisory authority, is permitted before 5 years.

Able to suspend payments

46. Issuers must be able to waive payments on a non-cumulative basis and for an unlimited period of time whenever necessary.

47. If the institution is in breach of its minimum capital requirements (or another level defined by the supervisor) then it must waive payments.
48. In addition, no provision in the terms of the hybrid instrument may prevent the supervisors from requiring institutions to waive payments at their discretion based on the financial situation of the institution.
49. Dividend pushers are acceptable but must be waived when either of the supervisory events mentioned above occurs between the date the coupon is pushed and the date it is to be paid. Under those circumstances, payment of the coupons will be forfeited and no longer be due and payable by the issuer.
50. The instrument is not cumulative in kind or in cash: any coupon or distribution not paid by the issuer is forfeited and is no longer due and payable by the issuer.
51. The issuer must have full access to waived payments.
52. Alternative Coupon Satisfaction Mechanisms are permitted only in cases where the issuer has full discretion over the payment of the coupons or dividends at all times, and only if the ACSM achieves the same result as a cancellation of coupon (i.e. there is no decrease in capital). To meet this condition, the deferred coupons must be contributed without delay to the capital of the issuer in exchange for newly issued shares having an aggregate fair value equal to the amount of the coupon/dividend. The obligation of the institution is limited to the issue of the shares. Hence, the issuer must have already authorised and unissued shares. The shares may be, afterwards, sold in the market but the institution must not be committed to find investors for these shares. If the sales proceeds are less than the coupon, the issuer must not be obliged to issue further new shares to cover the loss incurred by the hybrid holders.
53. Distributions can only be paid out of distributable items; where distributions are pre-set they may not be reset based on the credit standing of the issuer.

Included in Tier 1 up to a certain limit

54. CEBS believes that regulatory capital ratios should be met without undue reliance on hybrid instruments. It reaffirms that common shareholders' funds (common shares and disclosed reserves or retained earnings) are the predominant elements of capital.
55. CEBS puts forward two options for the limits for consideration. The objective of both options is to strengthen an institution's Tier 1.
56. Under option 1, Tier 1 hybrids may not at any time represent more than 30% of the required Tier 1 capital. If a bank operates above its minimum required Tier 1 capital, hybrids may represent up to a maximum of 50% of Tier 1 capital after specific Tier 1 deductions (but

without taking into account deductions from original and additional own funds).

57. Under option 2 there would be two buckets:

- Instruments which have additional features that make them behave in a way similar to equity must not – together with all other hybrid instruments – at any time exceed 50% of the total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds). For example, this is achieved through mandatory conversion into a pre-determined number of shares established at the moment of the issue of the instrument or through write-down (and possible subsequent write up) of principal *pari passu* with shareholders. The loss absorption mechanism shall be activated when the bank is in breach of capital requirements as defined by article 75 of Directive 2006/48/EC.
- All other non-innovative Tier 1 hybrid instruments must not at any time exceed 25% of the total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds).

58. Under both options, the limit for innovative hybrid instruments would be at all times 15% of total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds). The 15% would be included in the assessment of the limits above.

59. CEBS also proposes that the limits apply at all times. However, as for the limits relating to additional own funds, the supervisor should have the ability to waive the limits temporarily in exceptional circumstances.

Grandfathering

60. The eligibility of any instrument authorised or issued under existing national rules which no longer qualifies under the above interpretation as Tier 1 capital has to be gradually reduced over a period of 30 years.

61. Any redemption must be made at the initiative of the issuer and subject to prior supervisory approval.

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Part 1: General requirements

General requirements for Tier 1 hybrid instruments

- 1.1. The instrument must be issued and fully paid-up: any amount outstanding will not be included as eligible own funds as it is not yet available to support the on-going business of the institution.
- 1.2. The proceeds must be immediately available without limitation to the issuing institution, or if proceeds are immediately and fully available only to an issuing SPV, they must be made available to the institution (e.g. through conversion into a direct issuance of the institution that is of higher quality or of the same quality at the same terms) at a predetermined trigger point, well before serious deterioration in the institution's financial position.
- 1.3. The main features of the instrument (including whether it is grandfathered), the proportion of Tier 1 capital it accounts for must be periodically and publicly disclosed by the issuer. The main features of the instrument must be easily understood.
- 1.4. Moreover, the three economic characteristics must all be fulfilled at the same time - loss absorbency, permanence and ability of the issuer to cancel payments.

Part 2: Loss absorption

Tier 1 hybrids must be able to absorb losses on a going concern basis, in stressed situations, and in liquidation.

A. The Sydney Press Release (SPR) requires that Tier 1 capital instruments must be able to absorb losses on a going concern basis.

1. The SPR stipulates that 'all instruments included in Tier 1 must be able to absorb losses within the bank on a going-concern basis'. The wording of the loss absorbency requirement is similar to the description in the SPR of the loss absorbency qualities of ordinary shares and disclosed reserves/retained earnings: i.e. "common shareholders' funds allow a bank to absorb losses on an ongoing basis". Beyond the guidance implied by the comparison with ordinary shares and disclosed reserves/retained earnings and their ability to absorb losses, the SPR gives no further explanation of how the loss absorbency requirement is to be understood.

2. The capacity of an instrument to absorb losses in the case of liquidation will depend on its degree of subordination. The SPR states that "All instruments included in Tier 1 must be junior to depositors, general creditors and subordinated debt of the bank." Moreover, these instruments must "neither be secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors".
3. The SPR can be interpreted to mean that Tier 1 instruments must be junior to Tier 2 subordinated debt. There are no provisions in the SPR on the order of priority among the Tier 1 instruments themselves. Depending on the preferred loss absorbency of hybrid instruments, different requirements can be stipulated for the subordination of hybrid instruments compared to other Tier 1 elements and all of which will be consistent with the provision in the SPR.

B. In the EEA, the vast majority of Tier 1 hybrids are deeply subordinated. There are some variations with regard to the other characteristics of loss absorbency.

4. Various characteristics have evolved to provide loss absorbency of the principal amount of a hybrid capital instrument. These include subordination, principal write-down features, convertibility into higher forms of capital and the fact that the instruments must not be taken into account for the purposes of determining whether the institution is insolvent.
5. The relevance of these loss absorbency mechanisms varies depending on the actual situation of an institution. Subordination, for example, is most important in liquidation to ensure that hybrid holders' claims are not met before all more senior claims are satisfied. The write-down of the principal or the conversion of hybrids into ordinary shares, on the other hand, enables loss absorption on a going-concern basis and gives the institution the opportunity to recover.
6. A substantial part of the hybrid capital instruments issued, however, do not seem to have features that would allow them to be loss absorbent on an on-going basis in cases where losses are so large that they significantly erode Tier 1 capital.

Subordination

7. The vast majority of hybrid instruments (74 %) are senior to ordinary share capital.

HYBRIDS reported as original own funds as of 31 December 2006	All types (MEUR)	All types (%)	Non innovative instr. (MEUR)	(%)	Innovative instr. (MEUR)	(%)	Non cumulative perpetual pref shares (MEUR)	(%)
Pari passu with ordinary share capital	10,628	5%	5,581	7%	3,583	4%	1,465	4%
Senior to ordinary share capital only	158,375	74%	54,831	71%	72,353	72%	31,191	90%
Senior to other instruments in addition to ordinary share capital	43,683	21%	17,301	22%	24,506	24%	1,876	5%
Total	212,686	100%	77,713	100%	100,441	100%	34,532	100%

Preliminary data as of 31 December 2006- Source: CEBS Survey published in March 2007

8. This rises to 90% for non-cumulative preference shares. 5% of the hybrid instruments rank pari passu with ordinary shares. These include equity contributed through silent partnerships and non-cumulative trust securities issued in Germany, the innovative instruments issued in Norway and PIBS (Permanent Interest Bearing Shares) issued by building societies in the UK⁵. 21 % of the hybrid instruments are senior to other hybrid instruments.

Write-down of principal

9. For 39% of hybrid instruments the principal can be written down. However, this feature varies across the various types of hybrid capital instrument. Just over half (55%) of non-innovative hybrid instruments have a principal write-down feature, whereas 39% of innovative instruments and only 3 % of perpetual non-cumulative preference shares have such a feature.
10. A permanent write-down of the principal amount of hybrid instruments is only allowed in a small number of EEA countries, e.g. Spain and Norway. This accounts for about 13% of hybrid instruments.
11. A temporary write-down is possible for 17% of the hybrid instruments. In these cases, the principal is written back up again before profits start to accrue to ordinary shareholders.

Conversion

- 12.1% of hybrid instruments, consisting mostly of perpetual non-cumulative preference shares and few non-innovative instruments can be converted into ordinary shares.

⁵ Building societies are mutuals and do not have ordinary share capital. PIBS are therefore the most deeply subordinated capital instrument.

13. Approximately 18% of hybrid instruments can be converted into perpetual non-cumulative preference shares. Nearly all the convertibility clauses come into effect on the occurrence of a trigger event.

C. CEBS proposes that Tier 1 capital instruments must be able to absorb losses in the case of liquidation, and on a going concern basis

Objective of loss absorption

14. Capital absorbs losses to enable a bank to continue as a going concern and, in case of liquidation, to protect all depositors in a winding up.

15. The issue of going concern only becomes relevant when the bank suffers losses or loses the confidence of its creditors to such an extent that it may not be able to continue to trade.

16. The concept of a bank being a going concern is therefore wider than the auditing definition which states that a company is a going concern if it can meet its obligations as they fall due and its assets exceed its liabilities.

17. When elaborating on loss absorbency CEBS paid due consideration to the following principles :

- regulation of hybrids should not be more onerous than the rules on ordinary share capital; and
- the relative ranking of subordination of different Tier 1 capital instruments should be respected so that the ordinary shareholders should suffer the first losses.

18. It must be noted that most hybrid instruments have been issued recently and there is a very limited number of cases where one can see how hybrids perform in practice.

19. Tier 1 capital instruments must be able to absorb losses in the case of liquidation, on a going concern basis, in particular, in stress situations.

Loss absorption in liquidation

20. In cases of liquidation, losses are absorbed in accordance with the degree of subordination. In this regard the instrument must always rank junior to depositors, general creditors and the subordinated debt of the institution, i.e. hybrids are senior only to ordinary shares.

21. The instrument must neither be secured nor covered by a guarantee from the issuer or a related entity, nor other arrangements that legally

or economically enhance the seniority of the claim vis-à-vis the institution.

Loss absorption in going concern

22. On an ongoing basis, the instrument must absorb losses to help the institution to continue operations as a going concern which means:

- 1) that it should help to prevent its insolvency (deep subordination will not help to prevent insolvency and only absorbs losses in a winding up); and
- 2) that it should make the recapitalisation of the issuer more likely.

23. These two principles must be fulfilled by all instruments that are included in original own funds. If this is not the case, the instrument may be qualified as additional own funds. The possibility to cancel the coupon/dividend is not sufficient to qualify an instrument as original own funds because, if the issuer wants to continue to trade after a large loss, in practice, it must also be recapitalised, and, in order to make the recapitalisation more likely, the instrument must absorb a part of the losses, at least at a certain trigger point.

Prevention of insolvency

24. The instrument helps to prevent insolvency if the following conditions are met :

- the instrument is permanent (see part 3);
- the issuer has the flexibility to cancel coupon/dividend payment (see part 4);
- the instrument would not be taken into account for the purposes of determining whether the institution is insolvent; and
- the holder of the instrument cannot be in a position to petition for insolvency.

25. Insolvency is generally triggered by either a payment default by the issuer or, depending on the legal framework, by the fact that liabilities exceed assets. In order to avoid a payment default, it is important that there is no obligation to redeem the instrument or to pay a coupon/dividend. The holder of the instrument must not have the right to trigger insolvency. It is also necessary that the instrument would not be taken into account for the purposes of determining whether the institution is insolvent.

Not taken into account for the purposes of determining insolvency

26. The high level of subordination and the fact that there is no obligation to redeem the principal or to pay a coupon/dividend may, depending on the legal framework, not be sufficient to consider that the instrument is not a liability for the purposes of determining whether the institution is insolvent. When the insolvency law is based on a balance sheet test (assets must exceed liabilities), it is necessary to

assess whether the instrument would be taken into account under the legal framework for the purposes of determining insolvency. Where there is legal uncertainty, the supervisor may require that the instrument is converted into an equity instrument well before insolvency. The conversion may be done using different mechanisms such as a conversion into an equity instrument, or a write down mechanism. The write down can be permanent or temporary. If the bank goes into liquidation whilst the principal is written down the hybrid holder can claim the full principal amount.

Instrument holder not in a position to trigger insolvency

27. The investor, in its position as a hybrid holder, must not be in a position to trigger an insolvency procedure against the issuer. Therefore, the holder must not be in a position to require the redemption of the instrument or the payment of a coupon/dividend, without prejudice to accepting some limitation as mentioned in part 4 below (i.e. dividend pusher).

Make the recapitalisation of the issuer more likely

28. When the issuer has incurred losses, notably when these losses cause a breach of capital requirements, it is likely that it will need to be recapitalised. The simple fact that the principal is available to the institution and the terms provide the flexibility to stop the payment of coupons may not be sufficient to attract new shareholders. It is easier to attract new shareholders if they will benefit fully from the return of their investment after the firm becomes profitable again due to their intervention. Hence, the new capital provided to recapitalise the institution should not be used directly to benefit existing hybrid holders.

29. The hybrid must contain a meaningful mechanism that will make the recapitalisation more likely by reducing the potential future outflows to the hybrids holders. Possible mechanisms are for example:

- The possibility of writing down the principal permanently at a trigger point. If the nominal amount of the principal is permanently written down then the holders of that instrument absorb losses.
- The possibility of writing down the principal temporarily at a trigger point. The temporary write-down of the principal of a Tier 1 hybrid reduces future expenses to the extent that future coupons are cancelled or reduced while the principal amount is written down and until the full principal amount is written up back up again. The write up could be made out of future profits. A meaningful mechanism for a write up would, for example, be pari passu with the shareholders. During the write down period, the coupon could be cancelled or reduced and dividend stoppers and pushers must not apply. If the bank goes into liquidation whilst the principal is written down the hybrid holder can claim the full principal amount.

- The conversion into an equity instrument at a trigger point. If the Tier 1 hybrid converts into shares, then the hybrid investors may incur losses at the point of conversion depending on the amount and the features of shares they receive.
30. A combination of these mechanisms or other mechanisms may be applied provided the issuer can demonstrate to the satisfaction of the supervisor that it is capable of achieving the objective set out above.
 31. Any trigger point should be defined taking into account the objective of facilitating recapitalisation and the principle in paragraph 17. A permanent write down may penalise hybrid holders compared to ordinary share holders who can benefit from potential future profits. A permanent write down when the share capital is exhausted respects substantially the principle in paragraph 17 and will facilitate recapitalisation. A temporary write down will be more meaningful if it happens before the share capital is exhausted, notably when there is a breach of capital requirements.
 32. Possible triggers for loss absorbency mechanisms to be activated could be either a balance sheet loss or a breach of the capital requirements. The solvency ratio is easy to monitor and provides a clear indication of when an institution is in a stressed situation.
 33. If the trigger point is reached, the hybrid holders are expected to share losses. The mechanism is more meaningful if they share losses *pari passu* with common shareholders.
 34. Depending on the mechanism and the level of the trigger point, the instrument will absorb more losses and may be more effective in facilitating a recapitalisation. For example, a hybrid that absorbs losses *pari passu* with shareholders immediately when a loss arises or a hybrid that is mandatorily convertible into a prefixed number of shares after a certain period of time and in the case of a breach of solvency requirements may have loss absorbency characteristics which are similar to ordinary shares.
 35. The mechanism must be disclosed and transparent to the market and in the case of a principal write-down must be on the issuer's balance sheet (assuming this is possible from an accounting perspective). In addition, the mechanism must be legally certain.

CEBS proposal for a common EU definition of "Loss absorption"

- 2.1. The instrument must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids collectively are senior only to ordinary share capital.⁶
- 2.2. The instrument must neither be secured nor covered by a guarantee of the issuer or a related entity nor by other arrangements that legally or economically enhance the seniority of the claim vis-à-vis the institution.
- 2.3. On an ongoing basis, the instrument must absorb losses to help the institution to continue operations as a going concern which means:
 - that it should help to prevent its insolvency (deep subordination will not help to prevent insolvency and only absorbs losses in a winding up), and
 - that it would make the recapitalisation of the issuer more likely.
- 2.4. The instrument prevents insolvency if the following conditions are met:
 - the instrument is permanent (see part 3);
 - the issuer has the flexibility to cancel coupon/dividend payment (see part 4);
 - the instrument would not be taken into account for the purposes of determining whether the institution is insolvent; and
 - the holder of the instrument cannot be in a position to petition for insolvency.
- 2.5. When the issuer has incurred losses, notably when these losses cause a breach of capital requirements, it may need to be recapitalised. The new capital provided to recapitalise the institution should not be used directly to benefit existing hybrid holders. The hybrid must include a meaningful mechanism that will make the recapitalisation more likely by reducing potential future outflows to the hybrids holders.
- 2.6. Possible mechanisms are a write-down of the principal, a conversion into ordinary shares or other mechanisms, provided that the issuer can demonstrate to the satisfaction of the supervisor that the mechanism is capable of achieving the objective of facilitating a recapitalisation.

⁶ This does not prevent that different levels of subordination exist between different types of hybrid instruments. The term "hybrids" in the sentence refers to hybrids altogether.

2.7. The mechanism must be disclosed and transparent to the market and in the case of a principal write-down must be on the issuer's balance sheet (assuming this is possible from an accounting perspective). In addition, the mechanism must be legally certain.

Part 3: Permanence

Tier 1 hybrids are considered permanent if they are undated. Call options are acceptable under certain conditions and are always subject to supervisory approval.

A. The Sydney Press Release requires Tier 1 hybrids to be permanent. Early redemption is acceptable under conditions.

36. The SPR requires instruments eligible for Tier 1 to be permanent without providing a clear definition of "Permanence".
37. The SPR also states that 'call options are acceptable provided the instrument is only callable at the initiative of the issuer, only after a minimum of five years, with supervisory approval and under the condition that it will be replaced with capital of the same or better quality unless the supervisor determines that the institution has capital that is more than adequate to its risks.'
38. Incentives to redeem in the form of moderate step-ups in instruments issued through SPVs, as well as in directly issued Tier 1 instruments meeting the requirements of the SPR, 'are permitted, in conjunction with a call option, only if the moderate step up occurs at a minimum of ten years after the issue date and if it results in an increase over the initial rate that is no greater than, at national supervisory discretion, either:
- 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or
 - 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis.
39. The terms of the instrument should provide for no more than one rate step up over the life of the instrument. The swap spread should be fixed at the pricing date and reflect the difference in pricing on that date between the initial reference security or rate and the stepped up reference security or rate.

B. In the EEA, the vast majority of current eligible Tier 1 hybrids are undated. The conditions for early redemption are consistent with the SPR.

40. The CEBS March survey concluded that in the EEA, the 'Permanence' criterion is interpreted in such a way that the instrument must be permanently available.

41. 95% of the hybrids of EEA credit institutions are undated:

HYBRIDS reported as original own funds as of 31 December 2006	All types (MEUR)	All types (%)	Non innovative instr. (MEUR)	(%)	Innovative instr. (MEUR)	(%)	Non cumulative perpetual pref shares (MEUR)	(%)
Undated	201,950	95%	76,942	99%	90,476	90%	34,532	100%
Dated	10,736	5%	771	1%	9,965	10%	-	
<i>Total</i>	212,686	100%	77,713	100%	100,441	100%	34,532	100%

Preliminary data as of 31 December 2006- Source: CEBS survey published in March 2007.

42. Dated instruments (mainly innovative instruments and accepted by a very limited number of CEBS members) account for the remaining 5% and may decrease further with time as they mostly encompass grandfathered instruments.

43. 90% of hybrids contain redemption features which provide the issuer with the option to call the issue after a minimum time period. Such early redemption is always subject to prior supervisory approval. In most countries the minimum period before an early redemption call can be exercised ranges from five to ten years, depending whether the call option is associated with an incentive to redeem or not.

44. It is common practice for most CEBS members that early redemption can also be triggered by an event such as a change in regulatory recognition of hybrids or a change in the tax treatment of these instruments, subject to prior consent of the supervisory authorities. This is, however, not considered to be an incentive to redeem.

45. 58% of hybrids do not have any step-up.

46. In line with the guidelines set out in the SPR, moderate step ups of up to 100 basis points over the initial rate are common market practice. Only a few countries reported instruments that exceed that threshold (6% of cases), some of which were in line with the second option set out in the SPR which states that step ups can be up to 50% of the initial credit spread less the swap spread between the initial index basis and the stepped up index basis.

47. Principal stock settlement clauses allow for the substitution of one issue by another. Under this arrangement, a bank must deliver to the lender ordinary shares equivalent to the value of the amount borrowed or a fixed number of shares according to the terms of the instrument if it does not redeem the instrument at the call date.
48. Hybrids with principal stock settlement clauses are permitted in Belgium, Netherlands and the United Kingdom and account for 4 % of hybrids in the EEA. Such mechanisms may have dilutive effects and place an implicit pressure on institutions to redeem for cash rather than issue new shares, especially when combined with a call. Consequently, some supervisors have imposed limits on the quantum of shares that may be issued under them.

C. CEBS recommends that Tier 1 hybrids be undated and that early redemptions be subject to strict conditions and to prior supervisory approval

49. Permanence constitutes a primary feature of common equity which has no maturity and as such poses no refinancing risk to the issuer in a time of financial stress. Even if common equity can be repurchased, thus potentially reducing its theoretical permanence, the sole initiative for such repurchases rests with the issuing institution.
50. There is a common understanding among supervisors and market participants that permanence is a key feature for a hybrid instrument to be eligible as Tier 1 capital as it provides the bank with the greatest flexibility and ensures that capital is available in stress situations.
51. In essence, the guiding supervisory principles to be developed for Tier 1 hybrids have to be consistent with the principle stated for equity: hybrid capital, like equity, shall be available within a bank and remain so at any time.
52. This does not necessarily mean that a capital instrument cannot have a feature which allows its redemption by the issuing bank. After all, an institution can buy back its paid up capital. But, for Tier 1 hybrid capital, such early redemption must be exercised under strict supervisory conditions as incentives to redeem can damage the financial soundness of a bank.
53. Features such as interest rate step ups related to a call option weaken the permanency of hybrid instruments as they may place economic or reputational pressures on an issuer to call and refinance the hybrid even if the issuer is experiencing some deterioration in its financial position. Specifically, when hybrids are priced upon issuance assuming a call will occur in order to satisfy the hybrid investors, issuers often

feel obliged to initiate the call, even if the refinancing leads to a weaker capital structure or reduces future financial flexibility.

54. Indeed, the market expects that instruments with incentives to redeem will be called after ten years and prices them according to this expectation. Thus, market participants consider the date at which a call option with an interest rate step up can be exercised to be the instrument's effective maturity date.
55. As the SPR requirements have so far been applied consistently across the EU as a common market standard CEBS does not propose to depart from these requirements.
56. In particular, Tier 1 hybrid instruments are considered to be permanent if they are undated. This excludes contractually dated instruments from Tier 1 capital.
57. However, with the introduction of the Basel II requirements banks claim that there is an increasing need for more flexibility in their capital management and that the permanence of capital instruments becomes less important. In this context and taking into account the principle of "substance over form", some CEBS members stressed that the criterion of permanence could be interpreted in a less prescriptive way rather than requiring all instruments to be undated. This would also support the view of some market participants that the recent change in Basel II capital requirements requires more flexible provisions to deal with volatility/procyclicality issues. In addition, Article 92 para. 4 of the draft Solvency II Directive text published in July 2007 allows for greater flexibility in the permanence criterion. This is being discussed further by CEIOPS as part of the Level 2 implementing measures.
58. Although a contractually dated instrument, whose conditions give the supervisor the power to prevent the instrument's repayment at its final maturity may be considered as economically equivalent to the structure described above, CEBS considers that the charge of proof is reversed and therefore recommends, for the time being, excluding dated instruments from Tier 1 capital.
59. As stated in the SPR, it is important that call options can only be exercised at the sole initiative of the issuer: the replacement of the securities with less costly capital resources when issuers have the flexibility to do so, reflects the issuer's view of the most optimal capital structure.
60. Another crucial point is that the supervisor must have the authority to limit the incentives to redeem and to prevent the repayment of a capital instrument in order to preserve the financial soundness of the institution and to avoid refinancing risk in times of stress.
61. Principal stock settlement features in combination with a call are not specifically addressed by the SPR. CEBS regards them as an incentive to redeem. They must contain a cap on the conversion ratio in order to limit the potential dilution.

62. Instruments with a principal stock settlement feature should not be confused with mandatorily convertible securities (MCS). MCS mandatorily convert into ordinary shares after a specified period (for example 3 years) or upon a trigger event (such as a breach of regulatory requirements). There is no call option and therefore no possibility for the investors to receive cash. MCS do not provide the bank with an incentive to redeem because there is no call option and the instrument would be issued to equity or equity-linked investors.

CEBS proposal for a common EU definition of “Permanence”

- 3.1. Hybrid instruments are considered as permanent if they are contractually undated.
- 3.2. 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 instruments of the same or better quality unless the supervisor determines that the bank has capital that is more than adequate for its risks.
- 3.3. Hybrids may be callable after a minimum of 5 years if they contain a pure call option. If a call option is associated with an incentive to redeem, it is only permitted after a minimum of 10 years.
- 3.4. Step ups and principal stock settlements in conjunction with a call option are considered as incentives to redeem.
- 3.5. Step ups are permitted, in conjunction with a call option only if they are considered moderate, i.e. if they result in an increase over the initial rate that is no greater than, either:
 - 100 basis points, less the swap spread between the initial index basis and the stepped up index basis; or
 - 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped up index basis.
- 3.6. The terms of the instrument should provide for no more than one rate step up over the life of the instrument. The swap spread should be fixed at the pricing date and reflect the difference in pricing on that date between the initial reference security or rate and the stepped up reference security or rate, in line with the guidance given in the Sydney Press Release.
- 3.7. Principal stock settlement mechanisms must contain a cap on the conversion ratio in order to limit the potential dilution.
- 3.8. Early redemption triggered by an event such as a change in regulatory recognition of hybrids or a change in the tax treatment of these instruments, subject to prior consent of the supervisory authority, is permitted, before 5 years.

Part 4: Flexibility of payment

Issuers must be able to stop payments on a non-cumulative basis.

A. The Sydney Press Release requires Tier 1 hybrids to be non-cumulative. The issuer must have discretion over the amount and timing of distributions.

63. The SPR states that all instruments included in Tier 1 must be non-cumulative. In addition, the following conditions also have to be fulfilled:

- the bank must have discretion over the amount and timing of distributions, subject only to a prior waiver of distributions on the bank's common stock and banks must have full access to the waived payments; and
- distributions can only be paid out of distributable items; where distributions are pre-set they may not be reset based on the credit standing of the issuer.

B. In the EEA, the vast majority of Tier 1 hybrids are non-cumulative. The issuer has maximum flexibility over the amount and the timing of coupon payments.

Non-cumulativeness

64. The survey shows that 93% of the instruments are non-cumulative.

HYBRIDS reported as original own funds as of 31 December 2006	All types (MEUR)	All types (%)	Non innovative instr. (MEUR)	(%)	Innovative instr. (MEUR)	(%)	Non cumulative perpetual pref shares (MEUR)	(%)
Cumulative	14,025	7%	3,109	4%	10,916	11%	0	0
Cash	5,382	3%	594	1%	4,788	5%	0	0
Kind	8,643	4%	2,515	3%	6,128	6%	0	0
Non cumulative	198,661	93%	74,604	96%	89,526	89%	34,532	100%
Total	212,686	100%	77,713	100%	100,441	100%	34,532	100%

Preliminary data as of 31 December 2006-Source CEBS report published in March 2007

65. The small percentage of cumulative instruments with payment in cash includes grandfathered issues of silent partnerships in Germany and a few non-innovative and innovative grandfathered instruments in Ireland and Denmark. The small percentage of cumulative instruments with payment in kind includes mostly innovative and non-innovative instruments in the United Kingdom.
66. Direct issues of perpetual non-cumulative preference shares never incorporate cumulative features, be it in cash or in kind.
67. Coupon payments in kind, often called Alternative Coupon Satisfaction Mechanisms (ACSM)⁷, mean that the issuer can satisfy the coupon payment in the form of shares (as opposed to cash).
68. Instruments with this feature only account for a small part of the total but are, for tax reasons, significant in some jurisdictions, notably in the United Kingdom, Belgium and the Netherlands. A few grandfathered issues have been reported in Ireland and Austria.

Ability to suspend payments

69. There are a variety of circumstances under which the issuer is obliged to suspend payments. The most common reason is the breach of regulatory limits (68% of the cases) or of other limits fixed by supervisors (18% of the cases) as well as solvency difficulties (28% of the cases) etc., or a combination of these circumstances.
70. In 44% of the cases the issuer may stop interest payments on its hybrids in cases where dividends are not paid on another security class.
71. Other examples are the requirements in some countries that the institution must have full flexibility of payment at all times (notably no dividend pusher is allowed)⁸, e.g. Belgium, United Kingdom, Ireland and Netherlands, or that the issuer must suspend payment if no profit is recorded or no distributable funds are available.
72. There is no distinction between innovative, non-innovative instruments and perpetual non-cumulative preference shares on these trigger events. They apply in the same way whichever category the instrument belongs to.

⁷ *Alternative Coupon Satisfaction Mechanisms* can require the institution to pay with already existing ordinary shares or another equity instrument, or to issue new common stock or another type of securities in the market to raise enough cash to pay investors the deferred distribution.

⁸ In those countries, full flexibility of payment can be combined with ACSM.

C. CEBS proposes that Tier 1 hybrids should be non-cumulative and that the issuer must be able to stop paying its coupon whenever necessary

Objective of flexibility of payments

73. Flexibility of payments is closely interlinked with loss absorbency: non-cumulative cancellation of the payment of coupons in stressed situations increases the capacity of the instrument to absorb losses on an on-going basis.
74. On an on-going basis, the instruments must permit the institution to preserve cash by not paying out coupons if the financial situation of the institution requires it. The non-payment of coupons must not lead to a default on payment either.
75. Furthermore, the coupon payment on the instrument must not lead to liabilities exceeding assets and thereby triggering legal insolvency.
76. Another aspect is that tax authorities set different requirements for coupon payments to be tax deductible from one country to another. The recommendation below is intended to preserve the quality of regulatory capital at the EU level while providing the flexibility necessary to achieve a reasonable tax treatment of the instruments.
77. Therefore, the conditions of the instrument must enable the institution to cancel coupon payments whenever necessary. The institution must have discretion to decide whether it is able to pay coupons, and if so when and for how much, based on its financial situation at the respective coupon payment date. Any coupon or distribution not paid by the issuer is forfeited and no longer due and payable by the issuer; the unpaid coupon must not be cumulative. Lastly, the institution must have full access to the waived payment.
78. Practical experience indicates that even if the institution can defer at any time, it may refrain from activating its right for fear of the potential negative signal this could give to the market. Access to capital markets could then be restricted at the moment when the institution needs it most, thus leading to further deterioration in its financial situation.
79. This indicates the need to define mandatory triggers for deferral and also to ensure that there is no provision which may prevent the supervisor from requiring the issuer to defer on the basis of the financial situation of the issuer. As a mandatory trigger, a breach of the minimum capital requirements is considered as appropriate.
80. CEBS proposes that if the institution is in breach of its minimum capital requirements as defined by the Directive 2006/48/EC (or another level defined by the respective supervisor) the cancellation of the coupon is mandatory.

81. In addition, supervisory rules must provide that there are no conditions in the contract of the hybrid instrument that may prevent the supervisor requiring the institution to waive payments as the financial situation of the institution demands.
82. The ranking between shareholders and hybrids holders is also an aspect to take into consideration, as mentioned in paragraph 17. In this sense, a dividend pusher or stopper may be considered as acceptable if the issuers have a large degree of flexibility to cancel payments and because the hybrid holders have no voting rights.
83. A dividend pusher requires the issuer to pay its coupons on hybrids if it has paid dividends on its ordinary shares, in line with the rank of subordination of its capital structure. Dividend pushers are acceptable in order to preserve the subordination between shareholders and hybrid investors. Nevertheless, they must be waived at least when a breach of the minimum capital requirements occurs between the date the coupon is pushed and the date it is to be paid, or if deemed necessary by the respective supervisor.
84. A dividend stopper prevents the issuer from paying dividends in any period in which the issuer omits payment to hybrid holders. It is considered to be a restriction on the flexibility of payments on common shares bearing in mind that experience indicates that banks seem to be more willing to defer dividends on common stock, which constitutes the most junior claim on which distributions are totally discretionary, than they are on hybrids. Dividend stoppers should operate in a way that does not hinder recapitalisation.

Non-cumulativeness

85. The question whether an instrument is cumulative or non-cumulative is relevant to its capacity to absorb losses (see Part 2 above).
86. Payment of coupons in cash clearly depletes the institution's capital resources.
87. A hybrid instrument absorbs losses when the issuer waives payments of coupons which are then cancelled i.e. no longer due and payable. By contrast, cumulative instruments allow the issuer to defer payment to a later date, therefore preserving cash, but the issuer is still committed to paying and therefore the hybrid instrument has not absorbed a loss.
88. Because of tax reasons, some instruments contain Alternative Coupon Satisfaction Mechanisms (ACSM) (or a similar structure) whereby deferred payments are not cancelled but must be settled at a pre-specified future trigger point (e.g. payment of dividends on common shares) through the issuance of preferred or common shares.
89. ACSM may give rise to some prudential concerns if for instance the institution is not able to issue shares in time to pay the deferred

coupons in kind. For instance, the deferred coupon can accumulate in the absence of settlement with shares (e.g. the issuer has not found investors in the market) and therefore the deferred coupons will not serve to cover losses on a going concern basis.

90. Moreover, a sufficient amount of shares must be issued and sold to pay the full cash amount of the deferred coupon. There is a potential dilution effect but limited to the coupon.

91. Therefore ACSM is only acceptable if it achieves the same 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. To meet this condition, the deferred coupons must be satisfied without delay using newly issued shares that have an aggregate fair value equal to the amount for the coupon/dividend. The obligation of the institution is limited to the issue of shares. The issuer must already have authorised and unissued shares. The shares may be, afterwards, sold in the market but the institution must not be committed to find investors for these shares. If the sales proceeds are less than the coupon, the issuer must not be obliged to issue further new shares to cover the loss incurred by the hybrid holder.

<p>CEBS proposal for an EU definition of “flexibility of payments”</p> <p>4.1. Issuers must be able to waive payments on a non-cumulative basis and for an unlimited period of time whenever necessary.</p> <p>4.2. If the institution is in breach of the minimum capital requirement (or another level defined by the supervisor) it must waive payments.</p> <p>4.3. In addition, no provision in the contract of the hybrid instrument may prevent the supervisors from requiring institutions to waive payments at their discretion based on the financial situation of the institution.</p> <p>4.4. Dividend pushers are acceptable but must be waived when either one of the supervisory events mentioned above [paragraphs 4.2 & 4.3] occurs between the date the coupon is pushed and the date it is to be paid. Under those circumstances, payment of the coupons will be forfeited and no longer be due and payable by the issuer.</p> <p>4.5. Issuers must have full access to waived payments.</p> <p>4.6. Distributions can only be paid out of distributable items; where distributions are pre-set they may not be reset based on the credit standing of the issuer.</p> <p>4.7. The instrument has to be non-cumulative in cash or kind: any coupon or distribution not paid by the issuer is forfeited and is no longer due and payable by the issuer.</p>

4.8. Alternative Coupon Satisfaction mechanisms are permitted only in cases where the issuer has full discretion over the payment of the coupons or dividends at all times, and only if the ACSM achieves the same result as a cancellation of coupon (i.e an immediate increase in the capital).

To meet this condition:

- The deferred coupons must be satisfied without delay using newly issued shares that have an aggregate fair value equal to the amount for the coupon/dividend.

- The obligation of the institution is limited to the issue of shares. Hence, the issuer must already have authorised and unissued shares.

- The shares may be, afterwards, sold in the market but the institution must not be committed to find investors for these shares. If the sales proceeds are less than the coupon, the issuer must not be obliged to issue further new shares to cover the loss incurred by the hybrid holders.

Part 5: Limits to inclusion into Tier 1

Institutions' reliance on hybrid instruments must be limited in order to preserve the quality of regulatory capital.

A. The Sydney Press Release expects banks to meet the capital ratios without undue reliance on innovative instruments.

92. The SPR contains one explicit limit : "the aggregate issuances of non-common equity Tier 1 instruments with any explicit feature - other than a pure call option - which might lead to the instrument being redeemed is limited - at issuance - to 15% of the consolidated bank's Tier 1 capital".

93. Another limit is implicitly set by the press release when it states that "voting common shareholders' equity and the disclosed reserves or retained earnings that accrue to the shareholders' benefit should be the predominant form of a bank's Tier 1 capital".

B. In the EEA, the overall limit on hybrids ranges from 15% to 50% of Tier 1

94. A 15% limit for instruments with an incentive to redeem is generally applied across the EEA.

95. On the practical definition of "predominant" EEA countries have a great variety of interpretations. As shown in the last column of the table published on page 11 of the CEBS March 2007 report and updated in annex II of CEBS's June 2007 report, the overall limit on hybrids applied by EEA countries ranges from 15% to 50% of total Tier 1.

96. The application of different quantitative limits across CEBS members may lead to competitive distortions between EU banks.

97. At the June 2007 hearing (see website), all market participants acknowledged that it seems sensible to limit the inclusion of hybrids in Tier 1.

98. They also proposed that CEBS considers making some sort of trade off between the eligibility criteria and the limits on the inclusion of hybrids as eligible Tier 1 capital. If CEBS offers a clear definition of sufficiently robust criteria, and is sure that the hybrids can meet them, then there is room for having limits which are less stringent.
99. The market participants interviewed all agreed on the 15% limit for innovative instruments.
100. Regarding the overall limit for inclusion of hybrids in Tier 1 opinions varied a bit more. A majority of the market participants, however, would consider an overall limit between 30-35 % of Tier 1 as adequate; some including the 15% basket, some in addition to the 15% basket. These statements were clearly influenced by the limits used by the rating agencies. A higher percentage of hybrids, even if allowed under the national regime, might have a detrimental effect on the rating.

C. CEBS puts forward two proposals for consideration

101. While there is consensus on the 15% limit for innovative instruments, the need arises to set a limit for all other hybrids, or at least, (achieving the same practical effect) a comprehensive overall limit on hybrids eligible for Tier 1 capital.
102. A central objective of limiting the inclusion of hybrid instruments in Tier 1 capital is to strengthen the overall quality of an institution's capital. A majority of CEBS members therefore felt uncomfortable with setting a global limit higher than one third of total Tier 1 capital. However, some others already have a higher limit and raised concerns about the market disruption this could cause. Different approaches have been discussed. However, as all proposals brought forward contained features (e.g. cliff effects, need for further guidance and clarification, potential for different national interpretations, no consideration of the quality of a certain instrument) that could not be agreed to by all CEBS members, no consensus on one approach could be achieved.
103. Therefore, CEBS puts forward the following two options for consideration. The aim of the two options is to preserve the quality of own funds by ensuring that core Tier 1 is still predominant because core Tier 1 is more loss absorbent than hybrid instruments. In the two options, the overall limit for hybrids is also 50 % of Tier 1. Option 1 sets a minimum level of core Tier 1 compared to the capital requirements; option 2 sets limits for hybrid instruments that take into account the different quality of these hybrids. Option 2 was not included in CP 17 and was not subject to an impact assessment of the CEBS.

Option 1

104. Under option 1⁹, Tier 1 hybrids must at any time not represent more than 30% of the required Tier 1 capital, i.e. core Tier 1 must at all times represent at least 70 % of the required Tier 1 capital. If a bank operates above its minimum required Tier 1 capital, hybrids may represent up to a maximum of 50% of Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds).

105. In this option, core Tier 1 is defined as the total Tier 1 after specific Tier 1 deduction (but without taking into account deductions from original and additional own funds) less hybrids. Required Tier 1 capital is the target amount of Tier 1 required by the supervisor for the issuer. The required Tier 1 is at least equal to half the sum of minimum capital requirements and deductions from original and additional own funds. By reference to Directive 2006/48/EC this means:

- i. core Tier 1 is equal to the sum of :
 1. items (a) to (c) minus items (i) to (k) of article 57;
 2. items mentioned in article 65 provided that the instrument that gives rise to the minority interest, would be eligible for inclusion in items (a) to (c) of article 57
less hybrid instruments, directly and indirectly issued, that are included in original own funds
- ii. required Tier 1 capital is at least half of the sum of minimum capital requirements pursuant article 75 and the items (l) to (r) of article 57 of Directive 2006/48/EC.¹⁰

106. Rationale for this proposal is that institutions should have the flexibility to raise surplus Tier 1 capital in the form of hybrids. Option 1 also does not unduly restrict the amount of hybrid Tier 1 capital that can be issued by a well capitalised bank. CEBS also recognises that in practice market discipline will act as a constraint on the amount of hybrid Tier 1 capital a bank can issue. However, the SPR states that common equity and reserves should be the predominant form of Tier 1 and it would be a departure from this to allow hybrid capital to be greater than 50% of Tier 1.

⁹ Option 1 is explicitly supported by AT, BE, BG, CY, CZ, DE, DK, EE, GR, IE, LI, LU, LV, MT, NL, PL, RO and UK.

¹⁰ In other words, the minimum amount of required Tier 1 capital must be at least equal to:

$4\% * 12.5 * (\text{minimum capital requirements} + \text{deductions from original and additional own funds})$. 4% is half of the minimum capital requirements of 8% pursuant article 75 of the directive 2006/48/EC.

107. Some CEBS members which were not prepared to agree to this option indicate that they could agree to it if the level of 70% mentioned above was raised up to 100%.

108. An increase of the required level of core Tier 1 would also be supported by a number of CEBS members which agree to option 1. Some of these members suggest that, in this case, the limit could be calculated on basis of the minimum capital requirements of article 75 of the directive 2006/48/EC instead of the required Tier 1 capital. The reference to the harmonized minimum capital requirements might be better able to achieve the objective of reaching convergence within the EU than the reference to required capital which is defined by the supervisor (option 1) or the application of two different limits (option 2). Like option 2, this proposal was also not subject to an impact assessment.

109. However, some other CEBS members agreeing to option 1 pointed out that they would not be able to agree to an increase of the 70% level to 100%.

Option 2

110. Some CEBS members prefer another proposal¹¹. They note that hybrid instruments in practice differ a lot when compared with equity, i.e. they can have a very different quality. Therefore, they feel that a 50% overall limit for any kind of hybrid might not be appropriate. They suggest creating two distinct buckets with different limits for non-innovative hybrid instruments (in addition to the 15% limit for innovative hybrid instruments): One bucket for Tier 1 hybrid instruments (meeting the principles of going concern loss absorbency) subject to a limit of 25% of total Tier 1 capital (this limit includes the limit of 15% of Tier 1 capital for innovative hybrid instruments). Another bucket for higher quality Tier 1 hybrid capital instruments subject to a limit of 50% of total Tier 1 capital. The 50% limit includes all hybrids (15%, 25%). In contrast to option 1 there is no explicit link to the level of required Tier 1 capital. Although, in practice, in the (extreme) case of an institution operating with Tier 1 capital exactly equal to its Tier 1 capital requirements, core Tier 1 in the form of common shares and reserves, must be a minimum of half of Tier 1 requirements.

111. Instruments which have additional features with respect to the minimum requirements provided by this report, that make them behave in a way closer to equity in terms of loss absorption may be assigned to the higher quality bucket. In particular, such instruments shall absorb losses either through conversion into a pre-determined number of shares established at the time of the issue of the instrument or through write-down of principal *pari passu* with shareholders. In the latter case, the reinstatement (write up) of the principal shall also be

¹¹ Option 2 is explicitly supported by ES, FI, FR, HU, IS, IT, NO, PT and SI.

made *pari passu* with shares, i.e. future profits shall be allocated proportionally to equity and hybrids. Other mechanisms may be considered eligible provided that they produce identical effects to those outlined above, in terms of distribution of losses and allocation of future profits for reinstatement between shareholders and hybrid holders. The loss absorption mechanism shall be activated for instance when the bank is in breach of capital requirements as defined by article 75 of Directive 2006/48/EC. All other Tier 1 hybrid instruments would be assigned to the 25% bucket.

112. Some CEBS members that have not agreed with this option indicate that they could potentially agree to it if the level of 25% is increased up to 30-35 % and if the eligibility criteria and their relevance for higher quality Tier 1 capital are assessed carefully or if non cumulative preferred shares are included in the higher bucket. Some members agreeing on the option 2 may also accept an increase of the 25 % limit.

Comparison

113. Both options potentially improve the overall quality of capital.

114. **Option 1** firstly imposes a higher minimum required level of core Tier 1 capital than option 2. Secondly, it imposes less restriction on surplus (hybrid) capital which might be seen as allowing banks more flexibility for their capital planning. Thirdly, it does not create an additional hybrid bucket and accordingly does not require the determination of further criteria for assigning the instruments to the different buckets.

115. However, due to the discontinuity in the limit system, option 1 has a "cliff effect". Some members are concerned that this cliff effect may exacerbate a situation of financial stress and may introduce a potential procyclicality on the amount of eligible Tier 1 capital. Others believe that this effect is technical only and of little relevance in practice. Furthermore, they suggest it could be mitigated by the possibility of waiving the overall hybrid limit under exceptional circumstances (as is currently the case for the limit on Tier 2 capital).¹²

116. **Option 2** takes into account the different quality of Tier 1 hybrid instruments. Moreover, it avoids the "cliff effect" inherent to option 1. It seems to be also slightly more in line with the current regulatory practice of non-EU members of the Basel Committee which impose sub-limits, above the 15% limit for innovative hybrid instruments and below the overall 50% limit, for particular non-innovative hybrid instruments. In addition, some members find that option 2 offers more incentives to institutions to issue better quality hybrid capital.

¹² One member believes that option 1 is more complex to implement in practice, because it requires clarification on how to consider cases in which competent authorities oblige institutions to hold capital in excess of the minimum level laid down in article 75 of Directive 2006/48/EC.

117. However, as it creates an additional hybrid bucket, it firstly requires defining criteria for assigning hybrid instruments to the higher or lower buckets. Some members believe that it would be difficult to find meaningful criteria, which are neither too prescriptive nor too general (the latter might in turn jeopardise convergence due to different interpretations of the assignment criteria in Member States).¹³ Further, some members see the potential danger that the limit will be exploited, so supervisors would have the burden of policing the border between the higher and lower quality buckets. In addition, they consider that it could make grandfathering more complicated, as grandfathered instruments must be assigned to the two buckets which might be difficult in practice. Finally, another consequence of the additional sub-limit is that this increases the gearing effect inherent in any limit system.

118. In terms of a level playing field with countries outside the EU it seems difficult to come to an unambiguous conclusion. On one hand, the 70% limit related to required Tier 1 capital imposed in option 1 is not present in the SPR and not found in the current regulatory practices of non-EU members of the Basel Committee. On the other hand, some non-EU members of the Basel Committee impose sub-limits, above the 15% limit for innovative hybrid instruments and below the overall 50% limit, mainly for indirectly issued non-innovative hybrid instruments. In contrast, option 1 has no sub-limits.

Whether option 2 would create competitive disadvantages with non-EU members of the Basel Committee depends very much on whether or not the criteria for assigning hybrid instruments to the 50% bucket are stricter than the ones applied by non-EU members of the Basel Committee. Currently, this seems to be the case as option 2 requires equity-like features, whereas the sub-limits of non-EU members of the Basel Committee refer mainly to indirectly issued hybrid instruments.

Both options are stricter than the SPR with respect to the 15% limit for innovative hybrid instruments in that they impose the limit at all times, whereas the SPR requires the limits to be fulfilled at issuance only. This is, however, consistent with current supervisory practice in most Member States.

Other aspects

119. CEBS also proposes that the limits apply at all times. However, as for the limits relating to additional own funds, the supervisor should have the ability to waive the limits temporarily in exceptional circumstances.

¹³ One member believes that possible inconsistencies in the application of the assignment criteria would be mitigated by co-operation among supervisory authorities, which would be committed to a consistent application of these criteria.

CEBS's proposal for EU limits on the inclusion of hybrid instruments in Tier 1 capital:

Option 1

- 5.1. Overall limit: Tier 1 hybrids may not at any time represent more than 30% of the required Tier 1 capital.
- 5.2. When an institution operates above the required Tier 1 capital, hybrids may represent up to a maximum of 50 % of total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds).
- 5.3. Limit for instruments with an incentive to redeem: At all times 15% of total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds). This limit is included in the overall limit on hybrids.

Option 2

- 5.4. Overall limit: Instruments which have additional features that make them behave in a way similar to equity must not – together with all other Tier 1 hybrid instruments – represent at any time more than 50% of total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds). For example, through mandatory conversion into a pre-determined amount and number of shares established at the moment of the issue of the instrument or through write-down of principal *pari passu* with shareholders. All other Tier 1 hybrid instruments must not represent at any time more than 25% of total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds). The loss absorption mechanism shall be activated when the bank is in breach of capital requirements as defined by article 75 of Directive 2006/48/EC.
- 5.5. Limit for instruments with an incentive to redeem: At all times 15% of total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds). This limit is included in the overall limit on hybrids.
- 5.6. The limits apply at all times. However, the supervisor should have the ability to waive the limits temporarily in exceptional circumstances.

Part 6: Grandfathering

Grandfathering clause aims at limiting the impact on financial markets of the proposed common regulatory approach
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120. Hybrid instruments are currently included in Tier 1 on the basis of the eligibility criteria at the time of their issuance. In order to achieve convergence all CEBS members will have to amend their current rules on hybrids to some degree. Although not all existing hybrids will lose their eligibility, the volume of hybrid instruments in the market that may cease to qualify under the revised rules could be substantial.
121. Rules are needed that soften the impact of the new rules on the market and allow for an adequate transition period.
122. In its letter the Commission specifically asks that due consideration should be given to possible ways of limiting the impact on financial markets of any future common regulatory approach. The provision of "grandfathering" to guarantee that current issues will continue to be eligible is specifically mentioned and can be considered an efficient means of achieving the objective.
123. Any call for redemption will be subject to prior supervisory approval.
124. Regulatory calls (i.e. the issuer has the option to redeem if the instrument no longer qualifies as regulatory capital) will not be applicable whilst the instrument is subject to grandfathering since the instruments will continue to count as regulatory capital. Any grandfathered instrument which does not comply with the grandfathering rules will be disqualified as Tier 1 and considered as additional own funds (Tier 2).
125. Several options have been considered:
- a. Grandfathering for a pre-set time: this option could cause problems with outstanding instruments which have no option to redeem. It effectively makes all hybrid instruments dated. This would cause turbulence in financial markets because of the re-pricing of instruments which would lead to unanticipated mark to market profits or losses.
 - b. Grandfathering until the first call date: this would allow existing instruments to count as Tier 1 capital up to the point that the bank is first able to redeem the instrument. It effectively makes instruments with a call feature dated, whether or not there is an incentive to redeem and leads to the same issues as outlined in point a. above. This option does not address instruments without a call.

- c. Permanent grandfathering: this would allow all existing instruments to count as Tier 1 capital indefinitely. Permanent grandfathering does not effectively create a market with dated instruments.
- d. Gradual “amortisation plan”: according to this option the existing instruments would gradually lose their eligibility for inclusion in Tier 1 over a certain period of time.

126. In the opinion of CEBS a gradual amortisation of non-compliant instruments strikes the right balance between prudential concerns to eliminate these instruments from banks Tier 1 capital and concerns that a too abrupt grandfathering rule may cause market disruption.

CEBS proposal for grandfathering rules:

- 6.1. The eligibility of instruments that do not fulfil all the criteria mentioned above as Tier 1 capital will be gradually reduced over a period of 30 years (see below).
- 6.2. Any redemption should be made at the initiative of the issuer and subject to prior supervisory approval.

Years after new requirements entered into force	Limit for inclusion of grandfathered instruments
10 years	20% of Tier 1 capital*
20 years	10% of Tier 1 capital*
30 years	0% of Tier 1 capital*

*) after specific Tier 1 deductions, but without taking into account deductions from original and additional own funds.