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Danièle Nouy
Chair, CEBS
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25 Old Broad Street
London EC2N 1HQ
United Kingdom

Dear Ms Nouy,

Subject: Follow-up of the EBC meeting in hybrid capital instruments

At the meeting of the European Banking Committee EBC on 27th March we agreed that the Commission would write to you to confirm the decisions that we took on the treatment of hybrid capital instruments and to set out our expectations of how CEBS could take work forward in this field.

On the basis of the substantial work already conducted by CEBS that responds to the Commission's previous two 'calls for advice', achieving as much supervisory convergence as possible in this area (representing some €230 BN in the EU) is now generally considered to be crucial. The need for level playing fields between our financial firms and the imperative to have a sound capital base to withstand stressed market conditions dictate that the present divergent approaches are felt to be in need of urgent attention. This is now even increasingly echoed by the industry itself. In attempting to achieve such convergence in supervisory practices, it is also generally understood that we should now make a decisive effort to apply what was agreed at the G-10 level in the Basel Committee on Banking Supervision almost a decade ago. Greater convergence between our present supervisory practices will also greatly assist the EU in the upcoming discussions in Basel on the subject of regulatory capital.

In concrete terms and as a result of the EBC discussions, I am now inviting CEBS to seek concrete convergence in the following three main areas:

- (1) CEBS' latest report notes that EU-banking supervisors generally take three main qualitative features into account when considering eligibility of hybrid instruments for Tier 1 capital purposes: (i) permanence, (ii) loss absorption capacity and (iii) flexibility in payments.

CEBS is therefore kindly requested to develop general principles that could guide supervisors in each of these three areas. However, in order to be of operational

use, these general principles would need to clarify further at least the following aspects referred to in the CEBS' report:

- (a) permanence:
 - relation with the maturity of the instruments;
 - call features and any regulatory minimum period before early redemption;
 - redemption incentives;
 - possibility for issuers of using principal stock settlement .
 - (b) loss absorbency:
 - level of subordination;
 - principal write-down mechanisms and relevant trigger event, if any, to reinstate the notional amount;
 - convertibility of principal.
 - (c) payment flexibility:
 - ability of the issuer to suspend payments (e.g. existence of trigger events that may limit its discretion)
 - possible use of alternative settlement mechanisms (e.g. through new issuance of shares);
- (2) further convergence between the current different quantitative limits applied by EU-supervisory authorities to 'innovative' and 'non-innovative' hybrid capital instruments. This also represents a key issue since it may have a material impact on the composition of banks' capital;
- (3) due consideration on possible ways to limit the impact on financial markets of any future common regulatory approach, for example by allowing a "grandfathering" provision for instruments that have already been issued.

At the same time, the Commission and the EBC would like to ensure that the overall prudential goal to improve the quality of capital could be achieved in a reasonable period of time.

Fully understanding the complexity of many instruments issued, CEBS may wish to stress the principle of the substance prevailing over the form, which should drive prudential assessments of capital quality. For example, compliance with broad prudential principles needs to go hand in hand with an actual transfer of the issuer's risk to the market. CEBS may also wish to flag the importance of assessing any legal risk potentially embedded in hybrid instruments to ensure that they can be triggered when firms require capital most (e.g. in case of crisis situation). CEBS may also consider any other issue that it deems appropriate to discuss on this topic.

While carrying out the above work, CEBS should also benefit from contacts with industry representatives as well as with credit rating agencies.

I believe that the above adequately reflects our discussion at the EBC meeting. As regards timing, it was suggested and mutually agreed that the results of CEBS' work would be available at the end of this year.

The Commission and the EBC also agreed that CEBS is expected to indicate concrete areas in which it has been able to make the desired progress on converged practices that will be commonly applied by EU banking supervisors. Equally, CEBS is kindly requested to report in which specific areas, if any, such convergence may unfortunately not have been possible and indicate the precise reasons for this. This will greatly assist the Commission and the EBC in any further deliberations.

Although process and timing are different to those in insurance, if appropriate, you may wish to consider liaising with CEIOPS on this matter.

I look forward to our continued good cooperation in this important area.

Yours sincerely,



Jörgen HOLMQUIST

Thierry Stoll
Deputy Director General

c.c.: Messrs. Tertak, Wright, Pearson, Van Hulle, Merlin (CAB),
Mr T. Steffen (Chairman of CEIOPS).