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EBF response to the CEBS Consultation Paper entitled "Implementation Guidelines regarding Hybrid Capital Instruments"

KEY POINTS

- We commend CEBS on producing a clear set of implementation guidelines which were thoroughly assessed and which will be useful to market participants to achieve a full understanding of the new rules.

- The proposed guidance concerning the buy-back of hybrid instruments is the most critical part of the Consultation Paper. Our major concern is that the significant restrictions which CEBS is considering have not been mandated by the recent CRD amendments or by any recommendation made by the Basel Committee. Moreover, we disagree with the view taken in the Consultation Paper that, in economical and prudential terms, buy-backs would be equivalent to a call or redemption. Therefore, we also disagree with the proposed conclusion that the same process should apply to the buy-back of a hybrid instrument as to a call for redemption.

- Taking into account that supervisors are engaged in a regular dialogue with banks on their solvency situation, it should be possible to subject applications made by issuers for calling or redeeming a hybrid instrument to a less onerous and more flexible process which would, moreover, require supervisors to decide within a reasonable time-frame.

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GENERAL COMMENTS

The EBF welcomes the initiative to establish guidelines aiming at fostering convergent supervisory practices with regard to hybrid instruments across the EU as this will contribute to creating a level playing field in an area concerning which it is essential that competitive distortions are avoided.

Overall our comments on the proposed implementation of the new CRD provisions which are due to be transposed into Member States' national law by 31 October 2010 are positive. We commend CEBS on producing a clear set of implementation guidelines which were thoroughly assessed and which will be useful to market participants to achieve a full understanding of the new rules.

DETAILED COMMENTS

A. Permanence

<u>*Preliminary Comment*</u>

1. The Consultation Paper does not make any reference to the position taken by CEBS in its feedback to its previous consultation (CP 17) that "*also instruments whose maturity is linked to the life of the issuer fulfill the criterion to be undated*".

There is currently no reason to modify this assumption. Therefore, we would like to suggest that CEBS would confirm this position which is of interest to those issuers who typically do not issue pure undated instruments but rather financial instruments with a maturity equal to the duration of the bank.

1) <u>*Incentives to redeem [Article 63a (2), subparagraph (1), sentence , of the CR)]*</u>

Question 1:
1.1 Are the guidelines in relation to "incentive to redeem" sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

2. In general, the guidelines in relation to "incentive to redeem" are sufficiently clear.

3. It would, however, be useful if the final paper would elaborate more on the view taken that "*a principal stock settlement mechanism in conjunction with a call option shall contain a cap of no more than 150% of the conversion ratio at the time of issue to be considered a moderate incentive to redeem*" (paragraph 56). It would, more particularly, be helpful if the final version of the paper could provide more insight into the reason underlying the choice for the 150 % limit.

Question 1:
1.2 Please describe the potential impact of a cap of 150% relating to stock settlement of the conversion ratio. Please provide evidence.

4. We fully understand the view taken by CEBS that there is need for a cap. However, a cap which would be structured in the way proposed in the Consultation paper would be likely reduce the efficiency and usefulness of stock settlement to a substantial extent, if not completely. We would like to suggest considering putting a cap on potential dilution instead.

No reclassification of instruments with an incentive to redeem

5. According to the Consultation Paper the existence of an incentive to redeem will be determined at the issue date and cannot be reversed. We oppose this approach. Besides the fact that it is not reasonable from an economical point of view as described below, it is in opposition to the context of the rest of the guidelines and the text of the CRD. The CRD – in opposition to the Sydney Press Release – obliges banks to meet the requirements, e. g. for limits, at any time and not only at the date of issuance.

Instruments with incentives to redeem that are not called are to remain in the 15% bucket and not be reclassified as non-innovative instruments (paragraph 58). We believe that this paragraph would need to be amended. Once an incentive to redeem has occurred but the instrument has not been called, there is no incentive to redeem anymore and, therefore, the permanence of the instrument cannot be questioned. Consequently, going forward, the instrument must be treated as an instrument without incentive to redeem and the 15 % limit should not apply, but it should be allocated to the 35% or 50%-bucket, depending on its characteristics. The requirement of article 63a (2) that these instruments shall not be redeemed before five years after the date of issue is obviously still fulfilled as the incentive to redeem must not occur before 10 years after the date of issue.

2) Supervisory consent to a call or redemption of a hybrid instrument [Article 63a (2), subparagraph (2), sentences 1 and 2 and subparagraph (3), CRD]

Application for call or redemption

6. The proposed guidelines suggest that issuers who plan to call or redeem a hybrid capital instrument included in original own funds need to apply for prior supervisory approval (paragraph 60) and, furthermore, that such an application would need to be made within the framework of the Supervisory Review and Evaluation Process (SREP) (paragraph 62). It also specifies the data which the institution should submit to the competent authority together with its application for calling or redeeming a hybrid instrument (paragraph 64)

- We fully support the emphasis which the Consultation paper puts on the SREP and the ensuing dialogue between banks and their supervisors within the Internal Capital Adequacy Assessment Process (ICAAP). The mere existence of ICAAP which is conducted at periodic intervals provides supervisors with a framework enabling them to put applications made by banks to call or redeem hybrid instruments in a proper context.
- It can, therefore, be assumed that supervisors already have obtained sufficient information to decide on applications to redeem certain hybrid instruments. The need for additional information needs to be assessed against this backdrop to avoid duplication of data. It would, therefore, be useful for the final paper to clarify that the data listed in paragraph 64 need to be submitted only if the information is not yet available to the competent authorities.
- Moreover, it should be clarified that redemptions which are already announced within the periodic ICAAP and which have been discussed with the competent authority within this framework, do not require for an additional application to be made as the supervisory consent can be assumed. This implies that, if the capital plan of a bank is built on the assumption that all Tier 1 hybrids will be called on their first call dates without replacement, the bank should not be required to make an additional submission for the purpose of calling a hybrid.
- An amendment would in any event need to be made to the proposed requirement that the data to be submitted would need to include information on the planned development of current solvency data "*for the following x (e.g. 3-5) years based on its business plan including the planned development of the balance sheet and the profit and loss account*" [paragraph 64, (c)]. We consider the proposed time horizon to be too long as projection over such a long timeframe inevitably entails increasing uncertainty and thus reduces significantly the value of such projections. Such a requirement would in any event be too onerous taking into account that it would need to be observed just for the sake of calling a hybrid instrument, particularly if the instrument does not represent a significant amount of the issuer's eligible capital. We believe that a two-year time-horizon should be sufficient.
- A further amendment would need to be made to the proposed requirement that a bank's application for calling a hybrid shall include stress tests. Stress testing is a time-consuming exercise and comprehensive stress tests are conducted in the ICAAP process, which are based both on pre-specified scenarios and more specific scenarios. Supervisors should rely on those stress tests rather than requiring banks to conduct separate stress tests for the purpose of calling a hybrid.
- It needs to be observed, finally, that the ICAAP process is time-consuming whereas market circumstances may require supervisors to react swiftly to applications made for calling or redeeming instruments. This seems to indicate that supervisors may need to address such applications outside the proper ICAAP framework and, moreover, that a recommended time-frame be imposed on competent authorities which they would be expected to observe under normal circumstances. We believe that they should normally be in a position to take a decision within one month.

To summarise: taking into account that supervisors are engaged in a regular dialogue with banks on their solvency situation, it should be possible to subject applications made by issuers to a specific process which is less onerous and more flexible and which would, moreover, require supervisors to decide within a reasonable time-frame.

7. The Consultation paper specifies furthermore that, if the hybrid instrument has already been replaced by capital of at least the same or better quality the competent authorities may require less information in the context of the application (see paragraph 67).

We believe that supervisory consent should be presumed as, *ex hypothesi*, the instrument was replaced by capital of at least the same or better quality. In these situations it should be sufficient that a bank just makes a notification to the competent authority.

3. Supervisory guidance on buybacks of hybrid capital instruments in the market

General Comments

8. The proposed guidance concerning the buy-back of hybrid instruments is the most critical part of the Consultation Paper. Our major concern is that the significant restrictions which CEBS is considering have not been mandated by the recent CRD amendments or by any recommendation made by the Basel Committee.

Financial institutions need more flexibility in carrying out buy-backs in order to achieve the efficient management of their Tier 1 instruments with reference, for example, to market conditions, level of capital, Tier 1 ratios and capacity to expand or reduce risky activities.

We fully understand and support CEBS' wish to be pro-active as well as its desire to anticipate further discussions to be held at the level of the Basel Committee in this regard. However, we believe that it would be appropriate for CEBS to await the outcome of decisions to be taken at a global level concerning the definition of capital before moving forward in this area. In the meantime, buy-backs should not be made subject to supervisory approval nor should they be prevented from being bought back before five years after the date of issue. The European Supervisory Community should accept for the time being that it should be sufficient for banks to meet regulatory solvency requirements.

Question 2:
2.1. Are the guidelines in relation to "buy back" sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

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9. The proposed guidance concerning the buyback of hybrid instruments is sufficiently clear.

Question 2:
2.2. CEBS is considering whether buy backs should under certain conditions also be permissible before five years and without replacement. A number of CEBS members would support such a provision under strict conditions and subject to prior supervisory approval, notably if the buy-back responds to exceptional circumstances, is acceptable from a prudential point of view and results in a lasting improvement of the institution's solvency situation. A number of other members have concerns regarding such an exemption, in particular as it may compromise the permanence of the hybrid instrument by enhancing investors' pressure on banks to buy back outstanding hybrids and by providing incentives for banks to reduce their overall capital position at times when their own credit quality is decreasing.

10. The Consultation Paper takes the view that, in economical and prudential terms, buy-backs are equivalent to a call or redemption and concludes from this that the same process should apply to the buy-back of a hybrid instrument as to a call for redemption. However, buy-backs of hybrid Tier 1 securities are fundamentally different from call options as they represent a transaction between two consenting parties, as opposed to a unilateral right to redeem.

Moreover, redemptions are done at par value while buy-back transactions are done at prevailing market rates. So if, for example, a hybrid is bought back at a discount, the issuer will book a capital gain in the P/L, which will generate core Tier 1 capital. In such a situation, a buy- back can, therefore, be seen as a measure to improve the quality of the capital base. As a consequence it is difficult to understand why banks would not be allowed to buy back hybrids before five years after issuance if the capital position of the bank is sufficient from a prudential point of view after the buy-back transcation.

Finally, as evidenced by recent market developments, buy-back transactions executed by European financial institutions since March 2009 have in no way (i) resulted from market pressure on issuers to repurchase securities (as may be the case with respect to certain call option redemptions); or (ii) resulted in an undue reduction of issuers' capitalisation levels.

Question 2:
2.2.1. What would be the impact if buy-backs before five years after the issue of the instrument were only allowed under the conditions described in paragraph 72? Please provide evidence.

11. The proposed guidelines on buy-backs of hybrid Tier 1 capital securities are in any event too restrictive and would unduly limit the flexibility of issuers to repurchase hybrid Tier 1 securities. It is striking to note in this regard that the Consultation Paper fails to explain why an approval process for buy-backs of hybrid Tier-1 instruments would be mandated notwithstanding the fact that the company can freely take decisions concerning other elements affecting regulatory capital (such as dividend payments and buybacks of shares) unless the supervisor issued an order that suspends these payments..

They would, moreover, prevent issuers from restructuring their capital base, thereby potentially hindering recapitalisation. This is particularly relevant in the case of mergers or take-overs where buy-backs can be a way of removing legacy instruments with undesired payment pusher effects or providing capital at a group level where it is no longer needed (cf. the recent Santander/Abbey or Lloyds/HBOS buy-back deals);

Finally, they would prevent some issuers from using market opportunities to create core capital due to discounted buy-back prices, whilst other issuers would not.

12. It should not be required that the issuer would replace the instrument that he wishes to buy back with capital of at least the same or better quality when a bank has the choice between repurchasing shares and hybrid instruments to reduce the amount of Tier 1 capital. It would make little sense if the regulator would oblige a bank to lower the quality of its Tier 1 capital by allowing repurchase of core Tier 1 but not of hybrids.

Question 2:
2.2.2. Please describe circumstances – other than current market conditions - in which a buy-back at an earlier stage without the requirement to replace them with instruments of the same or better quality would be justified from a prudential perspective.

13. Subject to the issuance structure of hybrid Tier 1 a buy-back at an earlier stage makes sense and it is justifiable from a prudence perspective.

An example of where a buy-back would be possible at an earlier stage is a change in Risk Weighted Assets. If a bank's risk weighted assets (RWA) have decreased due to a reduction in the size of its balance sheet or particular types of RWA on its balance sheet, this means that, in total, it does not need a same amount of capital to maintain strong capital ratios. This would provide an opportunity for a bank to strengthen the mix of its capital by proceeding with a buy-back.

It may also arise if a bank holding company sells part of its business at a substantial gain thereby realising the market value of the operations and facing a large excess equity; in such a situation it would likely wish to restructure the different capital components. It may also arise after a period of stress and uncertainty when the bank has issued hybrid Tier 1 instruments to provide a capital buffer. When the situation normalises, the bank may rightly wish to reduce the buffers to normal levels. It would then not be sensible for regulators to prefer a repurchase of shares to a repurchase of the hybrid instruments issued as a buffer as this would lead to a reduced quality of the Tier 1 capital.

Question 2:
2.2.3. Which criteria should be provided in order to address the above mentioned concerns, and in particular to avoid setting incentives to deplete the capital base of banks whose credit quality is decreasing?

14. Buy-backs and exchanges are not driven by an incentive to deplete capital but by sound liability management and directly impact solvency and profitability management. Liability management transactions should be subject to rules governing capital ratios. Furthermore it should be left open to the discretion of a national regulator to determine whether a buy-back would be appropriate on the basis of the bank's overall capital position. We therefore consider notification of the competent supervisor and the supervisor's right to suspend payments including buy-backs to adequately address the situation.

<u>Holdings in own hybrid instruments by the issuer</u>

15. The Consultation paper takes the view that competent authorities should not be prevented from permitting limited buy-back activities for market making or for market smoothing purposes.

We believe that the final paper should be more prescriptive in this respect as the current wording of paragraph 73 may result in introducing a national discretion whereas the objective of the proposed guidelines is precisely to achieve convergent practices across the EU.

2.3. What would be the impact of limiting the amount of repurchased instruments held by the institution at any time to 5% of the relevant issuance? Please provide evidence.

16. Major Banks or Bank Holding Companies are at the same time issuer and lead manager / underwriter in a syndicate for placing hybrid Tier 1 instruments in the capital market. The lead manager of a transaction is expected to be able to make a market in instruments which are placed. Should the market making exception go away, investors would be subject to a potential substantial bid ask spread volatility which would prevent the instrument from being priced in a reliable way.

17. The proposal made in the Consultation paper takes the view that limited buy-back activities for market making or for market smoothing purposes may be permitted provided that at any time repurchased instruments held by the financial institution shall not account for more than 5% of the relevant issue. (paragraph 73)

We believe that the proposed percentage as 5 % may be too low, particularly where small issues are concerned and at the beginning of issuances. We would, therefore, like to suggest setting a limit as the biggest amount of:

- either 10% of the relevant issue should be capable of being redeemed or bought back without the prior approval of the competent authorities 10%,
- or 3% of all outstanding issuances.

B. Flexibility of Payment

General Introduction

18. The Consultation Paper takes the view that payments of coupons or dividends on hybrids can only be paid out of distributable items (paragraph 78). It should, however, be borne in mind that the statement made in this paragraph may have accounting and tax implications. We would, therefore, prefer the proposed paragraph to be deleted in the final version of the implementation guidelines. It basically concerns a company law issue. It should suffice from a regulatory point of view that the bank fulfils the capital requirements as described elsewhere in the guidelines. Deleting the paragraph would not influence the quality of capital.

1. Supervisory request for the cancellation of payments

19. We would like to suggest that the proposed guidelines would include less discretionary elements. More particularly, competent authorities should only be entitled to require payments to be suspended if the circumstances described in the paragraph 81, (a) would increase the risk of capital adequacy requirements being breached in the near term.

20. The suggestion made that competent authorities would base their decision on the planned development of solvency data spanning a period from 3 to 5 years [see paragraph 81, under (b)] does not seem meaningful for payments of coupons which are made today. Moreover, competent authorities may be expected to have received the information referred to in paragraph 81 within the framework of the bank's ICAAP.

2. Other features of hybrid instruments (e.g. dividend pushers and stoppers)

Question 3:
Are the guidelines in relation to dividend pusher or stopper sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended? What would be the impact of the restriction on the use of dividend pusher and stopper? Please provide evidence.

21. We agree that, in principle, competent authorities need to accept dividend pushers and stoppers as they are required to ensure the raking and the marketability of hybrid capital instruments.

Overall, the guidelines which the Consultation paper proposes in this respect seem appropriate (subject to the comments made below).

22. The Consultation Paper explains the circumstances under which dividend pushers must be waived [paragraph 83, (a) and (b)].

Listing these circumstances should suffice. We do not believe that it would be useful to specify on top of this that, under those circumstances, payment of the coupons/dividends will be forfeited and no longer be due and payable by the issuer. Moreover, the sentence saying that "*they should also be waived if the major part of the dividend to shareholders is not paid in cash but in shares*" should be deleted as well (paragraph 83, last two sentences).

3. <u>Substitution of payment of interest or dividend by a payment in the from of an instrument referred to in Article 57(a) (ACSM)</u>

Question 4: ACSM
Q 4.1 Are the guidelines in relation to ACSM sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals on how the text could be amended.
Q 4.2 What would be the impact of implementing these guidelines on ACSM mechanisms? Would you propose any other options?

23. It is proposed that an ACSM would only be acceptable if it achieves the same economic result as a cancellation of the coupon "*and when the issuer has full discretion over the payment of the coupons or dividends at all times*." (paragraph 90)

We believe that it would be useful to clarify this requirement in confirming that the requirement that banks must have full discretion of payments is subject to what is stated in paragraph 82 to 85 of the Consultation Paper concerning dividend pushers and stoppers

Furthermore, the requirement in the same paragraph that deferred coupons be satisfied without delay would need to be amended. The requirement to subscribe immediately reduces the element of flexibility that banks look for so that they can avoid issuing their shares when market conditions are unfavourable. The bank should be able to defer equity issuance until it has emerged from the other side of the stress it is experiencing, if that would be the most prudential approach." If the requirement to use ACSM without delay would nevertheless be maintained, it is important to understand that pre-authorisation for the issuance of share capital to allow for the payment of ACSM for some issuers could be onerous and complex from a legal perspective due to the required board actions, etc. Additionally, if there is systemic pressure and several banks are incentivised to dump ACSM shares into the market for common stock the banking system will suffer additional downward price pressure at a time that important new equity raising could be more important. Therefore allowing bank managers discretion on the timing of ACSM fulfilment based on their assessment of then current market conditions seems a more beneficial and holistic solution for the banks and banking system.

C. Loss Absorbency

II. Loss absorbing mechanisms

1 Ability to absorb losses in liquidation

24. The Consultation Paper takes the view that the existence of losses that make the institution unviable according to prudential banking and/or commercial regulation triggers its liquidation and continues in saying that in this case the trigger for loss absorbency mechanism to be activated is the winding-up of the issuer. (paragraph 100).

We would like to suggest that the term “winding-up” be clarified to ensure a level playing field among jurisdictions.

2. Ability to absorb losses in going concern

Question 5:
Q 5.1 Are the guidelines relating to the definition of loss absorbency in going concern sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

25. The definition of loss absorbency in going concern as it provided by the guidelines is sufficiently clear.

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Question 5:
Q 5.2 Do you agree with the definition of loss absorbency in going concern? If not why and what alternative would you propose?

26. In general we appreciate the definition of loss absorbency in going concern provided by the guidelines, but the part concerning "not hindering the recapitalization" is far too extensive (see further comments below).

2.2 Not hindering the recapitalisation

27. Concerning the requirement that the instrument should not hinder recapitalisation, the Consultation Paper explains at length why new capital provided to recapitalise the institution should not be used directly or indirectly to benefit existing hybrid holders (paragraph 112).

Our impression is that the proposed guideline overly focuses on the legal situation which may arise in those jurisdictions where hybrid instruments are being considered as a liability from a legal perspective for insolvency purposes.

It needs to be observed, furthermore, that the interpretation which is being suggested in paragraph 112 may give rise to differing approaches being adopted across the EU, thus reducing convergence as well as the level playing field between European financial institutions. We wonder in any event if the proposed paragraph is indeed relevant for the subject matter of the Consultation Paper as it rather addresses the restructuring of credit instruments. We would like to suggest removing the paragraph 112 altogether.
The Consultation paper takes the view that hybrid instruments must contain a meaningful statutory or contractual mechanism that will make the recapitalisation more likely by reducing potential future outflows to the hybrid holders and provides examples illustrating the impact of this principle (paragraph114). We believe that the four preconditions set out in paragraph 106 to be sufficient to meet the "loss absorption" requirement and that it would not be appropriate to impose any additional condition. .

Subject to this caveat, we consider the examples provided to be helpful. However, many questions remain. How would "recapitalisation" need to be defined in this context? When precisely would recapitalisation need to be facilitated? To what extent would this need to be done?

The reference which is made to the possibility of writing down the principal permanently (paragraph 114 a) excludes any possibility for the hybrid holders to recover their nominal in case of return to profitability. This is not coherent with their ranking.

The language used in the second example (temporary write-down) suggests that the enunciated principle would override any dividend pusher mechanism stipulated in the contract. We do not believe that this would be acceptable to the market.

In stress situations, all possible stakeholders - the company, the supervisor and the government/finance ministry - should in any event have the flexibility of applying appropriate measures instead of being tied by detailed rules.

We, therefore, would like to stress the fact, that the described possible mechanisms are examples for a meaningful statutory or contractual mechanism and could be modified if applied in a certain jurisdiction.

28. We object to the suggestion which is being made of introducing a particular trigger point at which the hybrid Tier-1 capital instruments would need to be written down or converted. Writing down or converting should be kept at the discretion of the institution and of its competent authority. This will maximise the flexibility to manage exceptional situations such as recapitalisations. We thus strongly recommend the removal of paragraphs 116 and 117.

Question 5:
Q 5.2 Do the guidelines provide sufficient flexibility for institutions to design mechanisms that fulfill the objective of loss absorbency in going concern? What alternative would you propose? Does this flexibility raise level playing field issues?

29. The guidelines provide sufficient flexibility, which is needed to meet the needs of the different jurisdictions. Of course this may result in level playing field issues, but we do not expect these to be very large. To manage these, we would like to suggest that CEBS would monitor how Member States have made use of the flexibility provided to them.

Question 5:
Q 5.4 Do you think that different levels of subordination allow sufficient transparency on the ability of these instruments to cover losses in liquidation? Alternatively, would you prefer to completely preclude different ranking between hybrids?

30. We believe that the ranking issue should be left to individual issuers and, consequently, that rules specifying the ranking within Tier 1 instruments are not needed – provided, of course, that each security meets by itself the overall subordination requirements (junior to depositors, general creditors and subordinated debt, and senior only to Article 57(a) capital instruments).

Limits

Question 6:

6.1 Are the guidelines relating to the assignment of hybrids instruments to one of the three limits sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

31. The guidelines are sufficiently clear in this respect.

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

32. The conversion mechanism which is suggested in the Consultation Paper is excessively severe for an investor who is exposed to all aspects of the risk associated with the bank. As a consequence, the hybrid holder will absorb all losses to the same extent as the shareholders if the value of the bank decreases.

We believe that, when CEBS will discuss guidelines on the definition of Article 57(a), it should be considered accepting those instruments as Core Tier 1 capital on the ground that they have the ability to absorb losses on an ongoing basis and during a liquidation in a manner highly similar to ordinary shares.

I. *<u>Features of hybrids instruments that may be included beyond the 35% limit</u>*

Mandatory conversion

33. We do not believe that it would be appropriate for the guidelines to require that the term "emergency situation" be clearly defined (paragraph 125). To do so might limit the ability of institutions and competent authorities to act with sufficient flexibility and may create unintended consequences which could increase volatility in distressed situations. It should be sufficient that such conversion may occur in case of a breach of capital requirements or regulatory discretionary intervention.

34. Moreover, we do not believe that it would be appropriate to require that any higher regulatory limit than the 4% Tier-1 and the 8% total capital ratio must be identified in the terms and conditions (paragraph 127). This to avoid disclosing discussions between institutions and regulators that should be treated confidentially as they are on forward looking assessments of profitability and business strategy.

Optional conversion

35. The Consultation paper touches upon a basic issue where it takes the view that, even if an institution meets the minimum Pillar 1 requirements, the competent authority may deem the amount of or the composition of its own funds as not adequate to cover risks assessed under the Pillar 2 framework and require the conversion (paragraph 130).

We believe that such a view over-stretches the significance of the Pillar 2 framework, which adopts an entirely different perspective than the Pillar 1 framework does. The Pillar 1 capital adequacy framework addresses a lesser amount of risk types than those which are covered under Pillar 2, and the Pillar 1 solvency requirements need to be assessed exclusively on the basis of those risk types. Referring to the possibilities provided for within the Pillar 2 framework in this context is not adequate. We would, therefore, suggest removing this paragraph.

Conversion ratio

36. The Consultation Paper takes the view that the objective of the predetermination of the number of instruments referred to in Article 57(a) into which hybrids will be converted is to ensure that the instruments included beyond the 35% limit will share losses from the trigger point on, i.e. the downside risk, *pari passu* with shareholders since the issuance (paragraph 133).

We disagree with the view which is taken here that the objective is to make sure that the instrument shares losses from the trigger point *pari passu* with shareholders since the issuance, as this is not relevant to judge the loss absorbency capacity of the instrument. Only the amount of capital raised and its permanence to absorb losses in critical situations are relevant in this respect. But these do are not affected by the conversion ratio as the raised capital has flown into the institute at the date of issue.

To conclude, we agree with the imposition of a maximum conversion rate, but not with the justification. We therefore propose to amend this paragraph as follows:

"*133. The objective of the predetermination of the number of instruments referred to in Article 57(a) into which hybrids will be converted is to avoid potential corporate governance issues associated to the unlimited increase in the number of such instruments in a context of strong decline of market prices and to limit excessive dilution risk for outstanding shareholders in such extreme downside scenario. ~~ensure that the instruments included beyond the 35% limit will share losses from the trigger point on, i.e. the downside risk, pari passu with shareholders since the issuance.~~)*"

37. The Consultation paper takes the view that the maximum number of instruments referred in to Article 57(a) to be delivered should be determined on the basis of the market value of these instruments at issue date (in order to equal the nominal value of the instrument). The mechanism of conversion may reduce this number if the share price increases but not increase it if the share price decreases (paragraph 134).

We strongly oppose that the maximum number of instruments to be delivered should be determined on the basis of the market value of these instruments at issue date. That requirement has nothing to do with the loss absorbency capacity of the instrument, having no impact on the total amount of capital raised or on the permanence of such capital in critical situations.

Instead, the issuer should have flexibility to determine such maximum, taking into account, among other factors, capital markets condition and risk aversion of potential investors.

We therefore propose to amend this paragraph as follows:

"*134. In order to achieve this objective, the maximum number of instruments referred in to Article 57(a) to be delivered should be determined* <u>*by the issuer*</u> ~~*on the basis of the market value of these instruments at issue date (in order to equal the nominal value of the instrument)*~~*. The mechanism of conversion may reduce this number if the share price increases but not increase it if the share price decreases.*"

II. <u>*Emergency situations under Article 66 (4)*</u>

38. The Consultation paper notes that Article 66(1) CRD requires limits to be respected at all times but highlights (i) that Article 66 (4) authorises competent authorities to permit institutions to exceed the overall 50% limit of hybrid instruments in the original own funds and (ii) that the competent authorities may also authorise exceeding the limits set according to the quality of the hybrid instruments i.e. 15% and 35%. It specifies in this respect that the authorisation to exceed the limits also covers the limits set to the additional own funds (paragraph 136).

We welcome that such "passive limit breaches" that are caused by a deterioration of the core capital would be tolerated. This is a significant contribution towards ensuring the permanence of the hybrid instruments from a capital point of view.

1. Issuances via SPV

Question 7: Are the guidelines relating to the indirect issues of hybrids instruments sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

39. The Consultation paper states that "*SPVs are consolidated within the accounts of their parent institution*" (paragraph 139, 2nd sentence).

The second sentence ("SPVs are consolidated…") is confusing as it might be wrongly understood as referring to consolidation as an accounting concept. We suggest deleting the sentence.

40. The Consultation paper states that **"***Original own funds instruments issued via an SPV should be either convertible into directly issued instruments of the same or better quality or subject to a temporary or permanent write-down upon the occurrence of certain trigger events.*" (paragraph 141)

We suggest deleting this paragraph as the relevant requirements are already mentioned in paragraph 140. What is more, paragraph 141 restricts possible mechanisms to write downs while these are only examples for direct issuances.