UniCredit Group

Reply to CEBS on
Its Implementation Guidelines on Hybrid Capital Instruments

General assessment
General assessment As a general consideration, UniCredit Group believes that it is of crucial importance that the level playing field is preserved. Therefore, the expectation is that the forthcoming European Banking Authority will play a key role in ensuring cross-border harmonization.

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

Reaction
We consider the guidelines in relation to "incentive to redeem" sufficiently clear. However we believe that under item 56 - “The cap on the conversion rate at the date of redemption shall not be more than 150% of the conversion ratio at the time of the issue” - it should be made clear that any difference between the nominal value of the instrument to be redeemed and the results of the application of the 150% ratio could be settled in cash. E.g. if the instrument’s notional value is 100 and the 150% ratio returns 75, then the 25 difference could be paid in cash.

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

Reaction
It should be made clear that the difference between the 150% cap to the conversion ratio and the nominal value of the instruments could be settled in cash. In that case there will not be any significant impact on the market. Otherwise, it could potentially be more difficult to price and market the instruments. <u>Additional comments on articles 49 to 70</u> Information listed on points 64.C and 64.D would be onerous to produce. In this regard, the information set already produced within the ICAAP process could be also used for the application for calling or redeeming a hybrid instrument.

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

Reaction
The guidelines in relation to "buy back" are sufficiently clear but we propose that, under certain conditions, buy backs should be made possible before 5 years from the issue data and without replacement. Among the aforesaid conditions, various capital generation actions (e.g. earnings retention, balance-sheet de-leveraging activities, sales of assets) are included. These capital-generation actions would also have the effect of improving the capital quality, by replacing a hybrid-tier 1 instrument with core-capital.

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.
As a basis for its decision CEBS, therefore, wishes to gather further evidence on the following points:
2.2.1. What would be the impact if buy-backs before five years after the issue of the instrument were only allowed under the conditions described in paragraph 72? Please provide evidence.

Reaction
The consequence of such limitations would be the lack of flexibility in capital management that can generate a sub-optimal capital structure. For instance, in case of capital in excess, under the aforesaid limitations a bank would eventually decide to repurchase ordinary shares or distribute larger dividends instead of buying back hybrids.

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.

Reaction
Circumstances in which a buy-back at an earlier stage would be justified: • Retained earnings larger than expected; • Obtaining optimal capital structure after a merger (i.e. as a result of a merger, the capital structure of the new entity could be unbalanced and consequently it could be necessary to take certain actions – including a buy back of hybrids – aimed at rebalancing it) ; • Sale/disposal of assets; • De-risking actions resulting in RWA reductions; • Generating core Tier I through Asset Liability Programmes (purchase price vs. nominal par value).

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?

Reaction
The requested prior written approval by the supervisory authorities based on: a. bank's full risk assessment and capital adequacy (pillar II information) b. economic soundness of the operation is deemed as sufficient to avoid setting incentives to deplete the capital base of banks whose credit quality is decreasing.

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.

Reaction
The regulatory framework should clearly differentiate between buy-back programmes triggered by fundamental changes (see point 2.2.2) in the capital position of a bank and general exemptions typically driven by market-making considerations. As far as the market making activity is concerned, we support the limitation of trading thresholds to 5% (vs. the previously authorised 10% in Italy). The market liquidity can not be generated by the issuing bank, but needs to be based on independent factors such as volume, diversity of investors etc.) The 5% limit would not have any significant impact, except possibly for smaller issuances. With regard to the capital management profile, buy-backs based on a newly assessed capital position should not be limited to any general threshold but be assessed by the regulator on an individual basis.

Question 3:
Are the guidelines in relation to dividend pusher or stopper sufficiently clear or are there issues which need to be further clarified? 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.

Reaction
The guidelines are sufficiently clear and should be maintained.

Question 4:
4.1. Are the guidelines in relation to ACSM sufficiently clear or are there issues which need to be further clarified? Please provide concrete proposals on how the text could be amended.

Reaction
As a proposal, the substitution of cancelled coupon payments with newly issued common or preferred shares should be subject to limitation in order to avoid dilution in times of financial distress. Such a limitation can be provided by applying a percentage cap or a restriction based on the nominal value of the shares outstanding (i.e. not to issue below the nominal value).

Question 5:

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

Reaction
The guidelines are sufficiently clear.

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

Reaction
Yes, we do.

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

Reaction
To some extent the guidelines are very tight and don't provide sufficient flexibility to design loss-absorbency mechanisms. As a result, not only would the issuer face higher costs, but also the marketability of the instruments could be significantly adversely affected. At the same time, discretionary power with the supervisory authorities is left which could cause the issuers to set the above-minimum loss-absorbency triggers at different levels which are different from country to country. As a proposal, criteria should be defined at EU level so as to set triggers which are consistent with the level-playing field approach.

5.4. Do you think that different levels of subordination allow sufficient transparency on the ability of these instruments to cover losses in liquidation?

Reaction
Yes, different levels of subordination should be able to allow sufficient transparency on their ability to cover losses in liquidation.

Alternatively, would you prefer to completely preclude different ranking between hybrids?

Reaction
No, we would not.

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 further clarified? Please provide concrete proposals how the text could be amended.

Reaction
They are sufficiently clear.

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

Reaction
As stated above, the guidelines should go towards a homogeneous regulation at a European level. If that is the case, the mandatory conversion provision (when it says that "Where competent authorities have set higher limits, either on a general basis (i.e. for all institutions) or for a single institution according to article 136, reference is made to such higher limits") leaves the discretionary power to set the limits to each single EU national regulator. This may result in differences between member states. Furthermore, the optional conversion - "the competent authority must have the option to trigger conversion of the hybrid" – goes in the same direction and hence we believe that either it should not be included in the guidelines or it should be written in a more objective way so that all the regulators should behave in the same way when facing similar situations.

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

Reaction
Guidelines are sufficiently clear. We would propose smoothing the requirement that "institutions that issue hybrid instruments in foreign jurisdictions must demonstrate that they have mitigated any associated legal risks" with a less imperative (for instance "institutions have considered any associated legal risk by providing a satisfactory legal opinion").

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