Committee of European Banking Supervisors

CEBS

23 June 2006

First part of CEBS technical advice to the European Commission on own funds

Analysis of the capital instruments recently created by the industry

Introduction

Purpose of the analysis

1. CEBS received in June 2005 a call for advice from the European Commission ('the Commission') to inform the Commission's planned review of own funds. One of the pieces of work CEBS is invited to undertake was an analysis of the capital instruments recently created by the industry.

2. In response to this call, CEBS has sent a questionnaire to market participants in order to set out its views on the lessons to be learned from the new trends in the quality of regulatory capital. This analysis includes capital instruments that national supervisors have recently been asked to consider for regulatory own funds purposes. New trends, market conventions and industry expectations have also been considered.

Methodology

3. A questionnaire to market participants was posted on the CEBS website in November 2005 for completion by February 2006. The following questions were asked:

(i) What kind of innovative instruments have reached a reasonable market standing? Why? What characteristics do they have in common?

(ii) What are the main market conventions/factors that govern the issues of innovative instruments?

(iii) What new trends, e.g. in terms of domestic market structures and investors' appetite have you identified? What would prevent/alternatively favour the development of innovative instruments?

(iv) What will be the characteristics of innovative instruments in the future?

(v) What are your key expectations and key concerns regarding the supervisors' approach to innovative instruments?

(vi) In your views as market participants, what main differences in supervisory approaches have the most important impact on the structure and quality of own funds?

4. Nine Banking associations and five individual entities kindly participated. All but two responses, whose authors requested that they remain confidential, are publicly available on the CEBS website

5. The report aims to reflect the input received.

6. Informal dialogue with experts designated by the CEBS Consultative Panel and of the main European banking associations was very useful to assess whether the survey was reflective of the industry issues and allowed for collection of complementary information.

Terminology used

7. Two terms -"hybrids" or "innovative" instruments - are commonly used by the industry when speaking about capital instruments. They may however have different meanings.

8. The term 'hybrids' is normally used by the rating agencies and internationally-active institutions to refer to instruments that combine to some extent the features of both debt and equity. Preferred shares or securities are often but not always included in this definition.

9. The term "innovative" is commonly used with the meaning of the wording of the Basel press release of 1998[1] ('the Sydney press release'). Since then the expression "innovative Tier 1" seems to designate a specific part of hybrid instruments: the new forms of capital eligible for Tier 1 which include an incentive to redeem, like a step-up or other features, and are usually limited to 15% of Tier 1. In this context, 'non innovative instruments' would refer to instruments without an incentive to redeem.

10. Supervisors face the same difficulties with such various terminologies. For the sake of clarity, and for the purposes of this report[2], the term 'hybrids' designates securities which seek to

[1] Please click www.bis.org/press/p981027.htm

[2] This terminology has also been used in the CEBS Survey of the implementation of current rules on own funds across member states. Please click www.c-ebs.org

replicate some of the qualities of common equity and the term 'innovative' designates hybrids with an incentive to redeem.

Main findings of the survey

- The issuance of hybrids depends first and foremost on the issuer's need for a higher level of own funds and on the market conditions available at the time of issuance. The characteristics of these instruments are specifically designed to allow for cost-efficient and less dilutive fund raising.

- When designing an issue, the market has in mind the three key prudential criteria that instruments will be assessed against in order to be eligible as original own funds: permanence, ability to absorb losses and flexibility of payments. Hybrids rank junior to all general creditors and subordinated liabilities of an institution and are perpetual. Payments of interest can be waived to absorb losses on a going concern basis and in periods of stress; redemption is not permitted if it endangers the solvency ratio.

- These key features are translated into complex provisions and mechanisms which differ from one country to another, mainly because of the variety of legal and tax systems. Market participants, including regulators, clearly face a wide range of instruments which try to strike a balance between the investors' views (high yield instruments which are expected to be redeemed), the institution's views (cost-efficient fund raising and a buffer to more senior debts in case of impending bankruptcy in order to be able to trade through a solvency crisis) and the supervisor (financial soundness and solvency of the institution).

- Market practices claim to be broadly in line with the Sydney press release which sets out (i) the high level principles and objectives that need to be satisfied in order for hybrids to qualify as Tier 1 and (ii) the 15% limit for qualifying Tier 1 hybrids with a step-up or any other incentive to redeem.

- However the market has also developed hybrid instruments without step-ups or other similar incentives to redeem which may be recognised as eligible Tier 1. The extent to which these hybrids are recognised differs across member states, from 15% up to 50% of original own funds.

The latest trends in the market

- The current European market for hybrids is estimated at around 60 billion euros.
- The market for hybrid instruments is a fast-growing market both in terms of volume and in terms of diversity of instruments: the market is very imaginative. In a favourable context of low interest rates over the past few years, this growth has mainly been driven by return on equity considerations and an increased focus on

capital management by a growing number of issuers. The widening of the investor base constitutes another major catalyst for growth.

- Respondents are of the opinion that the market is still under development. However market development can also reach its limits if instruments become structured in too complex a way to be easily understandable and marketed, and therefore less suitable especially for retail investors.

- The future characteristics of hybrid instruments will depend to a large extent on regulatory (which structure belongs to which class of capital), accounting (equity or debt) and tax requirements, and to the rating agencies' and auditors' approaches to these structures as well as to general market conditions, which are difficult to predict. The new structures which are developed often contain more complex structuring of coupons. In addition few recent structures were specifically designed to obtain a specific accounting classification under IFRS/IAS.

Approaches developed by rating agencies

- Hybrids have become an increasingly significant component of the fixed-income market. Given the current characteristics of such products, the challenge to rating agencies is to assess to what extent these instruments are behaving like debt instruments (they are paying regular coupons) and when they are behaving like equity (absorbing losses).

- Some rating agencies have recently refined the basis on their assessment method to put more emphasis on the 'equity' content of these instruments. Their assessment criteria of hybrids include that of permanence, of loss absorption and of flexibility of payments. They also put limits to the inclusion of hybrids in their capital measures (or/and haircuts on hybrids' nominal amount).

Main expectations expressed by respondents

- Given the global nature of the market, respondents advocated that it is important that any decisions made in the EU are taken with due consideration of the possible competitive distortions for European institutions.
- A more homogeneous regulatory approach across the EU is expected especially with respect to the establishment of 'standard-recognised features' e.g. harmonisation of maturity requirements, common treatment of stock settlement, common understanding of allowable coupon structures, participation in current losses and the degree of subordination. These requirements should be neutral as to how they are fulfilled under the applicable contracts or laws.

- The industry calls for a wider inclusion of hybrids (including innovative) instruments within original own funds.

- Respondents also asked for a mandatory disclosure of the supervisory practices

- Respondents raised concerns that supervisors could adopt a very conservative and prescriptive approach to innovation, therefore lagging behind the innovative industry. Concerns also pointed out the impact of divergent limits for cross-border groups.

- Respondents welcome any improvement in market practices themselves: greater recognition by rating agencies, common terminology, standardisation of the features and standardisation of legal documentation so that the instruments are more easily comparable and understandable, and thus easy to market.

- Contradictions sometimes appear between the different respondents e.g. (i) part of the industry advocates continuity of the current regulatory requirements, another wishes to see a common approach to regulatory own funds developed, by widening the discussion to all layers of capital and seeking harmonization with the insurance sector; and (ii) the supervisory approach should be flexible enough to allow for innovation but at the same time rules should be prescriptive to foster legal certainty.

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Part 1. Main features of the hybrid instruments covered by the survey

1. According to the respondents to the CEBS questionnaire, there is a range of hybrid instruments that has reached a reasonable degree of market standing. It includes non cumulative trust preferred securities, equity contributed through silent partnership interests, undated deeply subordinated non cumulative notes and perpetual bonds with a stock settlement mechanism.

2. The issue of hybrids depends first and foremost on the issuer's need for a higher level of own funds and on the market conditions available at the time of issue. The characteristics of these instruments are specifically designed to allow for cost-efficient fund raising.

3. Factors that influence issues are the treatment by the tax authorities, the legal and accounting framework, the requirements set out by the auditors, the views of the rating agencies in their capacity of assessing the capital structure of the institution and the supervisory rules with regard to regulatory original own funds.

4. It was noted that the interests of the parties concerned by the issue of hybrids are generally different, even sometimes contradictory. Whereas supervisors and rating agencies normally require that these instruments very closely resemble equity, investors have a preference for instruments that have the same features as debt. It was noted that this is the reason why the characteristics of the instruments are so complex.

5. Hybrids are advantageous to banks management and shareholders as they can raise funds in a form that is more cost-effective and less dilutive than common equity. Coupon payments are usually tax deductible, which makes them more cost effective in comparison with common equity. Issuance of hybrid instruments is also a strategic decision, in terms of pricing the instruments and of the distribution objectives of the issuer.

6. Unlike subscribed capital and reserves which are mandatorily denominated in the domestic currency, issuance of hybrid original own funds instruments is possible in foreign currency, e.g. EUR, USD, GBP or JPY. This allows issuers to hedge balance sheet exposures with capital denominated in the appropriate currency, or to raise capital at a more attractive all-in cost.

7. The generally observable features of hybrids include the following:

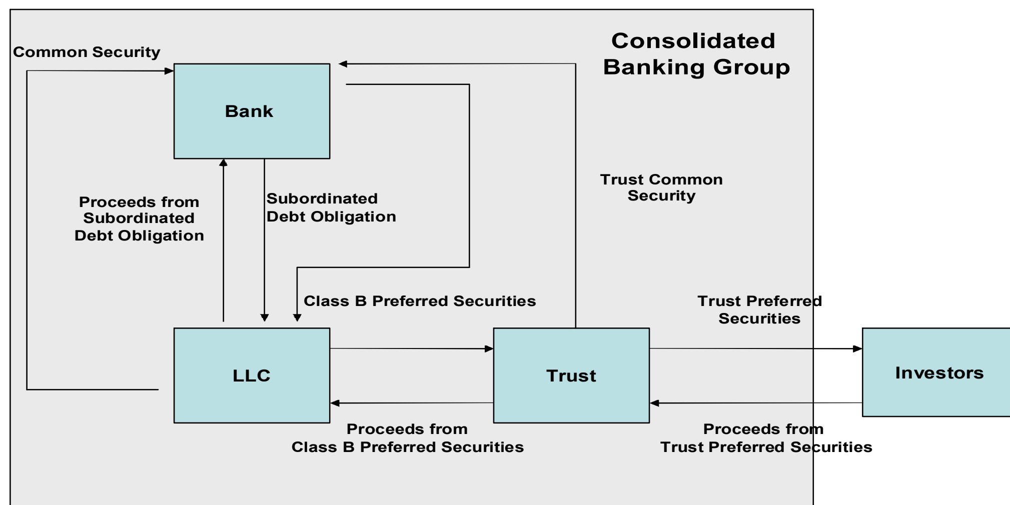
Indirect issuance

8. Originally, hybrid instruments were developed in the United States where they were issued indirectly through a special purpose vehicle structure. The first European hybrid instruments were indirectly

issued but the market quickly developed so that hybrids are now both directly and indirectly issued.

9. Issuance can be done directly by an institution or indirectly by using a Special Purpose Entity (SPE). The choice is often determined by the legal, regulatory and/or tax framework within individual national jurisdictions (e.g. direct issuance in Denmark, Finland and Norway; indirect issuance in Greece) However a significant number of jurisdictions permit issues in either direct or indirect form (e.g. Belgium, France, Germany, Italy Netherlands, Spain, Sweden Portugal and the United Kingdom).

10. Often an indirect issue is made from a SPE located in a low or non-tax paying jurisdiction or as a tax transparent vehicle in an EU jurisdiction. The subsequent inter-company loan back to the parent from the issuing vehicle results in the proceeds being advanced to the parent on issue. The following (slightly simplified) diagram shows the mechanism for such a transaction:



11. The choice of the issuing jurisdiction can depend on the nationality of the issuing institution but the most commonly used vehicles are Delaware limited partnerships, Jersey limited partnerships, English limited partnerships, and companies established in the Channel Islands or the Cayman Islands.

Subordination

12. Hybrids generally rank junior to all other obligations of the institution. They rank pari passu with preference shares and they are senior only to ordinary share capital. Subordination to the level of preference shares provides depositor protection in the event of insolvency.

Call features

13. Most hybrid instruments are undated. However, they often contain redemption features which provide the issuer with an unfettered right to call after a period of at least five years. The exercise of the call is at the complete discretion of the issuer but subject to regulatory approval.

14. The terms of hybrid instruments usually ensure that the issuer has full legal flexibility around the call features [with the exception of the minimum period of five years]. All the features set out below are not permissible within 5 years of issue.

Step-up

15. In a classic hybrid, the coupon remains fixed for the life of the instrument, i.e. the instrument pays a fixed annual amount in perpetuity. However, depending on the target investors' needs, the coupon structure might change ten years after issue (regulatory threshold), in conjunction with a call option, in the case of innovative instruments. The most common coupon adjustment is that a fixed coupon changes to a floating one or that it is reset to a new fixed coupon e.g. every five years.

16. Coupons on innovative instruments are then usually reset at a higher rate (step-up) if the instruments are not called. These 'option to re-finance' features are important for investors as they provide them with some confidence that the issue will be called. Investors believe that the institution will be able to refinance the issue more cheaply than at the increased coupon rate at the call date. Such securities are therefore priced to the first call, although if they were not called, the undated issue would remain outstanding as permanent capital. The step-up is generally 100 bps or 50 % of the initial re-offer margin.

17. In an impending bankruptcy scenario, most hybrids have the contractual flexibility not to be redeemed despite the existence of call and step-up features.

18. Usually, the call and step-up provisions are exercised subject to supervisory approval. This aims to prevent the institution from facing a situation where the impact of any of these provisions will actually increase the cost of capital just at a moment when it can least afford it.

Ability to suspend payments

19. Hybrids are usually legally non-cumulative, i.e. if the coupon payment is not made at a certain point in time, it is cancelled. Moreover, the current terms of hybrids grant full flexibility for the issuer to suspend payments in the case of concerns. However, they also contain sophisticated investor-friendly schemes which aim at securing some kind of payments for investors.

20. Hybrid instruments across Europe generally provide the issuer with discretion over whether to make cash distributions in certain circumstances or whether to opt for deferral of interest or dividend payments e.g. in the event of breach of regulatory capital ratios or solvency difficulties or bankruptcy.

Dividend stoppers/Dividend pushers

21. Hybrids generally include features preventing the payment of dividends (dividend stoppers) on common stock and other equally ranking securities or the repurchase of equity or equally ranking securities in the event that an issuer exercises its discretion to suspend coupon payments.

22. This is designed to preserve the hybrids' ranking ahead of ordinary equity and pari passu with other hybrids issued by the same institution.

23. On the other hand, some structures contain dividend pushers, requiring an institution to pay the coupon on the hybrid structure, often within a time window, if it has paid dividends on its common stock.

Alternative coupon satisfaction

24. Some issues contain an investor-friendly feature (commonly known as an *Alternative Coupon Satisfaction Mechanism*) requiring the institution to issue enough new common stock in the market to raise cash to pay investors the deferred distribution, either at redemption or upon return to regulatory health, when the institution wishes to resume coupon payments. No financial resources are transferred out of the institution to bondholders and payment to the investor is held for deferred distribution.

Scrip Features

25. Other issues contain a feature (known as a *Scrip Feature* or *Payment in Kind Feature*) which is sometimes used within the context of non-cumulative structures. This feature gives the issuer the option to forego cash payments and instead make payments by issuing additional instruments. For example, where the instrument is a preference share or preferred security, the issuer could give issuers additional preference shares or preferred securities in lieu of the cash payment. Scrip Features differ from the Alternative Coupon Satisfaction Mechanism described above because they are legally non-cumulative and therefore do not accrue a cash claim.

Principal Stock Settlement

26. A few issues also contain principal stock settlement clauses to repay principal. This meets the objective that capital should be flexible in its payment characteristics and meets the objective of permanence too, by substituting one permanent issue with another. Some

supervisors have expressed concern about the potentially dilutive effects of stock settlement clauses and their perception of the implicit pressure on institutions to redeem such structures for cash rather than issue new shares. Consequently some supervisors have imposed limits on the quantum of shares that may potentially be issued under them.

27. It can be argued that these are primarily corporate governance issues rather than regulatory ones. These stock settlement features can be dilutive for ordinary shareholders, however these ordinary shareholders have already approved the stock settlement feature in the knowledge that (in extremis) it could come at the expense of their loss of control of the institution. The key regulatory issue is whether, in a situation of financial distress, the quantum of stock that would be issued is potentially so large that it creates an incentive to redeem in cash when the institution (and its depositors) can least afford to do so.

Limited default

28. Innovative structures contain very limited events of default and no cross default provisions.

Regulatory limits

29. European Banking supervisors have established limitations on hybrid original own funds (instruments structured with and without the incentive to redeem) in their respective jurisdictions to limit "undue reliance on innovative instruments" as stated in the Sydney press release.

30. Instruments containing a step-up or other feature that might lead to the instrument being redeemed at a point in time (usually called innovative instruments) are generally limited to 15% of the consolidated institution's Tier 1 capital as explained in the Sydney press release.

31. Other hybrids that contain no incentive to redeem are often accepted with a higher limit. The limits applied to this category vary between countries and not always publicly disclosed. The table below gives an overview of the limits currently applied. Further detailed information can be found in the survey of the implementation of national rules on own funds: www.c-ebs.org

	Supervisory Limit on innovative (hybrids with step-up)	Supervisory Limit on hybrids excluding non cumulative preference shares (pref. shares are defined under national company law)	Limit on non cumulative preference shares as defined under national company law [1]
	Non additive limits		
Austria	15%	30%	50% [2][10]
Belgium	15%	33%	33% [8]
Cyprus	15%	15%	no limit [2]
Czech Republic	nr	nr	nr
Denmark	15%	15%	nr
Estonia	nr	nr	nr
Finland	15%	33% [3]	50% [4]
France	15%	25% [5]	nr [6]
Germany	15%	50%	nr
Greece	15%	30% [7]	no limit [2][4]
Hungary	nr	15%	no limit [2]
Ireland	15%	50%	no limit [2]
Italy	15%	15%	50% [2] [9]
Latvia	nr	nr	nr
Lithuania	no issuance	no issuance	33% [8]
Luxembourg	15%	15%	nr
Malta	15%	nr	nr
Netherlands	15%	50%	50%
Norway	15%	15%	no issuance
Poland	nr	nr	nr
Portugal	20%	20%	50% [2] [4] [10]
Slovakia	nr	nr	nr
Slovenia	15%	15%	49%[2]
Spain	15%	30%	30%
Sweden	15%	15%	no limit [2]
UK	15%	15%	50% [2]

nr=not recognised

[1] Excluding preference securities issued by SPV.
The definition and features of a preference share may vary between member states.
[2] Preference shares issued under national company law are considered as core original own funds
[3] 15% since december 2005
[4] Issuance by banks is unusual
[5] The 25% limit apply also on minority interests, even if they do not come from indirect issuance of hybrids
[6] No issuance so far
[7] 10% for innovative and 25% for any hybrid since 2006
[8] National Company laws provides this limit in percentage of the total of ordinary capital but banks have not yet issued any
[9] Limit applicable to listed institutions only and stated in percentage of total of ordinary capital, in the National company law
[10] limit stated in the national company law; calculated in percentage of total of ordinary capital

Source: CEBS Survey of the implementation of the current rules on own funds across member states: ***www.c-ebs.org***

Part 2: The latest trends in the market

A fast-growing market

32. Market participants indicated that the current European market for hybrids is estimated at have reached around 60 billion euros in 2005, with the number and the volume of issuances boosting after the Sydney press release in 1998. Industry experts indicated that the market is roughly composed by Perpetual Non Callable 10-y with step up (around 50 billions Euros in 2005, in favourable market conditions), but the amount of issuance without step up rapidly increased to account for around 10 billions Euros in 2005.

33. Industry experts identified three main geographic areas where there is a significant investor base for hybrids: the US market, the Asian retail market and the European institutional market. The European retail market is however becoming more and more prominent.

34. Within Europe, it is generally estimated that insurance groups in the United Kingdom and Benelux account for 2/3 of perpetual issuance volume since 2000. The United Kingdom accounts for almost half of the perpetual issuance volume in the banking sector. Corporates by contrast mostly issued in Iberia, Germany and Austria.

35. The institutional market is the most common market for hybrids where the focus is on credit analysis and relative value. Given that the alternative investments for the market participants are typically dated government and corporate bonds, these investors tend to look for hybrids with similar features and, particularly to innovatives (hybrids with an incentive to redeem, like a step-up).

36. The retail market is more commonly accessed for preference shares or other hybrids without an incentive to redeem, but is also available for innovative instruments that meet the buyers' investment priorities. Because retail investors hold smaller portfolios, and trade less often, they seem to be less focused on relative value, and more on finding instruments that are similar to the alternatives they have (often bank deposits). So they are more open to perpetual trades without step-ups.

Widening of the investor base

37. The broader market acceptance of hybrid instruments due to investors' higher risk appetite and their demand for deeply subordinated notes in recent years has led to significant widening of the investor base.

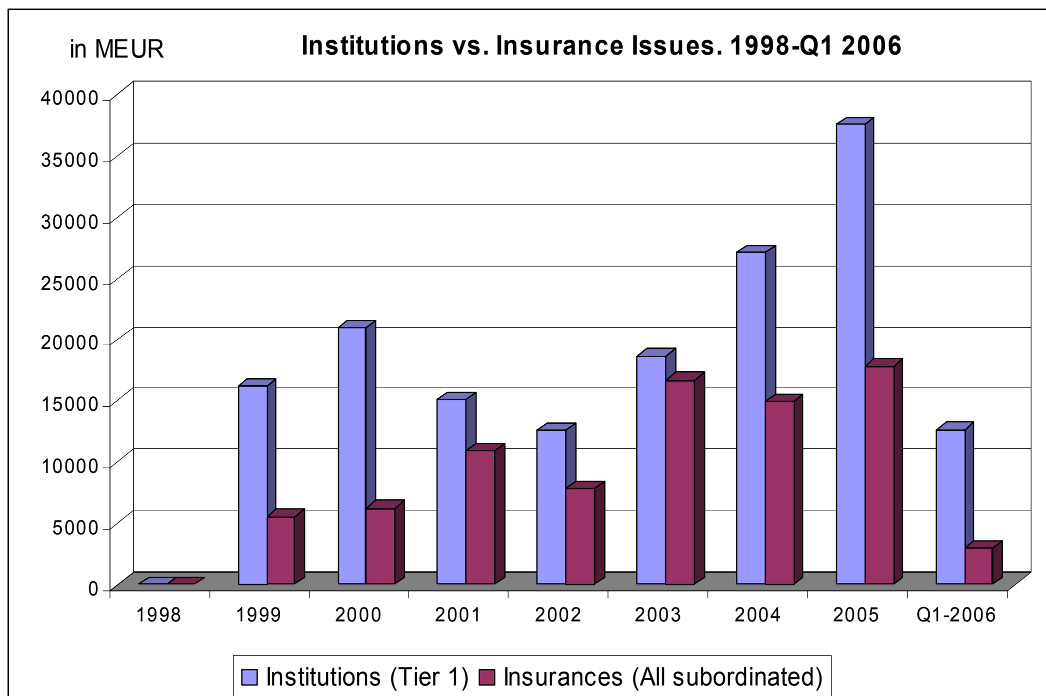
Retail market

38. Because of the historically low interest rate environment, investors (especially in the domestic retail markets) are attracted by the comparatively high yields hybrid instruments offer and grant issuers a higher degree of flexibility. Although the retail market has not been a reliable source of funding in the past, it has grown to a highly liquid and large investor base.

39. The economic terms available in the retail markets can often be an attractive alternative to those offered by institutional investors which has led to a trend towards greater domestic distribution of hybrids instead of the use of the pan-European capital markets. Some respondents believe that certain subordination features are not yet adequately priced by the markets. Institutions believe that once this has happened, possibly as a consequence of returning confidence in the stock markets or a higher interest rate environment, investors will no longer accept some features or the transactions will no longer be economically viable.

New issuers

40. In recent years non credit institutions such as insurance companies and non-regulated commercial enterprises have started issuing hybrids and institutions face growing competition from these issuers in the capital markets. The graph below illustrates this trend.



Source: Deutsche Bank

Increasing direct issuance

41. Although the market for hybrids has became broader and deeper in recent years, they have mostly been issued up to now by internationally-active institutions within global programs to meet the specific needs of particular investor groups and for tax optimization purposes.

42. Many of these transactions have been issued via SPEs, but there is a growing desire to develop directly issued and tax efficient instruments. Direct issuance leads to lower transaction costs, which also opens the market for smaller institutions. Hence the market share of direct issues is rising.

A search for higher yield with moderate risk

43. A higher degree of sophistication of products generally and demand from institutional investors are reasons for a greater variety of instruments and the complex structuring of their coupons.

44. Historically fixed rate structures have dominated the innovative market although there has also been periodic issuance in floating rate format. More recently there has been a trend towards instruments with more complex coupon structures where distributions are linked, for example, to outcomes in the swap market (e.g. distributions will be determined by the steepness of the Constant Maturity Swap curve). Such instruments are generally known as "CMS-linked". They are a specialised tool for reducing funding costs.

45. Some investors may also be interested in even more complex coupon structures to improve their returns. Against this background, particular care has to be taken by the issuing institution in terms of risk disclosure and investor suitability.

46. Institutions believe that the entry into force of the Capital Requirements Directive in 2007 might cause capital demand to become more volatile and procyclical, and in this context, some institutions expect the development of forward contracts or options on original own funds instruments to be issued to secure market access and funding.

A new accounting environment

47. The implementation of IFRS has introduced a changing of accounting classification of many hybrids instruments under IAS 32, though a consistent application has not yet been developed -the subject is still pending at the IFRIC level-. Hybrids are classified as equity under IAS 32 whereas they used to be treated as debt under national GAP. As IFRS prevent the application of hedge accounting to equity accounted instruments under IAS 39, it introduces P&L volatility because the economic hedging is marked to market while the underlying equity-accounted hybrid instrument is not. Consequently

few hybrid structures have then been recently designed to obtain an accounting classification as debt under IAS 32.

Part 3: Approaches developed by rating agencies

48. Besides the banking industry and supervisors, rating agencies are also important stakeholders in the markets for hybrid instruments. Hybrids have become an increasingly significant component of the fixed-income market. Given the current characteristics of such products, the challenge to both investors and rating agencies is to assess to what extent these instruments are behaving like debt instruments (they are paying regular coupons) and when they are behaving like equity (absorbing losses).

49. To reflect their growing experience with these instruments, three major international rating agencies, Moody's, Standard and Poor's and Fitch Ratings have updated their approaches to the evaluation of institutions' hybrids in the last 12 months.

50. Moody's has developed an equity-debt continuum, which is divided into five baskets, with each basket representing a certain degree of equity benefit that can be attributed to the instruments. It ranges from 0 to 25, 50, 75 and 100%. The assignment of a hybrid to one of the baskets is based on the ranking of an issue's characteristics along three dimensions "No Maturity", "No ongoing Payments" and "Loss Absorption" scored in terms of their strengths relative to common equity.

51. The approaches of both Standard and Poor's and Fitch Ratings are different as they allow a certain portion of an institution's capital, which is taken into account for capital analysis purposes, to consist of hybrid instruments. Both rating agencies also use an equity-debt continuum, which is divided into different classes. Hybrids are assigned to these classes depending on their loss absorbing characteristics (Fitch Ratings) or their equity content (Standard and Poor's). Instruments of higher classes (which are more similar to equity than to debt) are included up to a higher portion into the rating agencies' capital measures than instruments which are assigned to lower classes. The limits applied to the different baskets are not cumulative.

52. In the same vein as Moody's haircut applied to hybrids on the grounds of their equity content, Fitch Ratings applies a reduction to the nominal value of hybrids with cumulative features, in addition to their limitation in own funds.

Part 4: Expectations expressed by respondents

53. Market participants have often expressed contradictory views on the impact regulatory approaches have on the market and on how to promote a competitive European-wide market for high-quality and cost-effective hybrids.

54. The main concerns which have been expressed by market participants are:

Global perspective

55. Given the global nature of the market, respondents advocated that it is important that any decisions made in the EU are taken with due consideration of the competitiveness of European institutions.

Common regulatory approach in Europe

56. Some institutions argue that efficient development of hybrids is hindered by the different regulatory interpretations of the Sydney press release across Europe together with super-equivalent regulatory requirements in some countries.

57. One banking federation pointed out, however, that differences in the structure of the instruments result less from different regulatory approaches than from diverging company and tax laws in different member states which limit the institutions' options for issuing hybrids. These difficulties might be counterbalanced by a more flexible regulatory framework.

58. In particular, for one respondent, accounting equity should remain the basis for determining regulatory capital but international accounting standards in particular do not allow for the proper treatment of all instruments which fulfil the requirements for original own funds. Thus adjustments to accounting equity remain necessary to measure regulatory capital and the regulatory treatment of certain instruments should remain independent from their accounting as equity or debt or their taxation. The focus of the regulatory work should be on the economic substance and not on the legal or accounting form of a hybrid.

59. It was noted that any differences in supervisory approach to the classification or the characteristics of hybrids across the EU has an impact on the structure and quality of own funds. This is especially true for the distinction between innovative and non-innovative instruments implemented by some national supervisors as well as the detailed rules governing these instruments at national level, which may have a significant impact on the attractiveness of these instruments in the international capital markets. These differences may pose special problems for institutions in smaller countries,

which have to rely on international capital markets. Therefore, regulators should allow an open dialogue on structural features of hybrids which would make issuers more comfortable with pursuing new structures.

60. Beside these quite general remarks some detailed issues were raised by the industry when supervisory approaches differ across Europe:

- coupon deferral requirements should be harmonised: some supervisors allow the option to defer at any time while others require a mandatory deferral at certain trigger events;

- harmonisation of perpetuity requirements - long maturities (60 years) vs. perpetual structures; innovative instruments with long "soft" maturities should be allowed (30 to 60 years maturity); and perpetuity should no longer be mandatory;

- admission of hybrids with stock settlement features as original own funds' and up to what limit; and

- different views on allowable coupon structures or the level of step ups and the treatment of step up-structures vs. structures without step ups.

Cross borders issues

61. Different supervisory approaches towards new forms of capital might especially be a problem for banking groups with cross border activities in cases where the home and the host supervisor cannot agree on the regulatory treatment of the special features of a certain instrument. In this context, they may also have significant impact in Mergers & Acquisitions situations as they either offer cheap and quick access to funding when bidding for a target (in countries which allow a high portion of new structures in Tier 1), or hybrids cause problems if structures issued by a subsidiary are not recognized on a consolidated level in the country of the acquiring institution. A significant lack of harmonisation is seen in this context by the banking industry.

Corporate governance issues

62. It was pointed out it differences in corporate governance regimes when it comes to issue a bond-like or a share-like instrument, dilution of shareholders, distribution of dividends etc.., although not within the responsibility of banking supervisors can be an issue from an investor's perspective.

Principles based regulation

63. When developing a principles based approach to the recognition of hybrids, the judgement, whether an instrument can be included in Tier 1 capital or not, should be based on common criteria such as permanence or the term to maturity of the instrument, terms of the

coupon payments, repayment of the instrument, participation in current losses and the degree of subordination.

64. A common definition of these criteria should be developed which would aid both investors' understanding and regulatory clarity and transparency. In this context a clear and transparent definition of the terms "incentive to redeem" and "full discretion" are seen as being extremely helpful, as they are interpreted differently by different national supervisors. In this way disagreements over certain features between the banking industry and the supervisors could be avoided and a common understanding and more homogenous application of rules for own funds across Europe and in Basel countries fostered. This is particularly necessary in cases with complex coupon structures that can become very volatile, so that they may or may not be viewed as an incentive to redeem in different jurisdictions.

65. Supervisory convergence could also be promoted through supervisory disclosure of approaches to hybrid instruments.

Wider recognition of hybrids in original own funds

66. On the whole, the banking industry expects an increase of hybrids in overall Tier 1 capital over time.

67. Respondents advocate a generally wider recognition of hybrids in original own funds, as this would support future market development.

68. One of the underlying economic reasons of the growth of non-innovative hybrids put forward by market participants was that the market has matured and most institutions are currently approaching the 15% limit, and are issuing instruments with features (e.g. no step up, soft maturities, loss absorbent mechanisms) which could allow them to be recognised 'outside' the 15% limit.

69. The overall extent to which hybrids are included (the 'second limit' were the supervisory limits vary from 15% to 50%) should therefore be harmonised at the highest level possible.

70. The regulatory treatment of hybrids in the United States which allows cumulative perpetual preferred stock within certain limits as Tier 1 capital of bank holding companies, was also mentioned.

Grandfathering

71. Having clarity and certainty on the status of issuance under the existing rules moving forward is essential, as it could be costly to re-organise capital structures of institution in short notice. The regulatory treatment of existing issues of hybrids should therefore be maintained via grandfathering until their final maturity. When issuance is perpetual, transitional provisions should be put in place.

Standardisation of procedures

72. There was a broad acknowledgement that common definitions would help the understanding, clarity and transparency of the market. The lack of standardisation on the part of market participants, which is responsible for a variety of different documentation requirements, must be reduced.

73. In the context of callable structures which are in general subject to prior supervisory approval, the banking industry proposes the development of a standardised procedure which an issuer has to follow if he wants to exercise a call feature. As it is a two way process, the banking industry also recognises that issuers need to provide supervisors with the information they need to make the decision.

74. Procedures should also be put in place to set the timeframe within which the supervisor has to take a decision and to set out the information which the supervisor needs to make this decision. Indeed, a shorter period of time for the regulatory approval of market innovations would also favour further development of the market, as undue delays may lead to temporary market opportunities being missed.

75. Moreover, once supervisors have approved an instrument, there should be a predetermined number of days in which they have to decide on new issues with the same structure to enable issuers to take advantage of temporarily favourable market conditions.

Improvement of market practices

76. Adverse changes in accounting or tax treatment, such as the abolition of the tax deductibility of coupon payments, might negatively impact market development in the future. Tax optimisation must be possible without impacting the level playing field.

77. The banking industry states that a wider recognition of hybrids by rating agencies and more competition within the rating industry would favour development of the market in the future.

Towards a new set of rules and if so which ones?

78. Some institutions argue that no changes in the definition of regulatory own funds and treatment of hybrids should be made in the near future due to the complex Basel II implementation and advocate a continuity of regulatory requirements. There is also a concern that supervisors might not be able to bridge the gap between their ideas and the market's requirements if any new supervisory rules for Tier 1 hybrids are implemented in the near future.

79. On the other hand, some respondents advocated a common European approach as regards the definition of own funds. However, they put different emphases on what this approach should primarily aim at. Some highlighted that it should not only focus on the intrinsic features of the capital instruments at stake but should also take account to the largest extent possible of the local market environment. Others argued that this common approach should be neutral as how it should be fulfilled under the applicable contracts and laws.

80. Respondents also proposed widening the discussion on own funds to all classes of capital and the limits between them. They emphasized that there was a strong need for harmonisation between banking and insurance capital. The need to ensure a level playing field between issuers and to enable investors to compete in equal terms should drive the move towards harmonisation.

81. The respondents acknowledged that the main source of differences across Europe would remain the various national tax and company laws. A respondent suggested having a common tax deductible structure for all EU Member States.

82. Some respondents would favour a principles-based framework within which innovation could take place, others wish to have more certainty and prescriptive rules to smooth the design of capital instruments and keep the highest quality/yield of the products they invest in.