European Association of Public Banks

– European Association of Public Banks and Funding Agencies AISBL –

Committee of European Banking Supervisors – CEBS

cp27@c-ebs.org

23 September 2009

EAPB comments on CEBS' consultation paper on implementation guidelines regarding Hybrid Capital Instruments – CP 27

The EAPB would like to thank CEBS for the possibility to comment on its proposals for implementation guidelines regarding hybrid capital instruments. We also welcomed the open hearing CEBS organised on this issue beginning September.

Our members generally welcomed the principles based approach taken by the Commission and which was followed by the European Parliament and the Council in harmonising the rules for hybrid capital instruments. Given the speed of developments in this field and persisting national specificities, the stipulated principles leave enough flexibility for institutions.
We also deem it sensible that CEBS gives more guidance on the application of these principles and therefore welcome the draft guidelines proposed by CEBS. However, we call on CEBS to observe the limits of the Level 1 provisions and ask CEBS not to go beyond the legal requirements set out in the CRD II provisions.

We would also like to highlight once again the importance of hybrid capital instruments to banks. Fixed income investors have provided substantial amounts of bank capital in recent years. It is therefore important to maintain the attractiveness of hybrid capital instruments to investors. Therefore we urge CEBS to carefully consider in particular the issues of permanent write down or the disablement of dividend stoppers / pushers. Hybrid capital instruments should not unnecessarily be made unattractive to investors compared to equity. Eventually, reducing the possibility for banks to raise capital by means of hybrid capital instruments could also have a negative impact on pricing of banking services and products.

In the following, please find our comments on the questions posed in the consultation paper.

Avenue de la Joyeuse Entrée 1 – 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47

Website : www.eapb.eu

A. Permanence

I. Incentives to redeem

Question 1:

1.1 Are the guidelines in relation „incentive to redeem" sufficiently clear or are there issues which need to be elaborated further?

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

The EAPB members generally deem CEBS' guidelines on incentives to redeem sufficiently clear.
It would however be helpful to have examples for the proposed functioning of the cap on conversion ratio in case of a principal stock settlement mechanism. In particular, the reference of the conversion ratio is not fully clear (units /nominal value /market value).

The provisions for the definition of a moderate step-up clause are principally in line with the Sydney Press Release. However, in our view the definition in para 53 are going beyond these requirements: „Incentives to redeem can be defined as those features that, **in the perception of market participants**, provide for an expectation of the hybrid instrument being redeemed at the call date".
We do not deem it sensible to refer to the perception of the market participant. It is difficult to anticipate what the market 'subjectively' defines as a redemption incentive. To this extent each institution should document its own estimate comprehensibly for the supervisory authorities and in doubtful cases coordinate it with its auditor or the supervisory authorities.

Furthermore, it is not clear why an innovative instrument should not be handled like a non-innovative instrument with correspondingly higher restrictions after the expiration of the right to exercise options/call right (para 58). After the appearance of the incentive to redeem without exercising repayment by the issuer, there is no incentive – and often no possibility – left to terminate the instrument. It is thus necessary to evaluate it in its entirety and to reclassify it accordingly if necessary (e.g. as 'other hybrid' with the 35% limit of Tier 1). We therefore request that para 58 be changed accordingly.

II. Supervisory consent to a call on redemption of a hybrid instrument

Before answering your questions on buybacks of hybrid capital instruments, we would like to make some general remarks on the conditions for the approval process.

Avenue de la Joyeuse Entrée 1 – 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47
Website : www.eapb.eu

No double burden regarding information to be submitted

The minimum information to be provided by the institutions as part of the approval process is too extensive in our opinion. Moreover the volume of information is not justified given the documentation already available to supervisory authorities. The data to be supplied by the institutions should therefore be limited to the information not yet provided to the supervisory authorities, e.g. information submitted in the framework of Pillar 2 (ICAAP). Otherwise, it would lead to a doubling of the disclosure duties of the institutions. We take the view that the (audited) results of the ICAAP should be recognised as correct and sufficient.

More reliability on the assessment period

Para 62 sets out that "*the issuers shall schedule the submission of its application to call or redeem […] well in advance of the call or redemption date*".
However, any repayment or call depends on the market conditions on the effective date. This ambiguous formulation should therefore be made more specific in order to ensure a sufficient degree of reliability. For instance, supervisory authorities could be required to observe a maximum assessment period, which ideally should be rather short. In this case, the institution wishing to call would have a clear indication of the latest time by which the required documentation has to be submitted in order to achieve repayment on the scheduled date.

Sensible information to be submitted by institutions

The information and documentation to be provided by the institution, as specified in para 64, appear to be practically not feasible / not sensible, particularly with regard to the requirements of para 64 (c) and para 64 (d).

The EAPB therefore calls on CEBS to clarify in para 64 that the list is not a generally applicable checklist that must always be completed. Rather, the list should give the supervisory authorities an indication of information to be taken into account. Furthermore, it should be clarified that it is the responsibility of the relevant supervisor to determine whether information should be provided on consolidated or on sub-consolidated level. In particular, it should be possible for institutions using the waiver to provide corresponding documentation only at the consolidated level.

With regard to para 64 (c), we deem the planning horizon to be far too long. A five-year planning period is not common and the planning results would not be informative or useful, particularly in the current market situation. We therefore ask CEBS to limit the planning horizon to three years.

Avenue de la Joyeuse Entrée 1 - 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47

Website : www.eapb.eu

As to para 64 (d), the information required is already completely included in the ICAAP. However, to prevent misunderstandings, it would be necessary to clarify with regard to the stress tests mentioned in the last clause what type of stress tests and stress test results are to be submitted to the supervisory authorities.

No options / discretions for supervisory authorities

The options for supervisory authorities set out in paras 65 and 66 constitute disproportionately high barriers for institutions. Moreover, these options do not contribute to a convergent implementation of the new rules throughout the EU.

Effective reduction of information in case of replacement of capital

The mere possibility of reducing the information requirements set out in para 67 is not sufficient in our view. In case the hybrid capital has already been replaced by capital of at least the same or better quality there is no reason why an institution should be obliged to provide extensive documentation. As there is no degradation compared to the situation before replacing the capital, we ask CEBS to completely refrain from asking comprehensive documentation or at least to provide for clearly defined facilitations with regard to the information to be provided.

Prior consent of competent authority – specification

Finally, it would be helpful if CEBS could set out under paras 68 – 70 those cases in which the approval for redemption must always be granted. In particular it would be appreciated if CEBS could set out how "adequate capital buffers" under para 69 is to be defined as regards the amount as well as the time period for the buffer. In the absence of a uniform definition, the handling of the guidelines will not be convergent across the EU.

III. Supervisory guidance on buy backs of hybrid capital instruments in the market

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.

Although we deem the guidelines on buy-backs to be sufficiently clear, we ask CEBS to eliminate the guidance on this issue from the present guidelines. The issue of buy-backs is

Avenue de la Joyeuse Entrée 1 – 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47

Website : www.eapb.eu

not exclusively relating to hybrid capital instruments, but concerns also – in comparable form – elements outside the area of core capital. Therefore, we feel that the issue of buy-backs has to be discussed more comprehensively.
Regulation on this issue is not contained in any EU legislation or in the Basel framework / the Sydney Press Release, and is from our point of view not necessary, either. Thus, before a purely European regulation is established that is limited to hybrid capital instruments, a uniform international regulation for all tradable capital components should be aimed for, in as much as this is considered necessary.

Apart from the view expressed above, we deem the regulatory approval of buy-back programmes to be inappropriate.

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.

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.

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?

As set out above, we take the view that supervisory approval should not be required, if the instruments bought back were replaced by instruments of at least the same or better quality (cf. our comments above, previous to Question 2).

Avenue de la Joyeuse Entrée 1 – 5, B-1040 Brussels • Phone :+32 /2 / 286 90 62 • Fax : +32 /2 / 231 03 47
Website : www.eapb.eu

Although the buy-back of instruments generally reduces core capital, it will regularly increase the nominal volume of the traditional core capital. The buy-back of hybrid capital instruments below par results in profits which in turn increases retained earnings being part of the traditional core capital. In exceptional circumstances (e.g. exceeding the limits for hybrid instruments and thus no regulatory approval of these instruments) also the volume of the core capital can be increased.

The EAPB therefore holds that a less burdensome buy-back without regulatory approval should be possible, at least for those components which may only be recognised as supplementary capital due to the exceeding of the recognition limits.
The elimination of the regulatory approval should be all the more considered as the reduction of the overall capital level can already be the trigger for such a violation of the limit. As a consequence, unnecessarily high premiums must be paid for capital which is “not needed”.

Beyond that, certain exceptional situations such as a reorganisation of the institution may necessitate a buy-back of hybrid instruments. In these cases a buy-back prior to the end of the five-year period should be possible even without replacement by capital of the same or better quality.

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.

The EAPB generally supports the limitation of the amount of repurchased instruments held by institutions.
However, we feel that 5 % based on an individual issue is too low, particularly in the initial phase of an issuance (for market making). Thus the proposed limit of market support to 5% should not be based on the individual issues, but on the total amount of all hybrid instruments issued.

In the interest of a playing field all institutions should benefit from the possibility to deviate from the guidance on buybacks as set out in para 73. Therefore, we ask CEBS to replace the wording in para 73 which refers to a national discretion for such relief measures by a general rule.

Avenue de la Joyeuse Entrée 1 – 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47

Website : www.eapb.eu

B. Flexibility of payments

I) Supervisory request for the cancellation of payments

Referring to para 78, it would be helpful to clarify the definition „distributable items“. We assume that a coupon payment from retained earnings or disclosed reserves is possible.

Furthermore, it is not clear who would be required to provide the data necessary for the supervisory authorities' assessment (para 79 and 81). In contrast to the case in which data has to be provided by institutions when applying for approval for a call or redemption (para 64), institutions may not be obliged to provide information in case of a supervisory request for the cancellation of payments (in particular para 81 (b)). Anyway, we assume that the necessary information is already available to the supervisory authorities through the ICAAP.

Generally, we have doubts as to whether it is sensible to decide on the cancellation of coupons /dividends based on forecasts of supervisory authorities.

An early cancellation of such payments may even be the trigger of a crisis situation in an institution. Furthermore, based on experience, such forecasts can conceal considerable risk of compensation for damages at the expense of the supervisory authorities. Therefore, we take the view that above all, the ICAAP criteria should be used as basis. A breach of the ICAAP would consequently result in a cancellation of coupons / dividends. Therefore para 81 should be formulated as follows: „Hence, competent authorities may require the cancellation of coupon/dividends on hybrid instruments taking into account, the following information, stemming from the ICAAP: …“.

II. Flexibility of payments – 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? What would be the impact of the restriction on the use of dividend pusher and stopper?

The guidelines given in para 82 to 85 on dividend pushers or stoppers are from our point of view clear.

Avenue de la Joyeuse Entrée 1 – 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47

Website : www.eapb.eu

C. Loss absorbency

Question 5:

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.

The EAPB does not support CEBS' intention at all to newly define the term "insolvency" for regulatory purposes (para 97). The national insolvency rules must be applicable also for the banking industry. A differentiation of the term insolvency is difficult to manage in practice. Moreover, it would result in major liability risks for supervisory authorities in the case of erroneous decisions.

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

We agree with the definition of loss absorbency in going concern, as set out in para 105.

5.3 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?

The EAPB members deem the guidelines given in para 106 to 109 to be appropriate.

Regarding the mechanism described in para 114 for ensuring recapitalisation of an institution, it must be noted that the mechanism of writing down the nominal amount of the principal permanently described in para 114 (a) would lead to investors pulling back from investments in hybrid instruments. Providers of hybrid capital would be disadvantaged compared to shareholders by this mechanism, since shareholders anew participate in the success of the respective company through share price increases and dividend payments once the economic situation improves. In this regard it will not be possible to make investors understand why undated hybrid capital instruments are not assigned the original nominal value again. Consequently, it will be difficult to place such hybrid instruments on the market only and only at significant costs.

The possibility in para 115 to combine the mechanisms set out under para 114 is very much welcome by the EAPB.

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?

Avenue de la Joyeuse Entrée 1 – 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47
Website : www.eapb.eu

We welcome different levels of hybrid capital as long as they are disclosed and investors are informed transparently. Depending on the design, a differentiated ranking of hybrid capital instruments may even improve the quality of original own funds, as hybrid instruments are partly pari passu to equity in liquidation. Moreover, the possibility to differentiate between hybrid capital instruments constitutes an important tool for the institution with regard to the qualification of the respective issuance by rating agencies.

D. Limits

Question 6:

6.1 Are the guidelines relating to the assignment of hybrid 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.

In general, the guidelines are sufficiently clear with respect to the assignment of the hybrid capital instruments to one of the three categories. However, the functioning of the conversion ratio in para 135 could be clarified by means of an illustrative example.

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

In para 131 it should be clarified that the investor's conversion option does not need to be obligatory. Such a regulation would be difficult in our view. In case an institution would use such an instrument it would cause considerable dilution risks and it is possible that the attractiveness of the equity instruments would suffer considerably. Moreover, the requirement is not sensible from a regulatory point of view. It would not improve the capital situation of an institution. Such a regulation should in any case only be voluntary. Consequently, the last sentence of para 131 should be deleted.

Paras 136 to 138 should explain more clearly what is to be understood as an emergency situation, to provide for convergence across the EU.
We would also plead for including certain exceptional circumstances, such as mergers or acquisitions, in the definition of emergency situation. As hybrid capital instruments only have limited possibilities with regard to their cancellation, a temporary exceeding of the limits seems to be justified. An authorisation to exceeding the limits should therefore not be limited to the reorganisation or rescuing of an institution in distress.

Avenue de la Joyeuse Entrée 1 – 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47

Website : www.eapb.eu

Should you have any questions, please do not hesitate to contact us.

Kind regards,

Henning Schoppmann
EAPB

Walburga Hemetsberger
EAPB

The European Association of Public Banks (EAPB) represents the interests of 34 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.

Avenue de la Joyeuse Entrée 1 – 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47

Website : www.eapb.eu