7 December 2007

Draft proposal for a common EU definition of Tier 1 hybrids

Background

1. In June 2005 the European Commission ('the Commission') issued a Call for Advice inviting CEBS to provide technical advice in the form of:

    a. a survey of the implementation of the current rules on own funds across CEBS members;

    b. an analysis of the capital instruments recently created by the industry;

    c. the development of guiding principles behind own funds; and

    d. a quantitative analysis of the types of capital held by credit institutions within the CEBS members

2. The surveys answering Parts (a) and (b) were published on the CEBS website[1] on 23 June 2006. The quantitative analysis of all types of eligible capital instruments in response to Part (d) followed on 15 June 2007, with a special subset - a quantitative analysis of hybrid capital instruments - published separately in March 2007. These pieces of work provide a full picture of the similarities and differences between eligible capital elements across the EU and their quantitative relevance.

3. One of the CEBS key findings was the significant volume of 'hybrid' instruments (estimated at around 213 Billion EUR) which represents around 11.5% of total eligible own funds as of 31 December 2006 and the various regulatory treatments that these instruments are subject to.

4. Against the background of the CEBS' findings and the lack of EU legislation on the treatment of hybrid instruments, the Commission in its letter of 10 April 2007 (see Annex I) invited CEBS to consider whether convergence in this area can be achieved and to report back by end 2007.

5. More specifically, CEBS has been asked to:

[1] http://www.c-ebs.org/Advice/advice.htm

a. develop general principles that could guide supervisors in each of the three areas identified in the CEBS surveys (permanence, loss absorbency and flexibility of payments), and clarify detailed aspects of each of the principles (see below in the main report);

b. seek convergence on the current different quantitative limits to “innovative” and “non-innovative” hybrids; and

c. consider possible ways to limit the impact on financial markets of any future common approach e.g. by grandfathering current instruments.

6. In addition, ‘Consideration of the principle of ‘substance’ prevailing over the form and the importance of assessing any legal risk potentially embedded in hybrids in order to ensure that there is an actual transfer of the issuer’s risk to the market should also be explored’.

7. The Commission and the European Banking Committee were also keen for CEBS to ensure that the overall prudential goal of improving the quality of capital could be achieved in a reasonable period of time.

8. CEBS presented the key findings of its analysis at an open hearing held at its premises in June 2007.

9. The objective of the event was to hear about the range of concerns the current definition of own funds in the EU, and especially Tier 1 hybrid capital instruments, causes for market participants and their views on what a more consistent definition would look like.

10. A wide range of market participants including investment banks, commercial banks, trade associations and rating agencies contributed to the discussion and passed on the following main messages[2]:

    a. the industry warmly encouraged CEBS to define clearly the economic characteristics of Tier 1 eligible hybrid capital instruments to ensure convergence on the application of commonly agreed principles and a level playing-field across countries;

    b. overall the industry was supportive of the approach of basing convergence on the three eligibility criteria that the CEBS surveys had identified (permanence, loss absorption and flexibility of payments); and

    c. overall the industry was also supportive of work to achieve a common interpretation of the 1998 Sydney Press Release and considered that working in parallel with Basel on any new overall framework for own funds will be critical.

[2] A more detailed summary is available on the CEBS website (http://www.c-ebs.org/press/21062007.htm)

11. CEBS has been keen to continue its dialogue with market participants by organising informal technical contacts with internationally active rating agencies, investment banks and investors.

Objective

12. The EU legislation, so far, does not address hybrid instruments. The Basel Committee on Banking Supervision, on the other hand, while also not formally addressing them in the Basel Accord, has set out the conditions for these instruments to be considered as Tier 1 capital in the Sydney Press Release **('SPR')** of 27 October 1998 (see Annex II) as well as imposing limits on their inclusion.

13. As this work has not yet been reflected in the EU legislation, the objective of CEBS is not to create a brand new definition for Tier 1 hybrids but to provide guidelines for a common and clear interpretation and implementation across the EU of the eligibility criteria that hybrids must meet using, as the starting point, the common approach already agreed at international level in the SPR.

14. Accordingly, CEBS has based its considerations on the SPR guidelines with regard to the key economic features of permanence, flexibility of on-going payments and loss absorbency and on the characteristics eligible hybrids bear across the EEA. The separate discussion of each economic feature in this paper serves mainly to provide a clear structure to the report. In practice, the features are more closely linked than this structure might suggest and must be complied with altogether and at the same time. Cross references, or considerations of how a certain treatment of one feature may affect another feature, are therefore included where appropriate.

Terminology

15. According to the Capital Requirements Directive (CRD) regulatory own funds are composed of two main layers[3]: 'original own funds' which are of the highest quality and permanent, and 'additional own funds', which have lower quality and are less permanent. Article 57 of Directive 2006/48/EC sets out a list of eligible components. To cover market risks, institutions may also use 'ancillary own funds' (Article 13 of Directive 2006/49/EC).

16. There is no clear terminology for describing hybrid instruments which are considered to be eligible as Tier 1 capital. In that context, and without aiming to provide a general definition, the term "hybrids" has been used consistently in the CEBS surveys as well as in this report to encompass the following three broad categories:

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[3] Terminology of Directives 2006/48/EC and 2006/49/EC. Subject to technical differences, these layers correspond to the Basel Accord terminology of Tier 1 and Tier 2. Capital instruments used to cover market risks (Ancillary own funds) are commonly referred to as Tier 3. For the sake of simplicity the draft proposals refer only to the more commonly-used Basel categories. Therefore, hereinafter every reference to "Tier 1 capital" should also be understood as a reference to "original own funds".

a. innovative instruments (i.e. instruments with incentives to redeem such as step-ups);

b. non-innovative instruments (i.e. instruments which do not have incentives to redeem); and

c. non-cumulative perpetual preference shares, which some CEBS members treat as ‘core Tier 1 capital’.

17. Minority interests can comprise common equity, hybrid Tier 1 instruments or non-Tier 1 items. For the purposes of the proposals in this report minority interests should be classified according to the underlying component. For example, common equity and reserves should be classified as common shareholders’ funds, and hybrid instruments within minority interests should be subject to the permanence, loss absorbency and coupon flexibility features proposed in this report.

Methodology

18. The scope of the exercise encompasses:

a. all hybrid instruments, regardless of the category they belong to;

b. direct and indirect issuances of hybrid instruments (and in this respect minority interests);

c. all institutions subject to the CRD (i.e. credit institutions and investment firms); and

19. CEBS members will endeavour to apply the prudential requirements set out in this paper independently of the legal form of the institution[4].

20. In developing the proposals set out in this report, CEBS has applied the following principles:

a. Instruments eligible for inclusion in Tier 1 capital have to be measured against the benchmark of ‘equity’. Equity represents the highest quality of own funds. It can absorb losses that exceed current earnings, allowing the bank to continue its activities in times of poor performance. It is the most deeply subordinated claim (in liquidation) and is perpetual (no fixed maturity). In addition, the bank has full discretion over the amount and the timing of the distribution of dividends.

b. “Substance over form” - An instrument eligible for inclusion in Tier 1 capital should not only comply with the prudential requirements set out in this paper, regardless of its legal form, but also must result in the effective transfer of the issuer’s risk to the market.

[4] Institutions are incorporated in various legal forms and alternative but equivalent solutions may be necessary.

c. Have regard to the capital structure and rank of subordination of the capital instruments, whilst recognising that in times of stress hybrid instruments must also be able to absorb losses on a going concern basis;

d. Adopt a pragmatic approach, although there is a limited number of real cases where one can see how hybrids have performed in practice in stress situations, CEBS has tried to build on the experience and knowledge that market participants have gathered since 1998.

21. The issuance of hybrid instruments is usually guided not only by regulatory requirements but also by considerations outside the scope of supervision such as tax or company laws or accounting rules. These implications are highlighted as far as they form constraints on further convergence and cannot be resolved with amendments to supervisory regulation or practice alone.

22. Within the framework of the Joint Protocol between CESR, CEBS and CEIOPS and the 3L3 Work Programme for 2007, CEBS' and CEIOPS' experts have informed each other about their respective work.

23. The Basel Working group on the Definition of Capital, on which CEBS is an observer, has also regularly been kept informed.

24. The draft proposal for a common EU definition of Tier 1 hybrids was first presented at public hearing on 22 November 2007. It will subsequently be published on 7 December 2007 for a **public consultation until 22 February 2008**.

25. Following the publication for consultation, the proposals will be subject to a focused impact assessment in order to base the final advice on solid evidence and make sure that the final proposal is such as to maintain appropriate quality of capital in the EU.

CEBS is interested in getting market participants' views on its proposals.

Executive Summary

26. In recent years, EU banks have been increasingly relying on the issuance of hybrid capital instruments, which may combine features of debt and equity. The market for such instruments has been growing fast both in terms of volume and in the diversity of instruments which has arisen mainly as a result of the particular features of local markets and differences in national tax and company laws.

27. These hybrids are specifically designed to raise funds in a cost-efficient and less dilutive way than equity and to be eligible for regulatory purposes.

28. EU legislation has so far been silent on the treatment of such instruments in regulatory capital.

29. On 27 October 1998, the Basel Committee issued guidelines (Sydney Press Release, hereinafter "SPR") setting out conditions for these instruments to be considered of adequate quality to qualify in the highest tier of regulatory capital ('Tier 1') while imposing limits on their inclusion.

30. CEBS members investigated whether a common EU approach to these instruments could be found without jeopardising the quality of regulatory capital, using as starting point the SPR.

31. As a result, the 27 members of CEBS agreed on the conditions that any hybrid instrument must meet in order to be considered as eligible for Tier 1 capital in the EU. These conditions apply to all hybrid instruments, regardless of their denomination, the category (innovative, non- innovative instruments or non-cumulative preference shares) and the form of their issuance (direct or not). All the conditions must be fulfilled at the same time.

Issued and fully paid-up

32. The instrument must be issued and fully paid-up: any amount outstanding will not be included as eligible own funds as it is not yet available to support the on-going business of the institution.

Publicly disclosed and easily understood

33. The main features of the instrument (including whether it is grandfathered), the proportion of Tier 1 capital it accounts for and the Tier 1 requirements it effectively meets must be periodically and publicly disclosed by the issuer. The main features of the instrument must be easily understood.

34. Moreover, the three economic characteristics must all be fulfilled at the same time - permanence, loss absorbency and ability of the issuer to cancel payments.

Undated

35. The instrument meets the permanence test if it is undated.

36. It can however be callable but only at the initiative of the issuer and always with supervisory approval and under the condition that it will be replaced with capital of the same or better quality, unless the supervisor determines that the institution has capital that is more than adequate for its risks.

37. Hybrids may be callable after a minimum of 5 years after the issue date, if they contain a pure call option, or after a minimum of 10 years if the call option is associated with an incentive to redeem.

38. Step ups and principal stock settlements, when combined with a call option, are considered as incentives to redeem.

39. Step ups are permitted, in conjunction with a call option, only if they are considered moderate. A step up is moderate if it results in an increase over the initial rate that is no greater than, at national supervisory discretion of, either (i) 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or (ii) 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis.

40. The terms of the instrument must provide for no more than one rate step-up over the life of the instrument. The swap spread is fixed at the pricing date and reflects the differential in pricing on that date between the initial reference security or rate and the stepped-up reference security or rate.

41. Principal stock settlement mechanisms must contain a cap on the conversion ratio in order to limit the potential dilution.

42. A term allowing early redemption triggered by an event such as a change in regulatory recognition of hybrids or a change in the tax treatment of these instruments, subject to prior consent of the supervisory authority, is not considered to be an incentive to redeem.

Able to absorb losses of the institution

43. The instrument must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids are senior only to ordinary share capital.

44. The instrument must neither be secured nor covered by a guarantee of the issuer or a related entity, or other arrangements that legally or economically enhance the seniority of the claim vis-à-vis the institution.

45. In the case that the Tier 1 ratio falls below 2%, the instrument must be able to absorb losses either by ensuring that:

(i) the principal of the instrument can be partially or fully written down in order to enable the institution to absorb losses and the principal of the instrument can be reinstated only out of future profits and pari passu with the shareholders; or

(ii) the instrument can be converted into ordinary shares.

46. The mechanism must be disclosed and transparent to the market and in the case of a principal write-down must be on the issuer's balance sheet (assuming this is possible from an accounting perspective). In addition, it must be legally certain that under the terms of the instrument the principal can be written down on a going concern basis.

47. Future coupons are cancelled while the principal amount is written down.

48. If the bank goes into liquidation whilst the principal is written down then the hybrid holder will have a claim for the full principal amount.

49. If the bank wants to redeem the instrument whilst the principal is written down, it can only redeem it at the written down amount. Redemption at par will not be possible until the principal is completely written up.

50. The issuer must not pay any coupons until the principal is completely written up.

Able to suspend payments

51. Issuers must be able to waive payments at any time, on a non-cumulative basis and for an unlimited period of time.

52. If the institution is in breach of its minimum capital requirements (or another level defined by the supervisor), then it must waive payments.

53. In addition, supervisors can require institutions to waive payments at any time based on the financial situation of the institution.

54. Dividend pushers are acceptable but must be waived when one of the supervisory events mentioned above occurs between the date the coupon is pushed and the date it is to be paid. Under those circumstances, payment of the coupons will be forfeited and no longer be due and payable by the issuer.

55. The instrument is not cumulative in kind or in cash: any coupon or distribution not paid by the issuer is forfeited and is no longer due and payable by the issuer.

56. The issuer must have full access to waived payments.

57. Alternative Coupon Satisfaction mechanisms are permitted only if they are put in place solely for tax reasons and in cases where the issuer has full discretion over the payment of the coupons or dividends at all times. In addition, they are only permitted if (i) they are made out of already authorised and unissued shares, (ii) subscribed by the instrument’s holders, and (iii) exercised immediately to avoid the accumulation of debt.

58. Distributions can only be paid out of distributable items; where distributions are pre-set they may not be reset based on the credit standing of the issuer.

Included in Tier 1 up to a certain limit

59. CEBS believes that regulatory capital ratios should be met without undue reliance on hybrid instruments. It reaffirms that common shareholders’ funds (common shares and disclosed reserves or retained earnings) are the key elements of capital.

60. Accordingly, common shares and disclosed reserves or retained earnings must represent at least, and at all times, 70% of the required Tier 1 capital.

61. In addition, when an institution operates above the required Tier 1 capital, common shares and disclosed reserves or retained earnings must represent at least and at all times 50% of total Tier 1 after deductions. Instruments with incentives to redeem and instruments with ACSM features must not exceed 15% of total Tier 1 after deductions at any time (this limit is included in the overall limit to hybrids).

Grandfathering

62. Any instrument authorised or issued under existing national rules which no longer qualifies under the above interpretation is grandfathered under the following conditions:

    a. instruments with incentives to redeem can remain eligible to count as Tier 1 up to the first call date; and

    b. all other instruments (including hybrids with incentives to redeem which are not callable and those which are callable but have not been redeemed) must not exceed 20% of total Tier 1 in 10 years time, 10% in 20 years time and will stop counting as Tier 1 capital at year 30.

63. Any redemption must be at the initiative of the issuer and subject to prior supervisory approval.

Part 1: Permanence

Tier 1 hybrids are considered permanent if they are undated. Call options are acceptable under conditions and always subject to supervisory approval

A. The Sydney Press Release ('SPR') requires Tier 1 hybrids to be permanent. Early redemption is acceptable under conditions.

64. The SPR requires instruments eligible for Tier 1 to be permanent without providing a clear definition of "Permanence".

65. The SPR also states that 'call options are acceptable provided the instrument is only callable at the initiative of the issuer, only after a minimum of five years, with supervisory approval and under the condition that it will be replaced with capital of same or better quality unless the supervisor determines that the institution has capital that is more than adequate to its risks.'

66. Incentives to redeem in the form of moderate step-ups in instruments issued through SPVs, as well as in directly issued Tier 1 instruments meeting the requirements of the SPR, 'are permitted, in conjunction with a call option, only if the moderate step up occurs at a minimum of ten years after the issue date and if it results in an increase over the initial rate that is no greater than, at national supervisory discretion, either:

    - 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or

    - 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis.

67. The terms of the instrument should provide for no more than one rate step up over the life of the instrument. The swap spread should be fixed at the pricing date and reflect the difference in pricing on that date between the initial reference security or rate and the stepped up reference security or rate.

B. In the EEA, the vast majority of current eligible Tier 1 hybrids are undated. The conditions for early redemption are consistent with the SPR.

68. The CEBS March survey concluded that in the EEA, the 'Permanence' criterion is interpreted in such a way that the instrument must be permanently available.

69. 95% of the hybrids of EEA credit institutions are undated:

HYBRIDS reported as original own funds as of 31 December 2006	All types (MEUR)	All types (%)	Non innovative instr. (MEUR)	(%)	Innovative instr. (MEUR)	(%)	Non cumulative perpetual pref shares (MEUR)	(%)
Undated	201,950	95%	76,942	99%	90,476	90%	34,532	100%
Dated	10,736	5%	771	1%	9,965	10%	-	
Total	212,686	100%	77,713	100%	100,441	100%	34,532	100%

Preliminary data as of 31 December 2006- Source: CEBS survey published in March 2007.

70. Dated instruments (mainly innovative instruments and accepted by a very limited number of CEBS members) account for the remaining 5% and may decrease further with time as they mostly encompass grandfathered instruments.

71. 90% of hybrids contain redemption features which provide the issuer with the option to call the issue after a minimum time period. Such early redemption is always subject to prior supervisory approval. In most countries the minimum period before an early redemption call can be exercised ranges from five to ten years, depending whether the call option is associated with an incentive to redeem or not.

72. It is common practice for most CEBS members that early redemption can also be triggered by an event such as a change in regulatory recognition of hybrids or a change in the tax treatment of these instruments, subject to prior consent of the supervisory authorities. This is, however, not considered as an incentive to redeem.

73. 58% of hybrids do not have any step-up.

74. In line with the guidelines set out in the SPR, moderate step ups of up to 100 basis points over the initial rate are common market practice. Only a few countries reported instruments that exceed that threshold (6% of cases), some of which were in line with the second option set out in the SPR which states that step ups can be up to 50% of the initial credit spread less the swap spread between the initial index basis and the stepped up index basis.

75. Principal stock settlement clauses allow for the substitution of one issue by another. Under this arrangement, a bank must deliver to the lender ordinary shares equivalent to the value of the amount borrowed or a fixed number of shares according to the terms of the instrument if it does not redeem the instrument at the call date.

76. Hybrids with principal stock settlement clauses are permitted in Belgium, Netherlands and the United Kingdom and account for 4 % of hybrids in the EEA. Such mechanisms may have dilutive effects and place an implicit pressure on institutions to redeem for cash rather than issue new shares, especially when combined with a call. Consequently, some supervisors have imposed limits on the quantum of shares that may be issued under them.

C. CEBS recommends that Tier 1 hybrids be undated and that early redemptions be subject to strict conditions and to prior supervisory approval

77. Permanence constitutes a primary feature of common equity which has no maturity and as such poses no refinancing risk to the issuer in a time of financial stress. Even if common equity can be repurchased, thus potentially reducing its theoretical permanence, the sole initiative for such repurchases rests with the issuing institution.

78. There is a common understanding among supervisors and market participants that permanence is a key feature for a hybrid instrument to be eligible as Tier 1 capital as it provides the bank with the greatest flexibility and ensures that capital is available in stress situations.

79. In essence, the guiding supervisory principles to be developed for Tier 1 hybrids have to be consistent with the principle stated for equity: hybrid capital, like equity, shall be available within a bank and remain so at any time.

80. This does not necessarily mean that a capital instrument cannot have a feature which allows its redemption by the issuing bank. After all, an institution can buy back its paid up capital. But, for Tier 1 hybrid capital, such early redemption must be exercised under strict supervisory conditions as incentives to redeem can damage the financial soundness of a bank.

81. Features such as interest rate step ups related to a call option weaken the permanency of hybrid instruments as they may place economic or reputational pressures on an issuer to call and refinance the hybrid, even if the issuer is experiencing some deterioration in its financial position. Specifically, when hybrids are priced upon issuance assuming a call will occur in order to satisfy the hybrid investors, issuers often feel obliged to initiate the call, even if the refinancing leads to a weaker capital structure or reduces future financial flexibility.

82. Indeed, the market expects that instruments with incentives to redeem will be called after ten years and prices them according to this expectation. Thus, market participants consider the date at which a call option with an interest rate step up can be exercised to be the instrument’s effective maturity date.

83. As the SPR requirements have so far been applied consistently across the EU as a common market standard, CEBS does not propose to depart from these requirements.

84. In particular, Tier 1 hybrid instruments must be considered as permanent if they are undated. This excludes contractually dated instruments from Tier 1 capital.

85. With the introduction of the Basel II requirements, however, banks claim that there is an increasing need for more flexibility in their capital management and that the

permanence of capital instruments becomes less important[5]. Although a contractually dated instrument, whose conditions give the supervisor the power to prevent the instrument's repayment at its final maturity may be considered as economically equivalent to the structure described above, CEBS considers that the charge of the proof is reversed and therefore recommends excluding dated instruments from Tier 1 capital.

86. As stated in the SPR, it is important that call options can only be exercised at the sole initiative of the issuer: the replacement of the securities with less costly capital resources when issuers have the flexibility to do so, reflects the issuer's view of the most optimal capital structure.

87. Another crucial point is that the supervisor must have the authority to limit the incentives to redeem and to prevent the repayment of a capital instrument in order to preserve the financial soundness of the institution and to avoid refinancing risk in times of stress.

88. Principal stock settlement features in combination with a call are not specifically addressed by the SPR. CEBS regards them as an incentive to redeem. They must contain a cap on the conversion ratio in order to limit the potential dilution.

89. Instruments with a principal stock settlement feature should not be confused with mandatory convertible securities (MCS). MCS mandatorily convert into ordinary shares after a specified period (for example 3 years) or upon a trigger event (such as a breach of regulatory requirements). There is no call option and therefore no possibility for the investors to receive cash. MCS do not provide the bank with an incentive to redeem because there is no call option and the instrument would be issued to equity or equity- linked investors.

CEBS proposal for a common EU definition of "Permanence"

Hybrid instruments are considered as permanent if they are contractually undated.

Hybrids may be callable but only at the initiative of the issuer, always subject to prior supervisory approval and under the condition that they will be replaced with capital of the same or better quality unless the supervisor determines that the bank has capital that is more than adequate for its risks.

[5] In addition, the Solvency II draft directive text for insurance undertakings was published in July 2007. The eligibility criteria that regulatory capital must fulfil, including permanence are being discussed further by CEIOPS as part of the elaboration of the Level 2 implementing measures. In this context taking into account the principle of "substance over form", some CEBS members stressed that the criterion of permanence could be interpreted in a less prescriptive way than only being achieved by undated instruments. This could also support the view of some market participants to provide under the recent change of Basel II capital requirements more flexible provisions to deal with volatility/procyclicality issues. In addition, Article 92 para. 4 of the Solvency II draft directive text published in July 2007 allows for greater flexibility on the permanence criterion. This is being discussed further by CEIOPS as part of the Level 2 implementing measures.

Hybrids may be callable after a minimum of 5 years if they contain a pure call option, or after a minimum of 10 years if the call option is associated with an incentive to redeem.

Step ups and principal stock settlements in conjunction with a call option are considered as incentives to redeem.

Step ups are permitted, in conjunction with a call option only if they are considered moderate, i.e. if they result in an increase over the initial rate that is no greater than, at national supervisory discretion, either;

- 100 basis points, less the swap spread between the initial index basis and the stepped up index basis; or

- 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped up index basis.

The terms of the instrument should provide for no more than one rate step up over the life of the instrument. The swap spread should be fixed at the pricing date and reflect the difference in pricing on that date between the initial reference security or rate and the stepped up reference security or rate, in line with the guidance given in the Sydney Press Release.

Principal stock settlement mechanisms must contain a cap on the conversion ratio in order to limit the potential dilution.

Early redemption triggered by an event such as a change in regulatory recognition of hybrids or a change in the tax treatment of these instruments, subject to prior consent of the supervisory authority, is not considered to be an incentive to redeem.

Part 2: Loss absorption

Tier 1 hybrids must be able to absorb losses on a going concern basis, in stressed situations, and in liquidation

A. The SPR requires that Tier 1 capital instruments must be able to absorb losses on a going concern basis.

90. The SPR stipulates that ‘all instruments included in Tier 1 must be able to absorb losses within the bank on a going-concern basis’. The wording of the loss absorbency requirement is similar to the description in the SPR of the loss absorbency qualities of ordinary shares and disclosed reserves/retained earnings: i.e. "common shareholders' funds allow a bank to absorb losses on an ongoing basis". Beyond the guidance implied by the comparison with ordinary shares and disclosed reserves/retained earnings and their ability to absorb losses, the SPR gives no further explanation of how the loss absorbency requirement is to be understood.

91. The capacity of an instrument to absorb losses will also depend on its degree of subordination in case of liquidation. The SPR states that “All instruments included in Tier 1 must be junior to depositors, general creditors and subordinated debt of the bank.” Moreover, these instruments must “neither be secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors”.

92. The SPR can be interpreted to mean that Tier 1 instruments must be junior to Tier 2 subordinated debt. There are no provisions in the SPR on the order of priority among the Tier 1 instruments themselves. Depending on the preferred loss absorbency of hybrid instruments, different requirements can be stipulated for the subordination of hybrid instruments compared to other Tier 1 elements and all of which will be consistent with the provision in the SPR.

B. In the EEA, the vast majority of Tier 1 hybrids are deeply subordinated. There are some variations with regard to the other characteristics of loss absorbency.

93. Various characteristics have evolved to provide loss absorbency of the principal amount of a hybrid capital instrument. These include subordination, principal write-down features, convertibility into higher forms of capital and the fact that instruments are not being counted as liabilities for insolvency purposes.

94. The relevance of these loss absorbency mechanisms varies depending on the actual situation of an institution. Subordination, for example, is most important in

liquidation to ensure that hybrid holders' claims are not met before all more senior claims are satisfied. The write-down of the principal or the conversion of hybrids into ordinary shares, on the other hand, enables loss absorption on a going-concern basis and gives the institution the opportunity to recover.

95. A substantial part of the hybrid capital instruments issued, however, do not seem to have features that would allow them to be loss absorbent on an on-going basis in cases where losses are so large that they significantly erode Tier 1 capital.

Subordination

96. The vast majority of hybrid instruments (74 %) are senior to ordinary share capital.

HYBRIDS reported as original own funds as of 31 December 2006	**All types (MEUR)**	**All types (%)**	**Non innovative instr. (MEUR)**	**(%)**	**Innovative instr. (MEUR)**	**(%)**	**Non cumulative perpetual pref shares (MEUR)**	**(%)**
Pari passu with ordinary share capital	10,628	5%	5,581	7%	3,583	4%	1,465	4%
Senior to ordinary share capital only	158,375	74%	54,831	71%	72,353	72%	31,191	90%
Senior to other instruments in addition to ordinary share capital	43,683	21%	17,301	22%	24,506	24%	1,876	5%
Total	212,686	100%	77,713	100%	100,441	100%	34,532	100%

Preliminary data as of 31 December 2006- Source: CEBS Survey published in March 2007

97. This rises to 90% for non-cumulative preference shares. 5% of the hybrid instruments rank pari passu with ordinary shares. These include equity contributed through silent partnerships and non-cumulative trust securities issued in Germany, the innovative instruments issued in Norway and PIBS (Permanent Interest Bearing Shares) issued by building societies in the UK[6]. 21 % of the hybrid instruments are senior to other hybrid instruments.

Write-down of principal

98. For 39% of hybrid instruments the principal can be written down. However, this feature varies across the various types of hybrid capital instrument. Just over half (55%) of non-innovative hybrid instruments have a principal write-down feature, whereas 39% of innovative instruments and only 3 % of perpetual non-cumulative preference shares have such a feature.

99. A permanent write-down of the principal amount of hybrid instruments is only allowed in a small number of EEA countries, e.g. Spain and Norway. This accounts for about 13% of hybrid instruments.

[6] Building societies are mutuals and do not have ordinary share capital. PIBS are therefore the most deeply subordinated capital instrument.

100. A temporary write-down is possible for 17% of the hybrid instruments. In these cases, the principal is written back up again before profits start to accrue to ordinary shareholders.

Conversion

101. 1% of hybrid instruments, consisting mostly of perpetual non-cumulative preference shares and few non-innovative instruments can be converted into ordinary shares.

102. Approximately 18% of the hybrid instruments can be converted into perpetual non-cumulative preference shares. Nearly all the convertibility clauses come into effect on the occurrence of a trigger event.

C. CEBS proposes that Tier 1 capital instruments must be able to absorb losses in case of liquidation, on a going concern basis and in stress situations

Objective of loss absorption

103. The aim of capital absorbing losses is to enable a bank to continue as a going concern. The issue of going concern only becomes relevant when the bank suffers losses or loses the confidence of its creditors to such an extent that it may not be able to continue to trade.

104. The concept of a bank being a going concern is therefore wider than the auditing definition which states that a company is a going concern if it can meet its obligations as they fall due and its assets exceed its liabilities.

105. When elaborating on loss absorbency CEBS paid due consideration to the following principles :

- Regulation of hybrids should not be more onerous than the rules on ordinary share capital.
- The relative ranking of subordination of different Tier 1 capital instruments should be respected so that the ordinary shareholders should suffer the first losses.

106. It must be noted that most hybrid instruments have been issued recently and there is a very limited number of cases where one can see how hybrids perform in practice.

Scenarios and possible / potential loss absorbency mechanisms

107. CEBS has considered three scenarios:

- on a going concern basis, losses can be absorbed by waiving the coupons (see Part 3);

- in case of liquidation, losses are absorbed in accordance with the degree of subordination; and

- in stressed situations, where a bank makes significant losses, especially if it is in breach of its minimum capital requirements and is likely to need new capital either by issuing new capital or through future earnings (or alternatively it could try to reduce its capital requirements), Tier 1 hybrid instruments should not hinder recapitalisation.

108. CEBS has discussed a number of options to address such stressed situations, including:

    a. coupons are written down on a permanent basis;

    b. the principal amount of the instrument is written-down but is written back up;

    c. the principal amount of the instrument is permanently written-down on a mandatory basis; or

    d. the instrument mandatorily converts into ordinary shares.

109. Permanent coupon write-down permanently reduces part of the claims of investors. Permanent coupon write-down is not however as loss absorbent as permanent principal write-down. In the case of heavy losses, only the principal amount of the hybrid capital instrument may be sufficiently large to give the bank the opportunity to cover the losses

110. The temporary write-down of the principal of a Tier 1 hybrid allows reducing future expenses to the extent that future coupons are cancelled while the principal amount is written down and until the full principal amount is written up back up again. If the nominal amount of the principal is permanently written down then the holders of that instrument absorb losses. However, this seems to penalise hybrid holders compared to ordinary share holders who can benefit from potential future profits. Consequently, CEBS proposal is for a temporary write-down with a write-up of principal under certain conditions.

111. The temporary write-down of the principal of the hybrid instrument allows an issuer to reduce future expenses to the extent that coupons are cancelled while the principal amount is written down. Once the institution is recapitalised the principal amount would be written back up using future profits pari passu with shareholders until the full claims of the Tier 1 hybrid holders are restored[7].

112. If the Tier 1 hybrid converts into ordinary shares, then the hybrid investors may incur losses at the point of conversion depending on the amount of ordinary shares they receive. Any loss which hybrid investors incur will improve the position of

[7] The silent partnerships of German banks are written down pro rata with the reserves (which includes retained earnings and capital surplus) to cover net losses.

existing shareholders to the extent that future losses will be shared between previous shareholders and hybrid investors whose shares have converted. After conversion hybrid investors would benefit from a share of future earnings. The conversion itself does not of itself absorb losses but it improves the quality of the remaining capital of the bank to absorb future losses.

Trigger for loss absorbency mechanism

113. Possible triggers for loss absorbency mechanisms to be activated could be either a balance sheet loss or the breach of the capital requirements. CEBS suggests using the solvency ratio as it is easy to monitor and provides a clear indication of when an institution is in a stressed situation.

114. CEBS considered a level that would respect the principles set out in paragraph 104 above so that as soon as an institution reaches the trigger it is highly likely that the ordinary shareholders and the reserves have already absorbed part of the losses and that from this point on hybrid holders must also absorb losses to ensure that the bank remains a going concern.

CEBS proposal for a common EU definition of “Loss absorption”

The instrument must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids are senior only to ordinary share capital.

The instrument must neither be secured nor covered by a guarantee of the issuer or related entity or other arrangements that legally or economically enhance the seniority of the claim vis-à-vis the institution.

In the case that the Tier 1 ratio falls below 2%, the instrument must be able to absorb losses either by ensuring that:

(i) the principal of the instrument can be partially or fully written down in order to enable the institution to absorb losses. The principal of the instrument can be reinstated only out of future profits and pari passu with the shareholders; or

(ii) the instrument can be converted into ordinary shares.

The mechanism must be disclosed and transparent to the market and in the case of a principal write-down must be on the issuer's balance sheet (assuming this is possible from an accounting perspective). In addition, it must be legally certain that under the terms of the instrument the principal is written down on a going concern basis.

Future coupons are cancelled while the principal amount is written down

If the bank goes into liquidation whilst the principal is written down then the hybrid holder will have a claim for the full principal amount.

If the bank wants to redeem the instrument whilst the principal is written down, it can only redeem it at the written down amount. Redemption at par will not be possible until the principal is completely written up.

The issuer must not pay any coupons until the principal is completely written up.

Part 3: Flexibility of payment

Issuers must be able to stop payments on a non-cumulative basis

A. The Sydney Press Release requires Tier 1 hybrids to be non-cumulative. The issuer must have discretion over the amount and timing of distributions.

115. The SPR states that all instruments included in Tier 1 must be non-cumulative. In addition, the following conditions have also to be fulfilled:

- the bank must have discretion over the amount and timing of distributions, subject only to a prior waiver of distributions on the bank's common stock and banks must have full access to the waived payments; and

- distributions can only be paid out of distributable items; where distributions are pre-set they may not be reset based on the credit standing of the issuer.

B. In the EEA, the vast majority of Tier 1 hybrids are non-cumulative. The issuer has maximum flexibility over the amount and the timing of coupon payments.

Non-cumulativeness

116. The survey shows that 93% of the instruments are non-cumulative.

HYBRIDS reported as original own funds as of 31 December 2006	**All types (MEUR)**	**All types (%)**	**Non innovative instr. (MEUR)**	**(%)**	**Innovative instr. (MEUR)**	**(%)**	**Non cumulative perpetual pref shares (MEUR)**	**(%)**
Cumulative	14,025	7%	3,109	4%	10,916	11%	0	0
Cash	*5,382*	*3%*	*594*	*1%*	*4,788*	*5%*	*0*	*0*
Kind	*8,643*	*4%*	*2,515*	*3%*	*6,128*	*6%*	*0*	*0*
Non cumulative	198,661	93%	74,604	96%	89,526	89%	34,532	100%
Total	212,686	100%	77,713	100%	100,441	100%	34,532	100%

Preliminary data as of 31 December 2006-Source CEBS report published in March 2007

117. The small percentage of cumulative instruments with payment in cash includes grandfathered issues of silent partnerships in Germany and a few non-innovative and innovative grandfathered instruments in Ireland and Denmark. The small percentage of cumulative instruments with payment in kind includes mostly innovative and non-innovative instruments in the United Kingdom.

118. Direct issues of perpetual non-cumulative preference shares never incorporate cumulative features, be it in cash or in kind.

119. Coupon payments in kind mean that the issuer can meet the coupon by giving shares or preferred shares (as opposed to cash).

120. Instruments with this feature only account for a small part of the total but are, for tax reasons, significant in some jurisdictions, notably in the United Kingdom, Belgium and the Netherlands. A few grandfathered issues have been reported in Ireland and Austria. Alternative Coupon Satisfaction Mechanisms (ACSM)[8] allows the issuer to pay in kind.

Ability to suspend payments

121. There are a variety of circumstances under which the issuer is obliged to suspend payments. The most common reason is the breach of regulatory limits (68% of the cases) or of other limits fixed by supervisors (18% of the cases) as well as solvency difficulties (28% of the cases) etc., or a combination of these circumstances.

122. In 44% of the cases the issuer may stop interest payments on its hybrids in cases where dividends are not paid on another security class.

123. Other examples are the requirements in some countries that the institution must have full flexibility of payment at all times (notably no dividend pusher is allowed)[9], e.g. Belgium, United Kingdom, Ireland and Netherlands, or that the issuer must suspend payment if no profit is recorded or no distributable funds are available.

124. There is no distinction between innovative and non-innovative instruments and perpetual non-cumulative preference shares on these trigger events. They apply in the same way whichever category the instrument belongs to.

C. CEBS proposes that Tier 1 hybrids should be non-cumulative and that the issuer must be able to stop paying its coupon whenever necessary

Objective of flexibility of payments

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[8] *Alternative Coupon Satisfaction Mechanisms* can require the institution to pay with already existing ordinary shares or to issue new common stock or other type of securities in the market to raise enough cash to pay investors the deferred distribution.
[9] In those countries, full flexibility of payment can be combined with ACSM or cumulative features.

125. Flexibility of payments is closely interlinked with loss absorbency: non-cumulative deferral or cancellation of the payments of coupons in stressed situations increases the capacity of the instrument to absorb losses on an on-going basis.

126. On an on-going basis, the instruments must permit the institution to preserve cash and absorb losses without the risk of investors invoking default and triggering liquidation. This means the institution should be able to decide whether it can pay coupons and, if so, when and for how much.

127. In order to avoid default on payment, it is necessary that the institution is able to suspend all payments in order to preserve cash without triggering a default. Hence, the institution must have discretion over the timing of distributions.

128. In order to ensure that liabilities do not exceed assets (legal insolvency) the instrument must enable the institution to cancel payments of coupon when necessary. So, the institution must also have discretion over the amount of the coupon and have full access to the waived payment, and the unpaid coupon should not be cumulative.

129. Another aspect is that tax authorities set different requirements for coupon payments to be tax deductible which differ from one country to another. The recommendation below is intended to preserve the quality of regulatory capital at the EU level, irrespective of the potential consequences for the tax treatment of the instruments.

Non-cumulativeness

130. The question whether an instrument is cumulative or non-cumulative is relevant to its capacity to absorb losses (see Part 2 above).

131. Payment of coupons in cash clearly depletes the institution's capital resources.

132. The issuer can benefit from a free source of funding when it can waive the payments of its coupons which are then cancelled i.e. no longer due and payable. By contrast, cumulative instruments allow the issuer to defer payment to a later date but the issuer is still committed to paying.

133. Because of tax reasons, some instruments contain Alternative Coupon Satisfaction Mechanisms (ACSM) (or a similar structure) whereby deferred payments are not cancelled but must be settled at a pre-specified future trigger point (e.g. payment of dividends on common shares) through the issuance of preferred or common shares.

134. ACSM may give rise to some prudential concerns if for instance the institution is not able to issue shares in time to pay the deferred coupons in kind. For instance, the deferred coupon can accumulate in the absence of settlement with shares (e.g. the issuer has not found investors in the market) and therefore the deferred coupons will not serve to cover losses on a going concern basis.

135. Moreover, shares must be issued and sold in sufficient amount to pay the full cash amount of the deferred coupon. There is a potential dilution effect but limited to the coupon.

Trigger events

136. A deferral clause can be designed in various ways and with various degrees of severity: cumulative vs. non-cumulative, alternative ways of payment (e.g. in kind), trigger for deferral.

137. Practical experience indicates that even if the institution can defer at any moment, it may refrain from activating it for fear of the potential negative signal this could give to the market. Access to capital markets could then be restricted at the moment when the institution needs it most, thus leading to even further deterioration in its financial situation.

138. A dividend pusher requires the issuer to pay its coupons on hybrids if it has paid dividends on its ordinary shares, in line with the rank of subordination of its capital structure.

139. A dividend stopper prevents the issuer from paying dividends in any period in which the issuer omits payment to hybrid holders. It is considered to be a restriction on the flexibility of payments on common shares bearing in mind that practical experience indicates that banks seem to be far more willing to defer dividends on common stock, which constitutes the most junior claim on which distributions are totally discretionary, than they are on hybrids.

CEBS proposal for an EU definition of "flexibility of payments"

Issuers must be able to waive payments at any time on a non-cumulative basis and for an unlimited period of time

If the institution is in breach of the minimum capital requirement (or another level defined by the supervisor), then it must waive payments.

In addition, supervisors can require institutions to waive payments at their discretion based on the financial situation of the institution.

Dividend pushers are acceptable but must be waived when one of the supervisory events mentioned above occurs between the date the coupon is pushed and the date it is to be paid. Under those circumstances, payment of the coupons will be forfeited and no longer be due and payable by the issuer.

Issuers must have full access to waived payments.

Distributions can only be paid out of distributable items; where distributions are pre-set they may not be reset based on the credit standing of the issuer.

The instrument has to be non-cumulative in cash or kind: any coupon or distribution not paid by the issuer is forfeited and is no longer due and payable by the issuer

Alternative Coupon Satisfaction Mechanisms (ACSM) are acceptable solely if they are put in place for tax reasons and in cases where the issuer has full discretion over the payment of the coupons or dividends at all times. In addition they are only permitted if (i) they are made out of already authorized and unissued shares, (ii) subscribed by the hybrid holders and (iii) are exercised immediately to avoid the accumulation of debt.
These instruments are limited to 15% of total Tier 1 capital after deductions.

Part 4: Limits to inclusion into Tier 1

Institutions' reliance on hybrid instruments must be limited in order to preserve the quality of regulatory capital.

A. The Sydney Press Release expects banks to meet the capital ratios without undue reliance on innovative instruments.

140. The SPR contains one explicit limit :"the aggregate issuances of non-common equity Tier 1 instruments with any explicit feature - other than a pure call option - which might lead to the instrument being redeemed is limited - at issuance - to 15% of the consolidated bank's Tier 1 capital".

141. Another limit is implicitly set by the press release when it states that "voting common shareholders' equity and the disclosed reserves or retained earnings that accrue to the shareholders' benefit should be the predominant_form of a bank's Tier 1 capital".

B. In the EEA, the overall limit on hybrids ranges from 15% to 50% of Tier 1

142. A 15% limit for instruments with an incentive to redeem is generally applied across the EEA.

143. On the practical definition of "predominant" EEA countries have a great variety of interpretations. As shown in the last column of the table published on page 11 of the CEBS March 2007 report and updated in annex II of CEBS' June 2007 report, the overall limit on hybrids applied by EEA countries ranges from 15% to 50% of total Tier 1.

144. The application of different quantitative limits across CEBS members may lead to competitive distortions between EU banks.

145. At the June 2007 hearing (see website), all market participants acknowledged that it seems sensible to limit the inclusion of hybrids in Tier 1.

146. They also proposed that CEBS considers making some sort of trade off between the eligibility criteria and the limits on the inclusion of hybrids as eligible Tier 1 capital. If CEBS offers a clear definition of sufficiently robust criteria, and is sure that the hybrids can meet them, then there is room for having limits which are less stringent.

147. The market participants interviewed all agreed on the 15% limit for innovative instruments.

148. Regarding the overall limit for inclusion of hybrids in Tier 1 the opinions varied a bit more. A majority of the market participants, however, would consider an overall limit between 30-35 % of Tier 1 as adequate; some including the 15% basket, some in addition to the 15% basket. These statements were clearly influenced by the limits used by the rating agencies. A higher percentage of hybrids, even if allowed under the national regime, might have a detrimental effect on the rating.

C. CEBS proposes that ordinary shares and disclosed reserves/retained earnings represent at least and at all times 70% of the required Tier 1 capital. When an institution operates above the required Tier 1 capital, CEBS proposes that ordinary shares and disclosed reserves/retained earnings represent at least and at all times 50 % of the total Tier 1 after deductions. Instruments with an incentive to redeem and instruments with ACSM are limited to 15% (limit included in the latter one)

149. While there is consensus on the 15% limit for innovative instruments, the need arises to set a limit for all other hybrids, or at least, (achieving the same practical effect) a comprehensive overall limit on hybrids eligible for Tier 1 capital.

150. A majority of CEBS members felt uncomfortable with setting a global limit higher than one third of total Tier 1. However, some others already have a higher limit and raised concerns about the market disruption this could cause.

151. Therefore a compromise solution has been reached in order to preserve the quality of regulatory capital.

152. Under the compromise, only banks that have met 70% of their required Tier 1 with common shares and disclosed reserves/retained earnings will be able to count additional hybrid capital. Banks should have the flexibility to raise surplus Tier 1 capital in the form of hybrids and it is not intended to unduly restrict the amount of good quality hybrid Tier 1 capital that can be issued by a well capitalised bank. CEBS also recognises that in practice market discipline will act as a constraint on the amount of hybrid Tier 1 capital a bank can issue. The SPR states that common equity and reserves should be the predominant form of tier 1 and it would be a departure from this to allow hybrid capital to be greater than 50% of tier 1.

153. Some CEBS members, however, want the same 70% limit to prevail in all cases as in their view this would be more in line with the stated aim of improving the average quality of capital.

CEBS' proposal for EU limits on the inclusion of hybrid instruments in Tier 1 capital:

Overall limit: ordinary shares and disclosed reserves/retained earnings represent at least and at all times 70% of the required Tier 1 capital.

When an institution operates above the required Tier 1 capital, ordinary shares and disclosed reserves/retained earnings represent at least and at all times 50 % of the total Tier 1 after deductions.

Some CEBS members want the same 70% limit to prevail in all cases as in their view this would be more in line with the stated aim of improving the average quality of capital.

Limit for instruments with incentive to redeem and instruments with ACSM: 15 % of Tier 1 after deductions (this limit is included in the overall limit to hybrids)

Part 5: Grandfathering

Grandfathering clause aims at limiting the impact on financial markets of the proposed common regulatory approach

154. Hybrid instruments are currently included in Tier 1 on the eligibility criteria at the time of their issuance. In order to achieve convergence all CEBS members will have to amend their current rules on hybrids to some degree. Although not all existing hybrids will lose their eligibility, the volume of hybrid instruments in the market that may cease to qualify under the revised rules could be substantial.

155. Rules are needed that soften the impact of the new rules on the market and allow for an adequate transition period.

156. In its letter the Commission specifically asks that due consideration should be given to possible ways of limiting the impact on financial markets of any future common regulatory approach. The provision of “grandfathering” to guarantee that the current issues will continue to be eligible is specifically mentioned and can be considered an efficient means of achieving the objective.

157. Any call for redemption will be subject to prior supervisory approval.

158. Regulatory calls (i.e. the issuer has the option to redeem if the instrument no longer qualifies as regulatory capital) will not be applicable since the instruments will continue to count as regulatory capital. Any grandfathered instrument which does not comply with the grandfathering rules will be disqualified as Tier 1 and considered as additional own funds (Tier 2).

159. Several options have been considered:

   a. Grandfathering for a pre-set time: this option could cause problems with outstanding instruments which have no option to redeem. It effectively makes all hybrid instruments dated. This would cause turbulence in financial markets because of the re-pricing of instruments which would lead to unanticipated mark to market profits or losses.

   b. Grandfathering until the first call date: this would allow existing instruments to count as Tier 1 capital up to the point that the bank is first able to redeem the instrument. It effectively makes instruments with a call feature dated, whether or not there is an incentive to redeem. This option does not address instruments without a call.

   c. Permanent grandfathering: this would allow all existing instruments to count as Tier 1 capital indefinitely. Permanent grandfathering does not effectively create a market with dated instruments.

d. Gradual “amortisation plan”: according to this option the existing instruments would gradually lose their eligibility for inclusion in Tier 1 over a certain period of time.

CEBS proposal for grandfathering rules of instruments that do not fulfil all the criteria mentioned earlier:

- Instruments with an incentive to redeem: instruments remain eligible until the first call date.

- The eligibility of all other instruments (including hybrids with incentives to redeem which are not callable and those which are callable but have not been redeemed) will be gradually reduced over a period of 30 years (see below).

Any redemption should be made at the initiative of the issuer and subject to prior supervisory approval.

Years after new requirements entered into force	**Limit for inclusion of grandfathered instruments into Tier 1**
10 years	20 %
20 years	10 %
30 years	0 %