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Dear Madams and Sirs,

Sent by e-mail to liquidity@c-ebs.org

Response to CEBS CP 27 on Implementation Guidelines regarding Hybrid Capital Instruments

Introduction

The British Bankers Association (BBA) and The London Investment Banking Association (LIBA) are pleased to respond to the CEBS Consultation Paper 27 on its proposed implementation guidelines for hybrid Tier 1 capital instruments and fully support CEBS' objectives of promoting a harmonised approach to the treatment of hybrid instruments by European supervisors.

The BBA is the leading association for the UK banking and financial services sector, speaking for 228 banking members from 60 countries on the full range of UK or international banking issues and engaging with 35 associated professional firms.

Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

LIBA is the principal trade association in the United Kingdom for firms active in the investment banking and securities industry. The Association represents the interests of its members on all aspects of their business and promotes their interests both domestically and internationally.

We support a principles based approach

The joint trade associations support a principles based, substance over form approach to the regulatory oversight of hybrid instruments and agree with the objectives of achieving a common understanding among the competent authorities, fostering convergent transposition of the requirements and creating more transparency for market participants.

A principles based approach (rather than a prescriptive rules based one) is a more appropriate avenue for CEBS to consider. Overly prescriptive EU-wide rules will limit the flexibility for national regulators to address market innovation and the differences in legal, accounting and tax frameworks in the different European jurisdictions as well as exceptional circumstances of individual institutions, should they arise, whilst maintaining the robustness of the hybrid capital regime. Care should also be taken to ensure that CEBS' proposals do not hinder the transition into whatever guidelines on capital definition that are eventually issued by the Basel Committee. In addition, in our view, it properly emphasises that senior management should have primary responsibility for ensuring that the capital instruments issued by their firms meet the spirit rather than just the form of the regulatory requirements.

The guidelines on buybacks should be removed

We note that the proposed guidelines address the issue of hybrid security buybacks before five years even though this aspect of a bank's capital management and planning is not addressed in the latest amendments to the Capital Requirements Directive. So we believe this element of CEBS' work goes beyond its remit and should be removed from the Guidelines, or at the very least delayed until an international consensus is reached on this topic by the Basel Committee, bearing in mind that, depending on the conclusions reached by the Basel Committee, firms should not be restricted from using buybacks to fine-tune their capital structure.

Hybrid buybacks have actually been a significant generator of Core Tier 1 capital in recent months, as banks have sought to re-build their balance sheets as they emerge from the crisis. Penalising or preventing this option would be a perverse outcome.

We recognise that banks will discuss their capital composition, and any changes they anticipate to it at least annually with their supervisor in the Pillar 2 review. This is the best forum in which to raise the issue of any buybacks that the firm may be contemplating. The buyback opportunity is completely at the discretion of the bank management and the only incentives would be to maximize stakeholder returns by creating economic gains and/or generating additional core capital via the buyback at discounted prices.

The overriding regulatory consideration should be that after any operation to manage its capital via a buyback the bank should have sufficient capital to ensure that it continues to meet the regulatory minimum established as a result of the Pillar 2 discussion between the bank and its supervisor and to maintain flexibility to deal with a crisis. This remains the clear responsibility of senior management whose decisions are subject to regulatory oversight at all times.

While we agree that regulators should be fully aware of a firm's buyback plans, for instance through the Pillar 2 dialogue, ,care must be taken to ensure that they do not engage in micro management of the bank or potentially act as shadow management. In particular we recall paragraph 746 of the Basel II framework which emphasises that the Pillar 2 review should be focused on 'the quality of the bank's risk management and controls and should not result in supervisors functioning as bank management.' Rather we think that planning for capital adequacy remains the domain of the bank's board and senior management.

We do not believe that the CEBS' proposal is within the spirit of this principle and therefore recommend the complete removal of paragraphs 71 and 72 from the guidelines.

<u>Permanence</u>

Question 1:

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

The wording of paragraphs 52 to 57 which describe incentives to redeem are broadly as we expected.

In the interests of brevity, we recommend the deletion of the final three sentences of paragraph 53, starting 'However…….' This could potentially capture structures which are clearly non-step up in nature, for instance fixed/floating non-step resets, five year Gilt or Treasury resets or fixed for life callables.

We note that paragraph 62 states an issuer should inform the competent authority "as soon as it has made its decision to redeem a hybrid". However, Article 63a (2) creates a clear requirement that instruments may only be called or redeemed with prior consent of the competent authorities. The decision to call or redeem will form part of an issuers' capital planning process but will also be affected by current market and economic conditions at the time notice would need to be provided to investors/the market. We agree that plans to call or redeem instruments should be included in the ICAAP/SREP processes of entities and that competent authorities should be aware of intentions well in advance of the required call/redemption dates.

We therefore suggest that it would be helpful to remove the first sentence of paragraph 62 and amend the opening sentence of paragraph 64 to read:

> 'As far as it is not already available to the competent authority *as part of the regular ICAAP/SREP or other relevant process…..*

We note that paragraph 63 requires the host state regulator to inform the consolidating supervisor when it has received an application for a call or redemption, where the issuer is a subsidiary domiciled in another EU member state from the parent. This is reasonable, but we would not expect the consolidating supervisor to be able to exercise a power of veto – the decision should be at the sole discretion of the host state regulator.

We note that CEBS proposes that hybrid instruments that are not redeemed on the call date should retain their classification as innovative instruments. Once the final call date (or other final economic incentive to redeem) has passed we see no ongoing rational to continue to classify the instrument as innovative and recommend that the paragraph 58 be deleted.

Paragraph 70 appears to duplicate the information requirements of paragraph 64, and in any event this information will be available to the supervisor as part of the Pillar 2 process. We therefore suggest this paragraph should be removed.

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

We note that CEBS has proposed limiting the number of shares that may be issued under a principal stock-settlement provision to that number of shares that has a value equal to 150% of the principal amount of the hybrid on the issue date. We anticipate that the practical effect of imposing such a cap might be to significantly reduce (or possibly eliminate) its usage. This is because the cap would be viewed negatively both by fixed income investors, who generally invest in instruments that provide for a return of principal, and equity investors, who generally invest in instruments that entitle the holder to participate in the growth of the issuer. Since the cap exposes the holder to principal risk and limits upside participation, it risks alienating both fixed income and equity investors.

Indeed, since the FSA introduced a principal stock-settlement cap in the UK in 2003, no UK financial institutions have issued hybrid securities featuring principal stock-settlement. Prior to that date (when the number of shares was not capped), UK financial institutions issued in excess of £3 billion-equivalent of hybrid issues featuring principal stock settle provisions. Hybrid issues featuring uncapped stock-settlement provisions also have been issued successfully by financial institutions domiciled other countries.

It may be argued that an uncapped stock-settlement provision could facilitate a recapitalisation of the issuer in a financial distress scenario. The recent preferred and hybrid into equity exchanges executed by certain US banks are examples of transactions that boost an issuer's Core Tier 1 levels by converting hybrid and preference share instruments into ordinary shares, in some cases having a value approximately equal to the principal amount of the hybrid.[1] Although the preferred and hybrid into equity exchanges were not contemplated by the original terms of the preferred and hybrid instruments, their economics were similar to a principal stock-settlement.

Another example where the principal stock settlement has helped institutions to raise core capital is the Australian market. Over recent years, certain Australian banks have chosen to issue hybrid Tier 1 securities featuring the principal stock settlement mechanism convertible into a variable number of ordinary shares, based on the Volume Weighted Average Price on the conversion date, in lieu of exercising the cash call option, thereby strengthening their core capital2. Of note is also that under Australian regulatory rules, principal stock settled transactions can fall outside the 15% of Tier 1 bucket for transactions (which is for instruments containing an incentive to redeem), provided they do not contain an interest step-up and meet certain other criteria.

In addition, some government capital injections have also included principal stock settlement features with conversion into either a fixed or variable number of shares without a cap of the conversion ratio and qualifying as core capital (not hybrid capital).

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.

As we note above we are not convinced that a buy back is indeed analogous to a redemption or call. Investors have the option to participate or not in a buyback which is not the case with a redemption or call. An economically justified buyback creates capital and adds economic value to the bank as part of the inherent financial merit of buying back at a discount from the issue price/par – this is not true of redemption for cash – they are very different results.

We therefore consider that the inclusion of guidelines in relation to buybacks is unnecessary and not a requirement of the updated CRD package. They should be removed.

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[1] See for example preference share and trust preferred into equity equity exchanges executed by Bank of America, Citi, Fifth Third, KeyCorp, Regions and SunTrust

[2] See for example the conversion of ANZ Stapled Exchangeable Preferred Securities on Sept 15, 2008 or the Westpac (St George) Preferred Resetting Yield Marketable Equity Securities on 21 Feb, 2006.

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.

A prohibition of the buyback of hybrids in the first five years of an instrument would limit the flexibility of a bank to manage its capital structure and may, because of the more straight forward process for buying back issued common equity create the perverse outcome of redeeming equity before hybrids. A prohibition on buybacks would also impede banks' ability to take advantage of market opportunities to enhance core capital by buying back hybrid instruments that are trading at a discount (which is effectively a form of loss absorbency through market action).

Should CEBS decide not to remove the guidelines on buy backs then we would wish the revised guidelines to make it explicit that the prior supervisory approval requirement, referred to in paragraph 72 b), can be fulfilled as part of the annual Pillar 2/capital planning process providing the buyback was completed within 12 months of the finalisation of the Pillar 2 review.

In addition, the requirement in 72 c) that where a replacement or exchange is taking place the new instrument should already be in existence is too onerous. Transactions such as these usually take place contemporaneously – the words '*that the new instrument has already been issued and*' should be deleted.

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.

The obvious instances in which a buy-back would be justified, without the need to replace or exchange the instruments being purchased, would be where the institution has either taken actions to shrink its balance sheet, to reduce RWAs or experienced a significant increase in profitability and therefore reserves/capital and wishes to adjust the mix of its capital. Other buy back circumstances might arise from a desire on the part of the bank to manage its capital structure after a merger or acquisition, where consolidated group capital remains adequate and there is no longer any requirement for hybrid capital structures in newly acquired subsidiaries. There may also be particular circumstances where buy-backs may create additional ways of meeting regulatory concerns.

We firmly believe it is the responsibility of senior management to ensure that their bank always has sufficient capital to meet its capital requirements as specified by its supervisor as a result of the Pillar 2 process, which should explicitly include a discussion of its capital plan. In the Pillar 2 process a bank's capital adequacy should be assessed over the medium term, perhaps a period of three to five years, after the application of suitable stressed scenarios and it is a clear responsibility of senior management to ensure that it exceeds its minimum capital ratios at all times.

We would also point out that instruments can be called by the issuer at any time because of a change in tax or regulatory capital treatment, something we support, so preventing buy-backs in the first five years appears in comparison to be unduly restrictive.

It should also be noted that buybacks could improve the quality of the capital structure if securities are bought back at a discount and core capital is generated (so from this perspective should be viewed favourably by the regulator). Market conditions creating the economic/capital benefit of such a buyback could also mean that new replacement capital is not in the opinion of management as attractive as it could be at another time. Forcing an immediate replacement may inhibit the ability to capture the buyback opportunity. Management should be using its judgement to determine the most prudent and efficient sourcing of capital as they do in other areas of capital and risk management (FX, rates, etc).

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?

There is no need to include further criteria. Banks have no incentive to deplete their capital base as credit conditions deteriorate, senior management is required to ensure the proper solvency of the bank they manage at all times.

If the credit quality of a bank's portfolio is decreasing its Risk Weighted Assets will simultaneously be increasing, depending on write-off policy and it will be required to hold more capital in order to meet the regulatory minimum capital ratios – this is an ongoing responsibility of senior management which they take seriously. The appropriate regulatory architecture already exists to ensure that prudent capital levels are maintained, no more needs to be created.

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.

Market making is not the same as a buy-back or redemption of an instrument. We do not believe that an overall 5% market making limit is practical. A bank's trading book activities take place behind a Chinese wall and limiting total holdings to 5% of the relevant issuance could impede a bank's normal capital management and market making activities as its buys and holds a portion of an instrument, particularly in the placement phase, immediately after an instrument is brought to the market. We think a limit of not less than 10% should apply.

We note that the wording of 73 suggests that the market making/smoothing exemption is a national discretion. We support, wherever possible, the removal of national discretions from the regulation of banks and investment firms so believe that this should be re-written as a requirement, along the lines of:

"<u>Issuers may undertake</u> market making or market smoothing……"

Separately from the requirements in relating to market making we think that, subject to regulatory approval, a firm should be able to hold a proportion greater than 10% of its hybrids in issue in "treasury stock," giving the flexibility either to cancel or re-issue the hybrids in future, depending on its capital management plans and other objectives.

<u>Flexibility of payments</u>

Cancellation of payments

Paragraph 63a (3) subparagraph 3 is quite clear – a credit institution shall not pay the interest or dividend on a hybrid instrument if it would cease to comply with the capital requirements of

Article 75. Article 75 cross refers to further article 136 and thence to articles 123 and 124. This feeds into an institution's consideration of whether or not it will continue to meet the Article 75 capital requirements the ICAAP and SREP Pillar 2 processes, which are forward looking and require the use of stress testing. We do not therefore believe there is any further need to describe the circumstances around a supervisory request or deferral/cancellation of payments on hybrid instruments where the information described in paragraph 81 has already been provided in other regulatory disclosures. Furthermore such suspension can also be achieved contractually. So we recommend that the Guidelines remain silent on this, relying on member states to copy-out the legislation, which is an approach we generally support.

Payment from distributable reserves

We note that paragraph 78 suggests that coupons/dividends payments may only be paid from distributable reserves of the issuer. This could result in payments from adequately capitalised, profitable banks being restricted, particularly after a recapitalisation. We believe this paragraph should state that payments on hybrids can only be made if the issuer has "sufficient distributable items" as SPV structures do not require payments from distributable reserves but do require sufficient reserves to allow payment.

Question 3:

Are the guidelines in relation to dividend pusher or stopper sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended?

The requirements in relation to dividend pushers are clear but we recommend a couple of clarifications to them.

In relation to paragraph 83 we think the two conditions in a) and b) are sufficient and that therefore the last part of this paragraph may be deleted. As an alternative to deletion we recommend the addition of the wording below as it is not clear to us that it matters how dividends are paid. For instance shareholders may prefer, perhaps for tax reasons, to receive scrip or in specie distribution.

> They ~~should~~ may also have the option to waive the hybrid coupon/dividend if the ~~major part~~ *entire* dividend to shareholders is not paid in cash *or similar distribution* to shareholders but in shares.

Paragraphs 84 and 85 in relation to dividend stoppers however are less clear and some re wording would be helpful to make its meaning plain. In particular as paragraph 84 appears to be a statement of fact it could be deleted.

What would be the impact of the restriction on the use of dividend pusher and stopper? Please provide evidence.

Hybrid bank capital securities are useful in providing banks with alternative sources of cost efficient capital which further supports the cost effective provision of lending to the consumers and businesses in the broader economy. All features which increase the risk for hybrid capital security investors will increase the cost and limit the access to capital for banks and these negative results will therefore flow through to the consumers and businesses in the economy. Indeed recent comment about possible regulatory action in relation to payments to be made on hybrid instruments has already resulted in volatile markets.

Pushers/stoppers serve to distinguish the bank capital security investor from common equity investors and helps open up the fixed income market as an important alternative source of capital for the banks besides the equity markets. Pushers/stoppers seek to ensure that hybrid bank capital security investors are in no worse a position than the investors of common stock who are typically junior to the hybrid bank capital security investors. Eliminating or minimising this distinction will drive up cost and limit market access – particularly for second and third tier banks that can be vitally important to local economies and their citizens.

Question 4:

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

Yes.

4.2 What would be the impact of implementing these guidelines on ACSM mechanisms? Would you propose any other options?

Paragraph 90 requires deferred coupons in the form of Article 57 (a) instruments to be issued 'without delay'. The requirement to subscribe immediately reduces the element of flexibility that banks look for so that they can avoid issuing their shares when market conditions are unfavourable. The bank should be able to defer equity issuance until it has emerged from the other side of the stress it is experiencing, if that would be the most prudential approach.

Investors in hybrid instruments are typically fixed income rather than equity investors - indeed they may be prevented by their investment mandates from holding shares. So in cases where they receive shares as part of an ACSM they would typically expect the shares to be sold on their behalf, rather than actually taking delivery and subsequently selling them. For this reason we recommend the addition, in line 11 of the words:

> "‥, sold in the market by <u>or on behalf of</u> the hybrid holders ………"

A further concern arises in relation to paragraph 92 where the possibility of immediate cancellation of the ACSM payment substitution mechanism is created. This possibility of immediate cancellation will negate the tax benefits of a directly issued instrument resulting in the use of indirect issuance structures in some jurisdictions. While we welcome CEBS' equal treatment of SPV structures, there has been a general desire over recent years among issuers, investors and regulators to use directly-issued structures where possible, as these tend to be simpler for all concerned. We therefore recommend the deletion of the last sentence of paragraph 92 as the text of Article 63 (a) (3) implicitly contains this ability. Providing investors with some comfort that the ACSM provides a workable non-cash method to achieve hybrid payments will lower the cost of providing finance to banks and the beneficiaries. If the ACSM seems unlikely to benefit investors the cost of capital to banks and the public will increase and economic growth will be retarded. Additionally, if there is systemic pressure and several banks are required to sell ACSM shares into the market for common stock the banking system will suffer additional downward price pressure at a time that important new equity raising could be more important. Therefore allowing bank managers discretion on the timing of ACSM fulfilment based on their assessment of then current market conditions seems a more beneficial and holistic solution for the banks and banking system.

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.

We agree with the guidelines' interpretation of the CRD changes that holders of hybrid instruments should not be able to petition for insolvency in their capacity as hybrid holders.

We also agree that hybrid instruments should always rank as more junior to depositors, general creditors and the Tier 2 subordinated debt of the institution and are in no doubt that all hybrid instruments do absorb losses in liquidation and have evidenced some going concern loss absorbency e.g. liability management.

It appears to us that the wording of paragraph 112 refers to the restructuring of an institution rather than to the design of hybrid instruments. It should therefore be deleted.

Write down/conversion

As hybrids in the UK do help to prevent insolvency because they meet the four preconditions in paragraph 106 we do not believe that there is any further need to elaborate on the prevention of insolvency on a going concern basis. In particular, although we recognise that CEBS has been given a mandate under Article 63a(4) to elaborate mechanisms to ensure that the instrument will absorb losses and not hinder the recapitalisation of the firm, we consider that CEBS' suggested mechanisms (principal write down or conversion into ordinary shares) should not be seen as exhaustive and other mechanisms could be developed in the future.

The effect of such write down provisions would be that common equity and hybrid holders would effectively rank pari passu, which does not reflect the reality of the relative relationship and we recommend that paragraphs113 and114 be deleted.

Trigger points

We counsel against the introduction of a particular trigger point at which the hybrid would be written down. Writing down is an approach that we do not agree with but should CEBS choose to keep it we recommend that it be kept flexible and occur so as to preserve the relative rankings of hybrid holders and shareholders. Any exercise by the regulator of a loss absorption mechanism could signal to the market that the firm was in severe difficulty which could in itself hinder the bank's attempts to secure any needed liquidity, funding or capital (creating a downward spiral) and we thus recommend the removal of paragraphs 116 but agree with CEBS' presumption in paragraph 117 that such information should be contained in the prospectus.

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

It is important to note that from a company law perspective, deferrable, perpetual subordinated debt in the UK is adequate to ensure solvency. In this respect all hybrid instruments today fully comply with the description of going concern. It is in the context of banking regulation, where minimum equity is required, that a breach of the minimum levels would trigger regulatory actions.

We agree that the ability of an instrument to absorb losses on a going concern basis should be tied to its ability to prevent insolvency by, for instance, stopping the payment of coupons. But, as we have consistently argued, going concern loss absorbency should not also be linked to a judgment about whether or not the instrument hinders the recapitalisation of the credit institution. However, this wording is already included in the CRD and we do not believe further elaboration should be attempted. All that is needed is an assessment of the ability of the instrument to absorb losses in accordance with the objectives as described in paragraph 95. We therefore encourage CEBS to remove its requirement that there should be a meaningful statutory or contractual mechanism that requires temporary or permanent write down by deleting paragraph 114.

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 inclusion of a requirement that hybrid instruments contain a statutory or contractual mechanism to make recapitalisation more likely will be a significant impediment to innovation as CEBS' implicit promotion of write down mechanisms (which we do not support) will be likely to narrow the range of different models that may emerge. Such mechanisms decrease investor certainty, increase perceived risks and would be likely to increase the volatility of bank shares in distressed scenarios which will in itself aggravate any recapitalisation plans. We recommend the removal of references to write-down mechanisms.

Notwithstanding our general disagreement with the need for principal write down features, if such features are ultimately required, we think it is important to consider the interaction between cancellation of coupon payments and common dividend stoppers/pushers. We understand CEBS' concern that common dividend payments should not immediately push a full write back of principal and that common dividend stoppers might conceivably hinder recapitalisation in some circumstances. However, we strongly disagree with combining cancellation of hybrid coupon payments with the waiver of common dividend stoppers/pushers - as this would allow the payment of common dividends at a time when hybrid coupons are precluded. This would be a substantial concern for hybrid investors and could severely impact the marketability of hybrid securities with such features. A compromise that might meet all concerns would be to allow hybrid coupon payments during a writedown period, based on the current written down principal amount, in the event that common dividend payments are resumed.

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?

We believe that the question about whether there could be different rankings within hybrid Tier1 seems to be an area where flexibility is best left to individual banks, so they can balance transparency / simplicity of capital structure with any special requirements e.g. in the context of a recapitalisation.

<u>Limits</u>

Question 6

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

The limits are clearly expressed in the text of Article 66(1a) so believe this is sufficient but we have no objection to the wording in paragraphs 118to 122 of the Guidelines.

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

Overall, the requirement in paragraph 134 of the guidelines for the conversion ratio to be capped based on the price at the issue date is not in our view proportionate and balanced because it effectively requires hybrid investors to bear full equity downside risk without the same upside and other benefits enjoyed by shareholders.

Although this might be a feature of current forms of mandatory convertible (and which is reflected in their cost), it leaves little room for the development of other forms of hybrid convertible instruments that would fall outside the 35% bucket under the proposed rules. A potential way of giving issuers more flexibility to develop other marketable structures would be to permit a higher conversion ratio that would be agreed before issuance with regulators. This would result in a security where investors share in the equity downside risk upon an emergency conversion, but at a slightly later point than ordinary shareholders (the price buffer provided would effectively be a compensation for the fact that the convertible investors do not participate in the equity upside in the same way as ordinary shareholders).

In addition, we caution against requiring the definition of 'emergency situation' in the contractual terms of the instrument. To do so might limit the ability of competent authorities to act with sufficient flexibility in times of difficulty. A "hard wired" contractual security term may limit flexibility and create unintended consequences which could increase volatility in distressed situations.

Similarly we caution against the requirement that any higher regulatory limit than the 4% Tier 1 and the 8% total capital ratio to be identified. This would require the disclosure of post Pillar 2 individual capital guidance. Institutions strongly believe that their conversations with regulators should be treated as confidential based as they are on forward looking assessments of profitability and business strategy. It would also raise signalling issues at times when a firm's regulatory ratio changes. Such disclosure should not be mandatory.

<u>Hybrid instruments issued through an SPV</u>

Question 7

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

The guidelines provided are clear. However, we would add that some of CEBS' proposed structural requirements are likely to lead to issuers in certain jurisdictions (including the UK) having to use SPV structures in order to create tax-deductible hybrid instruments. In order to ensure a level playing field, it is important that both directly-issued and SPV-based structures are treated similarly for institutions in terms of both solo and consolidated capital treatment given that the loss absorption capabilities of both formats are substantially the same.

British Bankers Association **London Investment Banking Association**

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