Introduction

Moody's welcomes the Committee of European Banking Supervisors' (CEBS) Consultation Paper 27 and the opportunity to comment on the implementation guidelines for hybrid capital instruments.

As one of the world's leading rating agencies, Moody's has been classifying hybrid instruments for many years and places hybrids into different "baskets" based upon the hybrid's equity-like characteristics with respect to maturity, loss absorption, and ongoing payments. The basket assigned to a hybrid then influences how the hybrid is treated in the various capital, leverage and coverage metrics Moody's uses when rating a bank, insurer, or corporate. Since Moody's typically classifies hybrids across banking, insurance, and corporates in the same way, a hybrid with certain features will receive the same treatment no matter what the issuer type.

Moody's agrees with the policy articulated in the revised Capital Requirement Directives towards greater convergence of supervisory practices with respect to hybrid capital instruments. It is valuable for investors to know that a hybrid, which receives, for instance, Tier 1 treatment for one bank is similar to a hybrid that receives Tier 1 for another bank or an insurer, particularly in the case of bancassurance companies. We note, in particular, that the current proposal would create hybrid instruments, which in some cases, have substantially different features than those expected to be issued by European insurers following the CEIOPS-proposed changes.

Permanence / incentive to redeem

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.

A hybrid instrument typically contains provisions that lead to an expectation among market participants that it will be redeemed at the call date. The guidelines are clear in delineating these incentives to redeem, such as, interest rate step-ups and principal stock settlement combined with a call option. The guidelines permit a maximum step-up of either 100 basis points over the initial rate or 50% of the initial credit spread.

In its classification of hybrid instruments, Moody's is only comfortable with a moderate step-up that is limited to 100 basis points over the initial credit spread. Moody's is in agreement with the guidelines that a hybrid could have other features that provide an incentive to redeem, requiring analysis on a case-by-case basis.

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

The guidelines suggest that the cap on the conversion ratio at the date of redemption shall not be more than 150% of the conversion ratio at the time of the issue. In its classification of hybrid securities, Moody's is comfortable with a fixed conversion rate that is established at the time of issuance. For a principal stock settlement mechanism in conjunction with a call option, a cap of 150% seems generous and may contribute to stock dilution, thereby creating a strong incentive to exercise the call option.

2. Permanence / buy back

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.

The guidelines relating to buy-backs are sufficiently clear and do not require further elaboration. The consultation paper makes it apparent that, in economical and prudential terms, buy-backs are equivalent to a call or a redemption. As a result, supervisors will apply the same process to the buy-back of a hybrid as to a call or a redemption in terms of the equity content of the replacement security.

2.2 Buyback cases

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.

All else being equal, Moody's expects that a hybrid will be outstanding for some period of time to warrant the assignment of equity credit. It is beneficial from an equity credit perspective if a buy-back is subject to prior supervisory approval and after being replaced with capital of at least the same or better quality.

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.

Moody's does not have any comments.

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?

Moody's does not have any comments.

2.3 What would be the impact of limiting the amount of repurchased instruments held by the institutions at any time to 5% of the relevant issuance? Please provide evidence.

Moody's does not have any comments.

3. Flexibility of payments

3.1 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 on how the text could be amended?

The guidelines are sufficiently clear. Moody's has observed during the market crisis that pushers on parity securities may have hindered an issuer's ability to skip coupon payments when its financial condition weakened.

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

In its classification of hybrid securities, Moody's may consider giving more equity credit to hybrids where there is flexibility regarding the use of a pusher so that the bank has the unfettered ability to cancel coupon payments, if need be.

4. Flexibility of payments / ACSM

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.

Moody's has observed during the market crisis that optional coupon skip mechanisms coupled with Alternative Coupon Settlement Mechanisms (ACSM) or that are cumulative tend not to be utilized until a bank is in severe financial distress relative to non-cumulative securities. In addition, a liquidity rather than capital benefit is provided when coupons are skipped as they eventually need to be repaid. ACSM allowing for cancellation of the coupon as proposed in the guidelines is more equity-like than many existing versions of ACSM. It is also not clear to us how capital would decrease if deferred coupons are settled using ACSM.

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

There would be no impact on Moody's classification of hybrid securities.

5. Loss absorbency

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

The text is clear. Amendments are not necessary.

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

Moody's agrees with the definition.

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?

Yes, the guidelines provide flexibility as they allow regulators with the appropriate legal authority to transform a hybrid instrument to equity via a temporary or a permanent principal write-down or via a conversion into an equity instrument. However, this may not result in a level playing field because certain jurisdictions may not have the legal ability to avail themselves of the hybrid's flexibility.

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?

Different levels of subordination provide an indication of potential losses in liquidation. However, to formulate a comprehensive view of the ability of these securities to absorb losses both as a going and gone concern, it is necessary to analyze the features of an individual instrument together with the legal and regulatory framework of the jurisdiction.

6. Limits

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 guidelines are clear.

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

Moody's does not disagree with the conditions for mandatory convertibles.

7. Hybrids Issued Through SPV

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

Yes, the guidelines are clear as they state that hybrids issued via a SPV should meet the same requirements as hybrids issued directly by an institution.