

Swedish Bankers' Association

Svenska Bankföreningen

POSITION PAPER
20th February 2008

CEBS
By email to:
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CEBS Draft proposal for a common EU definition of Tier 1 hybrids (CP17)

Swedish Bankers' Association welcomes the opportunity to comment on the CEBS consultation paper on its proposal for a common EU definition of Tier 1 hybrids.

As a member of the European Banking Federation (EBF) we support the conclusions in the EBF response to the consultation paper. However, from the perspective of Swedish banks we want to emphasize the following:

Swedish Bankers' Association note that the objective of CEBS is 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 Sydney Press Release.

We welcome CEBS' initiative to harmonize the legislation on Tier 1 hybrids within the EU. Studies which CEBS recently have undertaken, at the request of the European Commission, show that the "implementation" of the Sydney Press Release differs between member states. This is especially the case with regards to the total limit for inclusion of hybrids in Tier 1, which varies between 0 and 50 per cent among Member States.

The Sydney Press Release is built on three eligibility criteria: (1) Permanence, (2) Loss absorption and (3) Flexibility of payments. When these criteria are implemented in to EU legislation it is very important to bear in mind that accounting, tax, bankruptcy and company law differ between member states. As these differences between member states are likely to remain, and also to change over time, we believe that EU legislation should stick to the principle-based approach in the Sydney Press Release, rather than moving to the proposed approach which in our opinion is overly prescriptive.

Swedish Bankers' Association is therefore of the opinion that the transposition of the Sydney Press Release in to EU legislation should focus on the differences among member states which truly creates distortions of competition and is an obstacle for creating a single European financial market. The main area where convergence needs to be achieved is the limits for inclusion of hybrids in Tier 1. In the light of the Sydney

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Press Release and the limits being used in the largest member states today, we are of the opinion that the EU should impose a 50 per cent maximum limit.

To make the harmonization effective we believe that the new EU legislation should not include any national options or possibilities for "goldplating". We firmly believe that the process for achieving greater harmonisation among member states with regard to hybrids should be emphasized so that we ensure a level playing field for banks' in Europe as soon as possible.

When it comes to the eligibility criteria we are of the opinion that CEBS should not go beyond the principles expressed in the Sydney Press Release.

Loss Absorption

The proposal states that in the case that the Tier 1 ratio falls below 2 per cent, the instrument must be able to absorb losses by including provisions for either a write-down or a conversion into ordinary shares upon the breach of the capital trigger. Today, the Swedish banks are able to write down the principal amount but subject to shareholder's approval and in order to avoid liquidation. The CEBS proposal could therefore lead to tax, legal, accounting and marketing problems for Swedish issuers.

The inclusion of a capital trigger may be an issue since it is unclear how the written down or written up amount would be treated from a tax perspective. The currently applied rules in Sweden allow for a write down of the principal, subject to the shareholder's approval, if it is evident from the liquidation balance sheet that more than 50 per cent of registered capital is lost. This feature is treated favourable from a tax perspective since the written down amount is not treated as a taxable gain. Further, the current rules allow for a write-up, subject to shareholder's approval and if it is done by drawing on the available unappropriated earnings stated in the balance sheet. Such a write up is considered as a dividend for corporate purposes but as a debt repayment for tax purposes. This allows the issuer to do the write-up from pre-tax earnings.

One consequence of the CEBS proposal may potentially be that a changed tax treatment of Tier 1 Hybrid instruments would lead to an increased volatility in the income statement, which is a counterproductive property.

We believe that the existing framework in Sweden already provides for the loss absorption which is expressed in the Sydney Press Release and that the examples above shows that it is problematic to come up with rules-based criteria for loss absorption.

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

Swedish Bankers' Association is of the opinion that the term ordinary share capital needs to be carefully considered in this context. For example under Swedish legislation all shares (including preference shares) are regarded as share capital but preference shares can "rank" senior to ordinary shares. If it is the meaning of CEBS proposal that share capital in this case shall be divided between ordinary shares and preference shares and that hybrids shall rank

senior only to ordinary shares it will be problematic to implement the proposal under Swedish legislation. It would from our perspective be better if CEBS would say that hybrids are senior only to share capital, regardless of share type. It is our understanding that the classification of preference shares as debt or equity as well as the legislation for ranking of preference shares differ between Member States and that it therefore might be useful to consider this issue in a wider context.

Flexibility of payments

CEBS is proposing an optional suspension of interest and a mandatory suspension based on the breach of a capital ratio. The implementation of this proposal could lead to accounting and hedging issues for Swedish banks.

The introduction of an optional suspension combined with perpetuity will result in equity accounting under IFRS - IAS 32. Under IFRS - IAS 39, hedge accounting is only possible where an instrument is accounted for as a liability, this would mean that banks would need to rely on additional features to secure debt accounting.

CEBS proposal for a financial trigger (2 per cent Tier I / RWA ratio) and the modification of the Swedish trigger should not have any meaningful impact on the treatment of the instrument. Also, the required optional suspension should not have an impact on the tax treatment of the instrument (i.e. loss of deductibility or imposition of withholding) because the tax treatment is defined by the corporate purpose of the instrument and not its accounting treatment.

The CEBS proposal states that supervisors should be able to require institutions to waive payments at their discretion based on the financial situation of the institution. We are concerned over this statement. This concern is, among other things, based on the fact that it is the management of the bank who operates the bank and therefore should take the decisions also in this area. In our view it should be enough to state that the institution must waive payments if it is in breach of the minimum capital requirement.

One key principle behind hybrid capital is that investors' claims on an ongoing basis and upon liquidation should rank ahead of equity at all times. We find the waivering of the dividend pusher / stopper upon breach of the trigger unnecessarily detrimental to this principle and it would impair our ability to raise capital as banks may be allowed to pay a dividend on common shares while Tier 1 hybrid investors are missing coupons. The requirement to not pay a distribution should be more than enough.

Limits to inclusion into Tier 1

CEBS propose that institutions, when operating above the required Tier 1 capital, should have an overall limit on hybrids of less than 50 per cent of the total Tier 1.

As shown in the surveys from CEBS the total limit in the Member States ranges from 0 to 50 per cent. These differences between the EU Member States seriously distort the competition conditions on the financial market in the EU. Therefore we strongly argue for a solution were all EU banks face the same limits for the inclusion of hybrids in Tier 1. In the light of the text in the Sydney Press Release and the limits being used in the largest member states today, we are of the opinion that the EU should impose a 50 per cent maximum limit. We also want to

emphasize that the necessary steps to create a level playing field must be taken as quickly as possible.

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