FEDERATION
BANCAIRE
FRANCAISE

The Director General delegate

Paris, September 23rd 2009

FBF comments on Consultation Paper on Implementation Guidelines regarding Hybrid Capital Instruments- CP27

Dear Sir,

The French Banking Federation (FBF) is the professional body representing over 450 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

The FBF is pleased to take this opportunity to comment on the proposed guidelines set out in CEBS's Consultation Paper CP 27. The document provides a good analysis of the issues regarding the main features of hybrid instruments, opportune proposals and additional guidance to banks.

We appreciate the initiatives taken by CEBS and broadly support its efforts to construe the hybrid status in Europe which is not yet in a definitive form. It is of the utmost importance that CEBS awaits the decisions to be taken by the Basel Committee before moving forward in this area. Indeed we feel that there might be insufficient understanding of the Tier 1 fixed income market and one must be very careful not to reduce investors' confidence when there are confusing messages in different fora about the quality and consistency of Tier one capital threatening the role of hybrids.

Banks require altogether more flexibility on some points and stable rules to be able to manage their capital in an efficient way in volatile markets. You will find our detailed comments in the annex attached.

The French Banking Federation wants to see the instigation of healthy competitive conditions and believes the only way to do so is to establish appropriate regulations. The FBF remains at your disposal for any further discussion on these matters.

Yours sincerely,

Pierre de Lauzun

Mr Arnoud VOSSEN
Secretary General
CEBS
Tower 42 (Level 18)
25 Old Broad Street
London EC2N 1HQ

French Banking Federation detailed comments on CEBS's consultation Paper 27 regarding Hybrid Capital Instruments

The FBF supports the objectives of CEBS to provide guidelines on criteria that hybrids must meet to achieve harmonization. We would like to stress however that we consider that some of the guidelines regarding loss absorbency in going concern and comments made during the public hearing held on September 8th show a lack of understanding of the Tier 1 fixed income market, which could very possibly result in the complete disappearance of this market and critical source of capital for banks. If, as a consequence of some guidelines not sufficiently thought over or overly prescriptive, the fixed income investors were deterred to invest in bank hybrid securities, it would have adverse consequences for banks in general, but even more so for the cooperative and mutual banks which have no access to the stock market to raise capital. We address the specifics of these issues in our answer to question 5 especially in Paragraphs 109, 112 and 114 to 117 where we identified the main threats.
Definitions concerning the capital taken at global level should also construe hybrids status, which is not yet in a definitive form. It is of the utmost importance that CEBS awaits the decisions to be taken at Basel level before moving forward in this area.

Question 1: 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.

We note that the definition of moderate step up, which is not specified in the CRD, refers to the Sydney accord.
Nevertheless we suggest that the definition of the moderate step up may be slightly modified to include also the case where the margin and therefore the step up is not calculated by reference to the Treasury Bill + swaps spread but by reference to the mid-swap recorded in the relevant market at the pricing date.

Instruments with incentive to redeem are classified in the 15% limit, but should be allowed in the 35% limit if they are not called.

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

Regarding the proposal to define a cap in the case of stock settlement, the calculation of the proposed cap should be clarified.

While a cap is understandable to ensure that such mechanism remains a moderate incentive to redeem, we believe that such a constraint imposed on stock settlement would make this a very weak incentive to redeem. This may be too low an incentive for fixed-income investors and not enough equity-like for equity investors, negating interest from investors for such mechanism. We would rather go for a cap on potential dilution to be introduced rather than the above measure.

Question 2: 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.

Provided that financial institutions are complying with the regulatory capital requirements, there should be enough flexibility in managing calls or redemption with a light supervision frame, in terms of consent deemed to be given in specified scenarios or information and data to be provided upfront. Also the timeframe and consent process of calls or redemptions to the competent authorities are made within the SREP and ICAAP frameworks, which must not duplicate the workload in engaging a call or redemption of hybrid instruments.

We consider that buybacks are of a materially different nature than calls or redemptions. Therefore the application process for call or redemption is not applicable for the buy-backs (cf. paragraphs 61 to 67) as it implies a large quantity of information and analyses to provide to the regulator, which is really demanding. We strongly recommend removing any reference in paragraphs 71 and 72 to a five-year restriction and to a mandatory replacement. Appropriateness of timing and replacement should be left at the discretion of the issuer and of its supervisor, depending on the specific situation justifying the economic and prudential rationale of a buyback. We are of the opinion that an alignment for consistency between treatment of ordinary shares and hybrid instruments in respect of timing should be considered.

We would suggest introducing a time limit of one month after the application to receive the prior consent of the regulator

Paragraph 64 to provide the estimated solvency data for the 3 to 5 years is very demanding. We would like to reduce it to a maximum of 3 years as rules are evolving
Paragraph 67 mentions that in case the hybrid instrument has already been replaced, the regulator may require less information. "Less information" should be defined and as reduced as possible.

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 buying back hybrid capital instruments in the first five years if and when the issuer has excess capital would seriously limit its flexibility to efficiently manage its capital structure.
Consequently, we strongly recommend removing any reference in paragraphs 71 and 72 to a five-year restriction and to a mandatory replacement.

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.

Such situation, justifying a rationale buyback from a prudential and economical perspective, could for instance occur after a drop in activity, merger or take-over to remove legacy transactions with undesired features, for a capital restructuring in view of a recapitalisation, or in case of substantial decrease of the risk weighted assets. This could also happen to replace and substitute excess Tier-1 or Tier-2 capital by equity through a buyback at a price that would be below the par amount.

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?

We believe that the appropriate regulatory architecture already exists to ensure that prudent capital levels are maintained.

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.

We appreciate that a 5% limit per issue is granted to institutions to enable them to hold self-issued bonds for market-making purposes only. We agree that those bonds should be deducted from the outstanding hybrids for own funds calculations.

We would like to recommend the increase of the proposed limit of 5%, which appears to be too low especially for smaller transactions, up to 10% minimum.

Question 3: Dividend
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? What would be the impact of the restriction on the use of dividend pusher and stopper? Please provide evidence.

Regarding the dividend pusher, we note that the guidelines are less investor-friendly than the rules applied today on the following point: currently interest payment on hybrids is compulsory if a dividend is paid either in cash or shares, except if it is only paid in shares. We do not wish to introduce the notion of "major part". It could represent an additional uncertainty discouraging investors. In paragraph 83 we propose to add at least: "save if the coupon is to be paid by ACSM".

Regarding the guidelines related to flexibility of payment, we note the requirement for dividends and coupons to be cancelled under supervisory request. We dispute such requirement to be on a fully discretionary basis. We strongly suggest clarifying the following, in order to avoid such an overwhelming and unfettered discretion impacting too severely the cost of hybrid capital. It is critical to precise in the guidelines that such regulatory intervention would remain an exceptional situation and to refer to a clearly identified risk that the institution will breach its capital requirements set according to Article 75 of the CRD or to refer to the concept of a "MAC clause" allowing regulatory intervention in case of major adverse changes."

Question 4: 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.
4.2 What would be the impact of implementing these guidelines on ACSM mechanisms? Would you propose any other options?

The definition of "without delay" should be deleted or clarified.

Paragraph 90 should confirm that banks must have full discretion of payments but subject to dividend pushers and stoppers as applicable.(...) when the issuer has full discretion over the payment of the coupons or dividend at all times, *subject to the application of dividend pushers and stoppers under conditions of paragraphs 82 to 85.*

Most structures provide for issuer flexibility to decide when ACSM should be enacted. We see tremendous value in leaving the choice for the issuer to decide when it should be enacted, possibly within an acceptable period of time of for instance 3 years, which would be in line with rating requirements.

Question 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.

We consider the guidelines related to the definition of loss absorbency in liquidation and in going concern to be broadly clear and principles-based, subject to critical comments made in responses 5.2. and 5.3.

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

CEBS takes the view in its guidelines that the definition of loss absorbency in going concern is to be assessed both from a capacity (1) to prevent insolvency and (2) to not hinder the recapitalisation / make the capitalisation more likely.

(1) Loss absorbency – Prevent insolvency

We agree with the definition of loss absorbency in going concern for what relates to the capacity to prevent insolvency as defined in paragraphs 106 to 109 taken from Paragraph 57(a) to (d) of the CRD;.

(a) Permanence
(b) Flexibility of payments
(c) Investors are not in a position to petition for insolvency
(d) Instruments are not taken into account for the purpose of determining insolvency

In some jurisdictions, it is noted that the preconditions (c) and (d) of paragraph 106 can not be met by the instruments issued by banks that embed the features of permanence, flexibility of payments and subordination. Only in these circumstances, we agree that alternative features, such as write-downs or conversions, may be required to achieve the criteria of paragraph 106.

This being said, as we agree that such alternative mechanisms like write-downs and conversions do not either increase the loss absorption capacity of hybrids nor improve the situation of the institution or the one of more senior creditors and depositors, it should be confirmed that the use of such mechanisms should be restricted to insolvency purposes exclusively to satisfy the criteria of paragraph 106. There is therefore no need to define a trigger in the terms and conditions as long as the contractual conditions of such mechanism properly address the requirements of paragraph 106.

(2) Loss absorbency – Not taken into account for the purposes of determining insolvency

We suggest modifying the wording of paragraph 109 which is too blunt in its formulation implying clearly a transformation into equity which has the potential to deter many fixed income investors.

"109. To make sure that the instrument would not be taken into account for insolvency purposes – notably if the instrument qualifies as a debt under insolvency, company or accounting law –, the competent authorities may require that the instrument ***has*** ~~is transformed into~~ equity ***features*** for the purpose of the application of the insolvency law. This may be achieved using different mechanisms such as a conversion into an equity instrument, or, if applicable for insolvency purposes, a write down mechanism. Depending on the relevant insolvency and accounting system the write down can be permanent or temporary."

(3) Loss absorbency – Not hindering the recapitalisation (make the recapitalisation more likely)

As hybrids do help to prevent insolvency because they meet the four preconditions in paragraph 106, we do not believe that it is any further needed to elaborate on the loss absorption capacity on a going concern basis. We suggest therefore modifying the wording of paragraph 112 as follows:

"112. The simple fact that the principal of hybrid instruments is available to the institution and the terms provide the flexibility to stop the payment of coupons may not be sufficient to restore the financial situation of the institution or attract new shareholders; notably because hybrid holders in general are being granted some form of preferential rights such as coupon/dividend payments. Due to these preferential rights, after a recapitalization hybrid holders might profit from it by immediately recovering the right to the full principal amount as well as to full coupon/dividend payments. ~~In this sense, hybrid instruments may hinder the recapitalization. It is much easier to attract new capital suppliers/owners/shareholders if they will benefit to a good extent from the return of their investment after the firm becomes profitable again due to their intervention. Hence, the new capital provided to recapitalise the institution should not be used directly or indirectly to benefit existing hybrid holders."~~

We are also in the opinion that it is going beyond CEBS's remit to request that hybrids should contain mechanisms such as permanent / temporary write-down or conversion into equity at a trigger point to demonstrate that they do not hinder recapitalisation and make it more likely. Consequently, we strongly suggest CEBS to remove paragraphs 114 and 115 from the guidelines.

Should CEBS decide to maintain paragraphs 114 and 115, we then advocate against the introduction and definition of a particular trigger point at which the hybrid Tier-1 capital instruments would be written down or converted, we strongly disagree with the use of both mechanisms. In the event CEBS decides to maintain this proposal we recommend that it be kept at the discretion of the institution and of its competent authority. This will maximise the flexibility to manage exceptional situations such as recapitalisations. We thus strongly recommend the removal of paragraphs 116 and 117.

We remind that hybrid capital satisfying eligibility criteria (other than those 114-117 disputed here) already prevent insolvency. CEBS is concerned, as described in the paragraph 113, that a balance between new shareholders and hybrid holders' rights is likely to be necessary for a recapitalisation. The hybrid instruments features derived from the CEBS guidelines, excluding paragraphs 114 to 117, already make it possible to achieve such balance. Payment of dividends or coupons is at the full discretion of the institution and of the competent authority. As long as required, the equity holders will have full ownership on the value creation while distributions on hybrid capital instruments can be cancelled on a non cumulative basis. This flexibility answers the need for tools allowing to build up a balance, or an incentive as the case may be, for a required recapitalisation.

This being said, the idea that new capital coming into the firm and subsequent profits could be used for distribution to ordinary shares while they should not be used "directly or indirectly" to benefit existing hybrid holders would effectively subordinate the rights of existing hybrid holders to holders of ordinary shares. We can't see how this would be acceptable, especially as "old" ordinary shareholders will not be able to be distinguished from new ordinary shareholders due to corporate law. As a result, existing hybrid holders would not only be worse off than new ordinary shareholders, but would also effectively be worse off than existing ordinary shareholders. We consider that this requirement would be hardly acceptable to fixed income investors, who represent the main available investor base for hybrid capital.

Similarly, should CEBS decide to maintain paragraphs 114 and 115, and the mandatory use of mechanisms such as write-downs, it should be confirmed that such mechanisms would stop to be in effect when the company would resume paying dividends, in order to respect the fundamental seniority of hybrid capital above ordinary shareholders.

Another possible mechanism favoured by CEBS to make a recapitalisation more likely is the conversion of hybrid Tier-1 capital into instruments referred to in Article 57(a) of the CRD. We are convinced that this proposal is counterproductive and fails ensuring the objective of making a recapitalisation more likely.

Mandatory conversion into ordinary shares may achieve a mere desired accounting objective of reducing liabilities for jurisdiction where hybrid Tier-1 capital is considered as liabilities for the purpose of determining insolvency, but are inadequate in many other aspects.

Such conversion mechanism would remove from the institution's balance sheet the hybrid Tier-1 capital component, depraving potential new equity investors from a meaningful leverage. Indeed, hybrid capital that has a fixed remuneration does not benefit from the subsequent recovery and value creation of the company, which remains the ownership of ordinary shareholders. Such conversion mechanism would force potential new equity investors to share all future value creation with a much enlarged group of shareholders. This appears as counterproductive when considering a required recapitalisation.
From a market perspective, fixed income investors are not holders of equity securities and may not be interested in hybrid securities with an automatic conversion feature. Even if they do, they would have to sell the shares in the market in case of effective conversion, triggering a substantial and long lasting selling pressure on the institution's stock price. This could also refrain new equity investors from recapitalising the company.
Other failures of a conversion mechanism are for instance that such provision would result in a massive dilution that could undermine the company's ability to recover and result in potentially new controlling stakeholders. This may stop recapitalisation prospects and lead to new shareholder's resisting recapitalisation plans.

To conclude, we are convinced that write-down or conversion mechanisms are neither necessary nor appropriate to ensure preventing insolvency [1] and to efficiently manage a

[1] Except in some jurisdictions where instruments are taken into account for the purpose of determining insolvency, where write-down, conversion or similar mechanism might be needed.

required recapitalisation. If hybrid Tier-1 capital meets the four preconditions in paragraph 106, amongst others preventing insolvency and not hindering recapitalisation, we are convinced that it is not further needed to elaborate on the loss absorption capacity on a going concern basis.

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?

We consider that the guidance in paragraphs related to loss absorbency in going concern for what relates to preventing the liquidation is sufficiently clear and principles-based.

To the contrary, guidance for what relates to making a recapitalisation more likely is over prescriptive and for reasons presented in answer 5.2, we recommend the removal of paragraphs 114 to 117.

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 do not object to the possibility to have several types of hybrids with different ranks in case of liquidation, for instance preference shares with calls (pari passu with ordinary shares in liquidation) and deeply subordinated notes which are senior in liquidation to all shares.

Question 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.

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

Hybrids of the 50% bucket are convertible in shares, either at the call date, either before in case of trigger event or at the discretion of the supervisory authority. Therefore it can be questioned why those instruments are not eligible as core capital (Tier one without threshold).

We do not support paragraph 125 requiring the definition of "emergency situation" in the contractual terms of the instrument. To do so might limit the ability of institutions and competent authorities to act with sufficient flexibility and may create unintended consequences which could increase volatility in distressed situations. It should be sufficient that such conversion may occur in case of a breach of capital requirements or regulatory discretionary intervention. More over such definition is quite subjective and should be interpreted on a case by case basis.

Similarly we caution against the requirement that any higher regulatory limit than the 4% Tier-1 and the 8% total capital ratio must be identified in the terms and conditions. This to avoid disclosing discussions between institutions and regulators that should be treated confidentially as they are on forward looking assessments of profitability and business strategy.

Question 7: SPV
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.

We fully agree that hybrids issued through a SPV should be classified the same way as a direct issue for prudential treatment.