IRISH BANKING FEDERATION

Nassau House
Nassau Street
Dublin 2
Ireland

t: +353 1 671 5311
f: +353 1 679 6680
e: ibf@ibf.ie
w: www.ibf.ie

IBF COMMENTS TO CEBS' DRAFT PROPOSAL FOR A COMMON EU DEFINITION OF TIER 1 HYBRIDS

The Irish Banking Federation welcomes the opportunity to comment on CEBS' proposals for a common EU definition of Tier 1 hybrids. Before addressing the specific proposals as set out by CEBS, we would like to note our high-level reactions to the consultation paper.

High-Level Comments

1.0 While we support the European Commission's objective of integrating the Sydney Press Release into EU legislation, and aligning how these guidelines are applied across Europe, it is our view that CEBS is proposing an overly prescriptive set of guidelines that go above and beyond the principles contained in the Sydney Press Release. By departing from the Sydney Press Release, CEBS is potentially placing EU issuers at a competitive disadvantage when compared with issuers in other non-EU jurisdictions. The proposed write-down feature for example, is unlikely to be received well by the investor community. Given that a similar provision has not been stipulated for US issuance, EU issuers accessing the US market are likely to be viewed less favourably than their US counterparts.

1.1 In the context of maintaining alignment between EU legislation and the Basel Committee treatment, we question the timing of these proposals given that the Basel Committee is due to begin deliberations in this area over the coming years. To maintain alignment, any changes arising from the Basel Committee's review should be incorporated into the EU legislation. However, the possibility that EU issuance will be subject to a second set of amendments within such a short period of time causes uncertainty and negatively impacts the hybrid capital instrument market.

1.2 The Tier 1 investor base has evolved as a sub-section of the fixed income investor base and has become a very important component of a bank's capital structure. A number of the proposals contained in the paper may however restrict an issuer's access to this investor base. The reason being that features such as the write-down requirements and conversion provisions run contrary to the investment restrictions of certain investors, therefore preventing them from investing in the instruments. Alienating this significant source is unhelpful in supporting a bank's capital position.

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1.3 CEBS document states that 'instruments eligible for inclusion in tier 1 capital have to be measured against the benchmark of 'equity'. This statement seems to ignore the fact that hybrid instruments may increase financial stability and should in fact be more readily accepted as Tier 1. Hybrid instruments provide for an additional cushion protecting depositors and senior bondholders. They diversify and broaden the investor base, which can be crucial to maintaining access to funding and capital in times of economic downturn. While equity tends to be highly volatile, fixed income instruments are much more stable. Whereas subscribed capital and reserves must be denominated in the reporting currency, hybrid instruments can be denominated in foreign currency, therefore assisting banks in foreign exchange rate risk management.

1.4 The consultation paper examines each of the three main eligibility criteria of hybrid instruments (permanence, loss absorption and flexibility of payments) in isolation. This approach ignores the fact that these characteristics are complimentary to one another and when combined, create the required profile of Tier 1 instruments. The proposal that all instruments contain a write-down provision for example, ignores the permanent nature of these instruments and the fact that issuers must be able to waive payments at any time on a non-cumulative basis for an unlimited period of time under the flexibility of payment requirements.

1.5 The grandfathering provisions, as currently presented, are a major cause of concern. As noted by CEBS, a substantial volume of existing hybrid instruments in the market will cease to qualify under the revised rules. It is also stated that the purpose of the grandfathering provisions is to limit the impact of the proposed common regulatory approach. This is not in our view achieved. All current EU hybrid issuance that is eligible as Tier 1 capital has satisfied the eligibility criterion that currently applies in that jurisdiction. The capital status of these instruments should not be impacted by the introduction of revised rules. The only means of achieving this is to apply the permanent grandfathering approach.

Terminology

2.0 It is stated in the paper that the term 'hybrids' is used to encompass three broad categories of instruments, one of which is non-cumulative perpetual preference shares. This is contrary to Irish legislation which defines equity capital as paid up ordinary share capital and perpetual non-cumulative preference shares/preferred stock. Irish Companies legislation permits the redemption of these instruments only out distributable reserves or out of the proceeds of a new issue of shares made for the purpose of the redemption. While the volume of preference shares issued by Irish institutions is not significant, it is our view that such instruments should not in fact be considered as hybrid instruments. At a very minimum, preference shares issued prior to the introduction of the revised definition should continue to qualify as core Tier 1 capital in Ireland.

Permanence

3.0 The Irish Banking Federation supports CEBS' proposals with regards to permanence and the interpretation that instruments must be undated in order to qualify as eligible Tier 1 instruments. We would however see merit in recognising dated instruments with a lock-in feature, whereby the capital can only be repaid at maturity with the permission of the supervisory authority.

Loss Absorption

4.0 CEBS' proposals with regards to loss absorption and the requirement that instruments must include a principal write-down feature or a provision to convert into ordinary shares in order to qualify for eligibility is of particular concern to our members, for a number of reasons. Firstly, it is unclear to us how these features would enhance the loss absorbing ability of existing hybrid tier 1 instruments. The perpetual nature of existing hybrid instruments, the flexibility in terms of coupon payments and the fact that hybrid investors cannot enforce a credit event / claim all ensure that these instruments already absorb losses.

4.1 Furthermore, a principal write-down would not increase the issuer's total Tier 1 capital because the write-down would have the affect of reducing an issuer's innovative or non-innovative Tier 1 capital and increasing the issuer's core Tier 1 capital by equivalent amounts. A principal write-down may thus be viewed as reflecting an improvement in the quality of the issuer's capital under regulatory accounting principles (as the amount of core Tier 1 would have increased). Yet, the actual quality of capital would remain unchanged. Indeed, under International Financial

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Reporting Standards (IFRS), such a write-down is unlikely to be reflected on the issuer's balance sheet. Thus, the representation of an actual write-down under regulatory accounting principles would be at odds both with economic reality and with the relevant disclosure under IFRS.

4.2 It is also unclear whether a principle write-down provision would aid a recapitalisation of the issuer. One might argue that the provision would aid recapitalisation because the issuer may redeem the hybrid instrument at its written-down amount, thereby removing a layer of capital that should otherwise have ranked senior to new ordinary shareholders. However, we do not believe this argument holds, as the issuer is unlikely to reduce its capital during a time of financial distress. Even if the issuer were so inclined, the issuer's regulator would be unlikely to permit a redemption of the hybrid instrument during a period of financial distress. Furthermore, new equity investors are unlikely to welcome a redemption because it would represent a capital outflow, precisely at a time when capital is needed most, thus triggering a need for yet more capital.

4.3 As part of the loss absorption criteria, CEBS state that hybrids must be senior only to ordinary share capital. This subordination ranking indicates that equity holders should not be better placed than investors of hybrid instruments. On this basis, we further question the requirement that hybrids contain a provision which allows the issuer to write-down the principal of an instrument when a similar requirement does not apply to equity. If an issuer's capital ratio falls, distributable earnings will be affected and no dividends will be paid to equity holders, but the par value of the equity remains the same. It therefore seems unjust that hybrids must contain such a provision.

4.4 In terms of the practical impact of the proposals, the loss absorptions proposal may also exclude certain investors from the hybrid market. For example, the equity conversion feature could restrict issuers' access to the US institutional investors market as the National Association of Insurance Commissioners (NAIC) could conclude that hybrid instruments containing such a conversion feature should be classified as common equity for the purposes of determining the risk-based capital (RBC) charge for insurance company investors. Insurance companies comprise a

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significant subset of the US institutional hybrid capital market, and a common equity designation implies an RBC charge of 30% of the principal amount of the investment, which is generally prohibitive for many insurance company investors.

4.5 In addition to excluding certain investors, the marketability of these instruments, and thus, the capital raising ability of institutions, is also likely to be affected by the imposition of this requirement, as investors are unlikely to react positively to such a provision.

4.6 While it can be assumed that this provision will not give rise to competitive issues in a European context, given that the same requirement will apply to all European issuance, it is likely to give rise to competitive issues between European and non-European issuance, as it is our understanding that there is no such requirement to include a principal write-down feature in jurisdictions outside Europe.

4.7 The accounting and tax implications of these proposals must also be considered. The equity conversion feature will mean that issuers will lose the tax-deductibility benefits currently associated with hybrid instruments. This may lead to an increase in special purpose vehicle (SPV) issuance, as issuers move towards jurisdictions where the tax implications are less severe. Increasing the level of complicated SPV structures as compared to direct issuance complicates the marketplace and makes, in our view, harmonisation even more difficult to achieve in practice. A re-instatement of capital that is written-down could arguably generate a profit to the accounts, and a profit that will therefore be taxable.

4.8 In addition to the write-down provision, instruments must rank junior to depositors, general creditors and subordinated debt. While we have no issue with this requirement, it is also stated that the instrument must neither be secured nor covered by a guarantee of the issuer. Clarification is sought as to whether this provision only relates to situations where a guarantee would change the subordination ranking of the instrument.

4.9 Bank failures are idiosyncratic and no two failures can be considered the same. We suggest that rather than the prescriptive approach to loss absorbency outlined in this

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paper, that CEBS outline broader objectives and guidelines for European supervisory authorities with sufficient discretion to allow optimal outcomes in individual situations.

Flexibility of Payment

5.0 The Irish Banking Federation fully supports CEBS' proposals with regards to flexibility of payment. All Irish issuance currently has this flexibility and this is considered a key provision in enabling existing issuance absorb losses.

Limits to Inclusion into Tier 1

15% Limit

6.0 The Sydney Press Release proposed that "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 – <u>at issuance</u> – to 15% of the consolidated bank's Tier 1 capital". The term 'at issuance' has been omitted from the CEBS proposals. It is in our view, imperative that this 15% limit be applied in line with the Sydney Press Release. It would prove extremely difficult for institutions to manage this restriction on any basis other than at issuance. It is also important to note that while the CRD states that the capital ratios must be met at all times, it is not stated that the composition of own funds must be the same at all times.

6.1 In addition to the difficulties in managing capital base, the application of limits "at any time" as opposed to "at time of issuance" will lead to a double negative impact on Tier I if an institution starts to report losses affecting its core Tier I. We do not see the benefits of applying the limit "at any time" given that hybrids that may be disqualified will still be providing the financial institution with the required payment flexibility and the ability to absorb losses.

Overall Limit

6.2 In terms of the overall Tier 1 thresholds proposed by CEBS, it is our view that a single quantitative limit should apply rather than introducing a two-tiered approach as proposed in this paper.

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6.3 The limit introduced should be aligned with the current majority position in Europe. As noted in the paper, six countries, one of which is Ireland, country apply a limit of between 49% - 50% on the total amount of hybrids eligible as Tier 1 capital. However, these six countries account for 72% of the total European hybrid issuance as at 31 December 2006.

6.4 While we recognise the flexibility that the proposal to allow institutions to increase their proportions in hybrids when operating in excess of the minimum capital requirements affords, this approach would create a cliff effect. If we consider the case where an institution suffers a fall in its capital ratios, the problems of this institution would be compounded by the requirement that they must reduce their proportion of Tier 1 in hybrids. This will only increase the volatility of capital ratios during a stress period and hurt the financial institution even further while the amount of Tier I capital remains the same.

Grandfathering

7.0 The grandfathering provisions proposed by CEBS are of major concern to our members. CEBS have recognised that the proposals will render the majority of current EU-issuance as ineligible. It is therefore recognised the proposed common regulatory approach will have major impacts for the hybrid market as it currently stands. The grandfathering provisions as set out in the paper do not in our view sufficiently address this. The only means of sufficiently limiting this impact is to apply the permanent grandfathering approach. As noted in our opening remarks, all current EU hybrid issuance that is eligible as Tier 1 capital has satisfied the eligibility criterion that currently applies in that jurisdiction. The capital status of these instruments should not be impacted by the introduction of revised rules. As such, the grandfathering provisions should be unqualified, such that all pre-dated instruments that qualified as Tier 1 capital under the rules that are currently in place in that jurisdiction should continue to qualify.

7.1 The paper appears to make a distinction between instruments with an incentive to redeem and those without, when it states that instruments with a call provision will remain eligible until the next call date and all remaining instruments will be gradually reduced over a period of 30 years. This effectively encourages institutions to call

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instruments, as otherwise the issuer will be forced to maintain the cost of servicing these instruments with no corresponding contribution to regulatory capital requirements. This in our view undermines the principles of permanence. Furthermore, it may not be appropriate for the issuer to call at that time. It may not be possible for the issuer to replace the capital with another form of capital of at least the same quality. In the current climate, there is also the possibility that the Regulator may not permit an issuer to call.

7.2 While as noted, it appears that the paper is making a distinction between instruments with an incentive to redeem and those without, it further states that those instruments which are callable, but have not been redeemed will be gradually reduced over a period of 30 years. Clarification is sought as to whether this allows issuers flexibility on redeeming, such that if the issuer chooses not to redeem, the instrument will continue to qualify as eligible, subject to being gradually reduced over a period of 30 years.

7.3 There are other roll-on effects that these provisions may give rise to from our members' perspective. For example, a bank may have instruments in issue, which at the request of the Regulator and subject to the satisfaction of certain conditions can be converted into preference shares. While the instruments may have qualified for grandfathering prior to their conversion, it appears that the proposals as currently presented would mean that these substituted securities would no longer qualify for grandfathering.

7.4 In addition to having to secure regulatory approval, in order for an instrument to be called, paragraph 86 of the paper states that the securities must be replaced with less costly capital resources when issuers have the flexibility to do so. Clarification is sought as to how such flexibility would be determined.

7.5 Paragraph 87 of the paper states that the supervisors must have the authority to limit the incentives to redeem and to prevent repayment of a capital instrument in order to preserve the financial soundness of the institution and to avoid financing risk in times of stress. Clarification is sought as to what would be interpreted as a time of stress;

and specifically whether the current market climate could be determined as a time of stress?