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BBA/LIBA response to CEBS Hybrids consultation paper

Introduction

The British Bankers Association (BBA) and The London Investment Banking Association (LIBA) are pleased to respond to the CEBS Consultation Paper 17 on hybrid capital.

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.

There is no current need to incorporate formally the Sydney Press Release in the Capital Requirements Directive

Whilst we support the need for greater convergence and the greater use of these instruments that a level playing field will bring, we are also committed to principles based, substance over form approach to the regulatory oversight of hybrid instruments. The underlying three principles of the

1998 Sydney Press Release (SPR) have been unnecessarily embellished by CEBS so that its proposals are overly prescriptive requirements and do not recognise the differences in company law, insolvency law and tax regimes that exist in different member states, which CEBS cannot solve.

More importantly we challenge the immediate need to formally incorporate the SPR hybrid capital principles into EU law, via revision of the CRD. This is not necessary at this stage.

We are aware that the Basel Committee for Banking Supervision (BCBS) is currently reviewing the definition of capital which may or may not result in a revision to the SPR. Were significant revisions to be proposed there would be a risk that these would not be properly reflected in the CRD after the currently proposed Q4 2008 revision. This would result in a temporary un-level playing field whilst the CRD was again revised to bring it into line with the updated SPR and an unnecessary intermediate revision to the EU Directive. This would complicate hybrid capital issuance for our members until EU requirements were brought into line with updated international requirements.

Our internationally active members manage their capital (as they do liquidity) on a global basis, drawing on pockets of investor demand to optimise the structure and cost of this capital. It is important to them that changes to the definition should flow from the BCBS downwards to regional and national regulators, who are then tasked with implementing them in a way that is as closely aligned as possible to the international intent.

Hybrid instruments are highly attractive funding vehicles for our members and attract a diverse range of investors. That such a vibrant market for hybrid capital instruments issued by EU institutions has evolved since 1998 in spite of a background of differing national approaches – for instance to tax and aspects of company/insolvency law - demonstrates that investors have become familiar with the nuances of individual jurisdictional specificities and are comfortable and realistic in recognising they will continue to exist.

Harmonisation of regulatory approach now is not necessary to improve the working of the market, will not iron out other impediments to uniformity, such as tax and other local law and is not required to correct a market failure, of which we have seen no evidence.

A priority in 2008 for some banks may be the reinforcing of their Tier 1 capital ratios following the market turmoil caused by problems in the US sub prime market. Problems with SIVs and a contracting ABCP market have resulted in banks taking assets back onto their balance sheets which, alongside recorded write downs has weakened banks' capital ratios. As a result, where innovative Tier 1 capital deals cab be brought to market, banks are paying up to four times the spread that would have been paid on a comparable deal before the summer of 2007.

At a time when market access is already very restricted, changing well-established structures once or even twice can only cause confusion in the market and impede vital access to capital.

We strongly urge CEBS to reconsider its proposals on hybrid capital at this time. Change should be delayed until the outcome of the BCBS debate in this area is known to avoid unsettling investors and the market more generally at this sensitive time.

We commend CEBS for the work it is undertaking with CEIOPS on approaches to harmonise the definition of eligible capital that may be employed by both banks and insurance companies. We believe that in the interests of promoting a level playing field amongst all participants in the European financial services industry these definitions should be harmonised. We note however that certain of the CEBS proposals in relation to ongoing loss absorption will lead to more indirect issuance - a structure that UK insurance companies are not currently able to adopt.

The key characteristics

We now examine CEBS's proposed interpretation of the SPR, focussing on each of the key characteristics in turn and in the order in which CEBS's proposals are of most concern to our members.

Loss absorption

We support CEBS's contention that hybrid capital should always rank behind all other depositors, senior and "less deeply" subordinated creditors. They should not only be permitted to be senior only to ordinary share capital but also to other more junior ranking Tier 1 instruments (e.g. other classes of shares).

We contend that there is no reason to elaborate on the SPR statements on loss absorption as it is demonstrable that hybrids do absorb losses as:

- the institution has full control over the cash raised from the point of issuance
- in the UK at least, the issuer has full discretion over coupon payments at all times
- in the UK at least, the absence of any obligation to make any payment (both coupons and repayment of principal) means that UT2 and T1 are excluded from the calculation of liabilities for legal insolvency purposes, thus providing economic support (cash) for the institution while also not impeding its board's flexibility to continue trading to "operate" its way out of trouble

- a restriction on making cash payments (e.g. upon breach of regulatory ratios) can be achieved contractually without also needing to write down or convert principal
- a hybrid Tier 1 instrument by definition already counts as Tier 1 - write-down/conversion only increases one type of Tier 1 while decreasing another - it doesn't add to the total. Even worse, it may be a taxable item, thus reducing the total amount of Tier 1!

Mandatory hybrid write-down

Our major concern relates to the requirement that the hybrids be written down if Tier 1 ratios fall below 2%. This is super-equivalent to the SPR and deals with a situation that is very unlikely to occur. Management (and probably regulatory action) will already have been taken even before the Tier 1 ratio fell below 4%. Catering for a situation which is very unlikely to occur will only risk misinterpretation by hybrid investors and consequent increased funding costs, for no real benefit to a firm's ability to meet its regulatory capital obligations.

Write down of hybrid capital is only a paper exercise which shuffles one sort of Tier 1 capital into another form of Tier 1. Even if it generates an accounting profit it does not result in a cash flow. It can also potentially create a partially offsetting tax liability, in which case the write down is deemed to have created a taxable gain – resulting in a potential cash outflow. It makes hybrids less attractive to investors who will bear the pain ahead of ordinary shareholders – hybrid investors should only be at principal risk if ordinary shareholders have already lost their investment.

As an example, for Tier 1 issues targeted at US institutional investors, the inclusion of write-down features may cause the NAIC (National Association of Insurance Commissioners) to classify the hybrid instrument as "equity", thereby reducing or eliminating demand from insurance companies, who have traditionally been active investors in hybrid Tier 1 instruments.

Furthermore any new owners of the business would be likely to want to have an element of Tier 1 hybrid capital in the capital structure (or else they could have to inject even more capital into the business). A recently distressed institution would need to pay more for this - therefore, the new owners will have a lower cost for this hybrid Tier 1 capital by retaining existing instruments rather than redeeming them and replacing them with new ones. So arguably existing Tier 1 capital should help facilitate an equity recapitalisation

Our strong view is that write-down mechanisms should not be required universally. Where national regulators continue to require principal write-down mechanisms, we would advocate 'cure mechanisms' which would allow the issuing bank to address the situation with the possibility that the write-down may (subject to supervisory approval) be avoided if inappropriate.

mandatory conversion into ordinary shares

The alternative requirement, that in the event that Tier 1 capital falls below 2% hybrid capital should be converted into ordinary shares, ignores the different investor types to which hybrid capital and ordinary shares appeal. Hybrid capital is largely bought by fixed income investors who are typically not permitted, under the terms of their investment criteria to hold equity investments. They would thus be forced, in order to comply with the terms of these investment criteria, to sell the shares acquired as the result of the mandatory conversion. This would exacerbate the firm's difficulties depressing the market price further and making a recapitalisation plan less likely to proceed.

In addition, buyers of such an instrument may seek to hedge potential equity exposure by short-selling the underlying equity (or purchasing out-of-the-money put options), which may have an adverse impact on the bank's share price.

For issuers the existence of a write down requirement will increase their annual cost of capital, even whilst they are a going concern. The only benefit the write down could provide would be for a specific failing bank at the point of its failure.

CEBS's proposals will require all banks to pay for insurance now (via higher hybrid Tier 1 costs) so that on liquidation a failing bank may debatably have an easier restructuring. This is not a proportionate requirement.

What matters is the temporary suspension of the rights of hybrid investors to receive payments once a certain Tier 1 capital trigger has been breached. This can already be achieved contractually so we do not believe there is a requirement for further regulatory intervention. The objective of such suspension would be to prevent redemption and the payment of coupons but ensure that the investment remained in the hands of the hybrid investors rather than becoming part of shareholders' resources. In this way hybrid investors would benefit from any potential upside once the firm had set back on the path back to good health alongside the ordinary shareholders. Requiring permanent write-down would create an asymmetry in which ordinary shareholders, who should bear the greater proportion of the economic risks and losses, would receive all of any subsequent gain in the firm's value. This does not reflect the intended position of ordinary shareholders as the most junior stakeholders in the firm's capital structure.

making issuance more complex

The proposal that the required write-down or conversion must occur on the issuer's balance sheet will mean that more issuance of this type of structure will be carried out using off balance sheet special purpose subsidiary issuance vehicles (SPVs), rather than directly, in order to preserve the tax benefits. The use of SPVs invariably complicates the nature of a group's corporate structure, confounds the process of recapitalisation and generates extra day-to-day governance requirements. This contradicts the general move - which is supported by regulators, investors and issuers alike - towards direct issuance structures that are simpler and minimise legal risk. It will also codify a lack of consistency between direct and indirect issuance across Europe (that had been harmonising towards direct issuance via the non-cash cumulative (non-cash) Alternative Coupon Settlement Mechanism (ACSM), despite convergence being the goal of CEBS.

To summarise we do not believe that the potential marginal benefits it is hoped this new prescriptive loss absorption provision will bring warrant the incremental burden that will be imposed across all issuance. It should be removed.

Flexibility of payment

waiving of payments

We agree that cash coupon payments and dividend pushing structures should be waived by the issuer in the event that it is in breach of its minimum capital requirement. CEBS's proposals should also accommodate dividend stoppers with a regulatory "short-circuit" preventing the payment of coupons.

However we do not agree with the CEBS proposals that payments should be waived just because the regulator thinks it is a good idea – i.e. '*at their discretion based on the financial situation of the institution'*. This introduces a lot of doubt about the circumstances in which such a judgement call might be made, introducing a degree of optionality into the product which investors will want to be paid for, increasing industry's costs and leaving too much room for differential interpretation between regulators in different member states.

alternative coupon settlement mechanisms

CEBS's proposals in relation to ACSM also cause us some concern.

In the majority of cases, ACSM is included as a means to satisfy criteria for tax deductibility and/or to enhance marketability. We agree with the notion that SPV based structures (until tested in a bankruptcy scenario) carry inherent cross-border legal risk, as already highlighted by at least one European regulator. To the extent CEBS continues to take a conservative stance on ACSM, we believe mechanisms can be put in place to mitigate any concerns. For example, the number of shares issued under ACSM in any given year could be limited to a pre-specified maximum, thus eliminating concerns about excessive dilution.

The limitation of ACSM to ordinary or preference shares which must be subscribed for by the hybrid holders themselves and exercised immediately is too prescriptive. To repeat the point made above the majority of hybrid buyers are fixed income investors so may be prevented by their investment criteria from buying ordinary shares upon exercise. The requirement to subscribe immediately also 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 is in its best interests.

The requirement in subparagraph (i) that ACSMs should be made out of 'already' authorised and unissued shares is superfluous. The authorisation of new capital is a simple process which can be swiftly completed, so the word 'already' should be removed.

We note that some structures employ an ACSM mechanism that is cumulative but it must, if deferred, be paid in the form of Tier one capital: not only strictly defined common shares. This is important in the context of mutual building societies in the UK which have no access to common share capital and must be permitted Payment in Kind if direct issuance is to continue to work.

The requirement in subparagraph (iii) that ACSMs should be amended to read 'are structured to avoid the build up of debt'.

We do not think that ACSM should only be permitted if they are used for tax reasons which in itself is distortive in effect. Regulatory capital treatments should not be tied to any particular tax, accounting or rating agency treatments.

Permanence

dated or undated

Whilst requiring an instrument to be undated would ensure that there is no doubt about the permanent nature of a hybrid instrument we do not believe that such a requirement is absolutely necessary. After all share capital, the task of which is to absorb unexpected losses before all other forms of Tier 1 capital, can be redeemed with the approval of a court. Indeed listed entities can repurchase ordinary shares in the open market at any time.

The implementation of the Basel 2 via the CRD has changed the way in which banks manage their capital. Particularly once the floors fall away it will become much more dynamic as capital requirements fluctuate in line with the economic cycle.

Long-dated instruments with a call date, subject to supervisory oversight of any repayment and suitable lock-in provisions, should be permitted to allow banks to manage this volatility. Furthermore, shorter dated instruments callable at any time at the discretion of the bank should also be recognised as innovative Tier 1, subject to the same repayment constraints. Such a flexible approach would mean that the terms and conditions of a bank's hybrid capital instruments can more easily be adapted to regulatory changes or changes in the legal structure or risk profile of the bank. But flexibility will not automatically mean that banks would issue significant amounts of short-term instruments as this would lead to higher than normal transaction costs.

To summarise "permanence" does not equal "undated" although we would accept that if regulators do want to maintain some oversight then dated structures should only be permitted provided that the maturity may be deferred if regulatory approval is not granted at the initial maturity date.

step ups

There is some divergence across Europe in relation to criteria for step-ups: some jurisdictions permit a choice of 100bp or 50% of the initial credit spread, while other jurisdictions limit step ups to 100bp. We believe the step up criteria should be harmonised such that the 100bp/50% choice is provided to all banks. Recent widening of secondary market spreads for Tier 1 securities have demonstrated that 100bp can rapidly become insignificant when credit spreads move 100-200bp wider in a matter of weeks.

dilution

Also we note that CEBS suggests that principal stock settlement mechanisms must contain a cap on the conversion ratio in order to limit potential dilution. There is no need to restrict principal stock settlement mechanisms that involve the conversion into preference shares, which do not dilute ordinary shareholder. Further we think that the extent of any dilution is a governance matter for the shareholders to agree in the appropriate meeting of the company – it should not be prescribed by the regulator.

early redemption triggers

There are a number of other important triggers, such as the loss of a particular accounting treatment or rating agency action which we suggest should also be included in the (non-exhaustive) list of examples.

Limits

70% limit

The requirement that ordinary shares and disclosed reserves/retained earnings should always represent at least 70% of the required Tier 1 capital is not welcome. It will hinder a firm's ability to raise Tier 1 hybrid capital, reducing flexibility at a point when it might be about to come under a stress which the tax deductibility and other structuring features of hybrids could alleviate.

The SPR refers to ordinary shares and disclosed reserves/retained earnings being the 'predominant' form of a bank's Tier 1 capital, we think 70% is super-equivalent and may reduce flexibility for national regulators to address specific situations (e.g. M&A situations where a moderate increase above 30% non-equity Tier 1 may be appropriate).

The limit should be at least 50% in line with those banks operating above their Tier 1 capital requirement to avoid unintended cliff effects.

15% limit

The 15% limit on instruments with incentives to redeem or ACSMs - which appears to be an ongoing requirement is super-equivalent to the SPR, which imposes this limit *at issuance* only. In recent months we have seen a number of prominent institutions suffering large write-downs to earnings and/or reserves. If capacity limitations for hybrids were applied on an ongoing basis, then banks may suffer dramatic deterioration in capital ratios at times of distress, thereby exaggerating the negative impact on capital.

In addition we do not believe that instruments with ACSMs provide the issuer with an incentive to redeem – they should be excluded from the 15% (at issuance) limit.

On a more technical point instruments with incentives to redeem (and with ACSM) are limited to 15% of Tier 1 after deductions. We believe this is contrary to Basel 2 where, once the basic capitalisation test is met the calculation of the 15% limit on innovative capital instruments (and all the other gearing ratios) is made against a Tier 1 total calculated before deductions.

Grandfathering

We thank CEBS for the helpful approach it proposes taking in relation to grandfathering but note the possibility for great grandfathering – i.e. that Tier 1 capital issues issued before the 1998 SPR should fall outside CEBS's proposed grandfathering limitations and remain grandfathered for life.

We assume that any hybrid capital issues that despite having a ten year step up/call option have not already been called will not be included in the scope of grandfathering and thus remain as eligible Tier 1 capital. The same analysis applies to the sorts of irredeemable hybrid Tier 1 securities that have been issued by UK building societies - we would assume that they would remain forever as hybrid Tier 1 and not be excluded from Tier 1 capital in 30 years time.