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	BSBV 115/2008 Dr.Rudorfer/We	3137	20th of Feb, 2008

Re: **Comment on "Draft proposal for a common EU definition of Tier 1 Hybrids"**

General comments:

- We welcome the efforts of the EC and the CEBS to harmonise the definition of hybrids across the EU. The intentions as formulated in the proposal are in line with current market practice and underpin **the importance of hybrids** as an instrument to **cover economic capital needs**. We fully support the idea that **all EU banks** should have **equal opportunities to use these instruments** and that in this respect a level playing field is warranted.
  This specifically refers to the fact, that various EU jurisdictions currently do not recognize these instruments and a general application of the BIS Sydney Press Release (SPR) would thus make intra group capital management easier.

- The current proposals place too much emphasis on what the instruments should look like. This is done in quite a prescriptive way and comes across as the weighted sum of the requirements in many jurisdictions.
  The SPR could form the base for the envisaged unification. Regulations going beyond that contain the implicit danger of disrupting international market balance. Delays and limitations in the implementation of Basel 2 in major economies have aggravated our concerns in this respect.
  Other major supervisory authorities in Member States suggest a different more principles-based approach (FSA - Dec 07 Discussion Paper on the "Definition of Capital").

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- Furthermore the differences in the legal systems of the member states (civil law, security law, tax law, fee law…) have to be taken into account in a clearer and more structured manner and also due to that we appreciate a more principle-based approach considering the main regulatory objectives linked with tier 1 – capital.

- The three principles of permanence, loss absorption and flexibility of payments proposed by CEBS are a good way to describe the necessary elements and functions that hybrids should have in order to be treated as Tier 1 capital.

Comments in detail:

Definition

The term "hybrids" according to the CEBS-paper is rather wide and encompasses the following three broad categories:

a. innovative instruments (i.e. instruments with incentives to redeem such as step-ups);
b. non-innovative instruments (i.e. instruments which do not have incentives to redeem); and
c. non-cumulative perpetual preference shares, which some CEBS members treat as 'core Tier 1 capital'.

Non-cumulative preference shares and similar instruments are extremely equity-like, especially those ranking pari passu with ordinary shares in case of liquidation. Therefore, they should not be seen as hybrid capital but treated as common shares. As such capital fulfils the objectives of tier 1 – capital there is no economic reason to limit its eligibility as tier 1 – capital.

As definition b) provides no differentiation to common equity the subsequent considerations lack clarity or tend to become too strict. Instruments are benchmarked versus common equity and under the targets of CEBS have similar features. Under customary legal principles it will then be difficult to differentiate between the treatment of common equity and such instruments when calculating Tier 1 capital. It will not be possible to maintain a clear "common equity" concept anyhow, as long as cooperative banks and public law entities or other specific forms of financial institutions exist.

Write-down feature/Conversion

The write-down feature will not ensure a level-playing-field as legal frameworks are much too different. Especially the problem arises that these write-downs may be taxable in some countries.

The crucial point is to make sure that the bank is able to recapitalise by attracting new capital. On the other hand the question remains whether the hybrid investors will be treated even worse than common equity because it has no upside potential.

One should not forget that the principal write-down does not itself restore capital to the bank.

It has not been explained what the tangible regulatory benefit of a temporary write-down is, especially considering that it does not affect the total Tier 1 amounts and there is no accounting impact under IFRS because it is only temporary.

The conversion in ordinary shares may also be not desirable because it may use up access to fresh equity and limit the ability of the bank to raise real fresh money.

Furthermore the concept of write down was heavily criticised by market participants in the London CEBS meeting. In fact, there are many reasons available against this feature. Informal discussions seem to indicate, that the trigger for this point of discussion within CEBS is reorganisation. There should be other solutions to this problem.

As different limits apply capital ratios after write down may become a function of the structure of the hybrid capital instruments used.

Another aspect raised is insolvency law. To our knowledge a write down feature would neither reduce nor increase the danger of insolvency, as it would be considered similar to equity in that respect.

The key topic is, that a write down does neither change the economic situation nor should it change regulatory capital ratios of a bank.

In case of a write down solution it will be difficult to differentiate between hybrid capital and common equity. Common legal principles will then require that such hybrid capital be considered like common equity also for regulatory purposes.

It may be possible to introduce a new – additional - variant of hybrid capital with write down features. As those mirror extremely common equity it has to be accepted like common equity without limitations as core tier 1 capital. Again, a unilateral restriction of hybrid capital to instruments with write down features would harm competition with non EU banks. It should be noted that the differences in pricing will become relevant especially in stressed capital market environments and with new issues.

Step-up and principal stock settlement

Hybrids should enable the bank to absorb losses on a going concern basis. We are of the opinion that this is already fulfilled by the issuer being able to defer coupons on a non-cumulative basis and not having to repay the nominal in times of financial distress. What else can be demanded from an investor's point of view? The investor runs the risk of not receiving a coupon and not being redeemed at the first call date.

We do not think that an incentive to redeem automatically weakens the permanence of the instrument. Rather it enhances the financial flexibility and improves investor diversification. An instrument will not be called if the issuer is not able to refinance cheaper or when the capital is redundant.

15% Step-up limit at any time

Applying the limit at any time is counterproductive as it would reduce for no good reason the available solvency capital when the bank is sustaining losses.

50% and 70% limit

We highly appreciate the opportunity to have more hybrid capital capacity within Tier 1 as we are of the opinion that this capital fully serves its purpose of loss absorbency on a going concern perspective. Nevertheless, the intended switch from 50% to 70% creates a cliff effect which could cause severe additional problems in times of stress.

CEBS requires all Tier 1 instruments to be undated

This clearly goes beyond the "permanence" stated in the Sydney Press Release. We are of the opinion that the capital would still have the same quality if a dated instrument with a "lock-in" feature that would be triggered at a predetermined point of stress in relation to the issuer's regulatory capital resources is used. Capital does not need to be issued in the form of an undated instrument if it is ensured that the capital is available when needed.

SPV versus direct issue

CEBS is not making a distinction between direct and SPV issues. In order to ensure a level-playing-field we think this is a fair approach for all the banks operating in a jurisdiction where SPVs are necessary to obtain e.g. tax deductibility.

Deferral/ACSM

We agree that issuers must be able to waive payments at any time on a non -cumulative basis and for an unlimited period and that it must waive payments if minimum solvency requirements are breached.

We do not believe that hybrid holders should subscribe for the new shares. This would be impractical, not in their interest and would in no way improve the quality of the instrument. In fact it would limit the marketability of the instrument.

ACSM should also not be exercised immediately. This would seriously limit the financial flexibility of the issuer to restore its solvency position in the way it deems to be optimal. Rather it should be able to defer any payment until it is out of stress and back into a more normalised situation.

In addition to that we are of the opinion that instruments with ACSM should not be limited to 15% of total tier 1.

From our point of view there is no need to go beyond the Sydney press release regarding the points in time when the limits have to be fulfilled. Sydney demands „at issuance whereas the CEBS proposal refers to fulfilling the limits „**at all times**

Further specific comments:

ad 7)
We have to separate the targets of "convergence in the area of hybrid capital" and "improving the quality of capital". The first task will improve a level playing field and is in the interest of all parties involved. The latter task will create uneven playing fields versus financial institutions from the US, Canada and other countries not following such EU regulations. Depending on the measures taken typically the costs of instruments could become higher thus creating an incentive to run European banks at tighter capital ratios than outside the EU. The background for this is the fact, that in international banking higher costs of capital can not easily be transmitted to the business partners of the bank.
As pointed out in the general part the topic has to be restricted to harmonisation not to disrupt international competitiveness of the European banking industry.

47), 50)
This should be linked to a capital ratio. Just assume a recapitalisation via a capital increase or the divesture of RWA – why is a coupon payment then a problem?

52)
This makes it hardly possible to avoid individual capital requirements to become public.

53)
This has to be clarified. Stopping payments should only be possible if that threatens the maintenance of minimum capital requirements.

57)
Typical tax laws evaluate features as not present if made solely for tax reasons. Besides that, we see no reason why ACSM should only be possible for tax reasons.

60), 61)
It should be noted that there is no serious analytical background for a 15 % limitation. The only reason for its application seems to be that it is the current regulation – not that this automatically implies to be good regulation. We should nevertheless agree to its application to follow the overriding principal of harmonising the SPR without changing its content. If the new regulations would on the other hand unbalance the level playing field an increase of the 15 % limitation has to be seriously discussed.

63)
This can only be valid for instruments which effectively form part of the regulatory capital. If for whatever reason (end of grandfathering, limitations, changes in mix of capital instruments etc.) an instrument no longer qualifies as tier 1 capital it can be redeemed without permission.

72)
This should also include changes of the treatment under IFRS (debt/equity)

80)
No harmonisation is visible concerning supervisory discretion to approve redemptions. Such redemption should automatically be allowed if the same amount of capital (same

quality or better) is raised and/or the bank maintains a Tier 1 capital of at least 125 % of the regulatory minimum capital.

p.15/last sentence
It sounds somewhat strange that if the regulator denies capital status redemption still needs the prior consent of the regulator. The regulator should not interfere in instrument, which he does not accept as tier 1 capital for what reason ever.

p. 16/first sentence (also 107/3rd scenario)
The definition goes beyond the SPR which is neither deemed necessary nor justified.

109)
This is pure accounting treatment like a reduction of nominal share capital against losses: no economic value for the company. The concept of capital write down is questionable. Instruments offering such feature are probably "more core Tier 1 than common equity".

p.20/box par 3
Write Down features are questionable in value. If they exist, a 2 % limit raises problems e.g. concerning the level (solo, subgroup, group) and the applicable regulatory environment (which regulator has which responsibility in cross border cases, especially beyond the EU or EEA area).

In case write down regulations will be decided distributions on written down capital should be subject to proper capitalisation and not to write up of the instrument.

Write downs effectively transfer hybrid capital into core Tier 1 without an economic change of the quality of the capital. That leads to the conclusion that either there are

- no limits on capital instruments boasting write down features
- limits, but only to be obeyed at the time of issuance

147)
Following the remark to 11) it remains unclear to what extend the issuers as main affected parties could contribute to this view. We do not necessarily share this view – the only reason to follow the 15 % limit is to strictly follow in all respects the provisions of the SPR

148)
The quite different approach of the rating agencies in no way should influence the regulatory capital discussion. It remains a management decision how to act in case of differing opinions of rating agencies and regulators. It would be a totally wrong and very disturbing signal if rating agencies could influence regulatory supervision of banks.

158)
It is assumed that hybrid capital not accepted as Tier 1 becomes Upper Tier 2

p31/ last box
It is assumed that these limits exist on top of limit stated in other parts of the paper.

159)
The current proposal aims to cover all sorts of hybrid instruments. Non innovative hybrids (no step up) have been issued with perpetual maturity and call rights for the issuer starting year 5. In the absence of redemption incentives these instruments were considered to be of a perpetual nature with long dated swap agreements (40-50 years, sometimes even perpetual) against them. With the end of grandfathering after 30 years such instruments economically have to be called while it may be impossible to call the corresponding swap agreement – which may, depending on the then current spread environment, well yield an economic loss to the issuing bank.
Therefore, we suggest modifying grandfathering for the final 10 % from 30 years to the effective maturity of the relevant instruments.

Yours sincerely

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