Committee of European Banking Supervisors

I

22 June 2009

Consultation Paper on

Implementation Guidelines regarding Hybrid Capital Instruments – CP 27

Introduction

1. The latest amendments to the Capital Requirements Directive (CRD)[1] introduce explicit rules for the treatment of hybrid capital instruments (hereinafter also referred to as "hybrids" or "hybrid instruments") and in particular requirements for their inclusion into institutions'[2] original own funds[3]. The amendments will have to be transposed into Member States' national law by 31 October 2010 and will be first applied from 31 December 2010.

2. The new provisions build largely on CEBS's advice to the European Commission regarding a common EU definition of Tier 1 hybrids[4], which was published in April 2008.

3. Article 63a stipulates the key criteria for the eligibility of hybrid instruments as original own funds: permanence, flexibility of payments and loss absorbency. Art. 66 (1a) sets out limits for the inclusion of such instruments. The limits are tiered and relate to certain features that define the quality of the particular instruments.

4. This consultation paper responds to the request in Article 63a (6) that CEBS shall elaborate guidelines for the convergence of supervisory practices with regard to hybrid instruments[5].

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[1] Directives 2006/48/EC and 2006/49/EC. In this document references to particular articles of the CRD should be understood as referring to Directive 2006/48/EC.

[2] The term "institutions" encompasses all institutions subject to the CRD (i.e. credit institutions and investment firms). In some parts of this document "institutions" may also be referred to as "issuers".

[3] By the time of the publication of this Consultation Paper the amendments were not yet published in the Official Journal of the EU. The text of the amendments as adopted by the European Parliament on 6 May 2009 can be found at http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P6-TA-2009-0367&language=EN&ring=A6-2009-0139#BKMD-35.

[4] http://www.c-ebs.org/getdoc/06e25083-2f37-4146-90f3-9e9a40365117/hybrids.aspx

[5] The guidelines regarding instruments referred to in Article 57(a) will be the subject of a separate document.

Objectives and methodology

5. The objectives of the consultation paper are to:

    a) achieve a common understanding among competent authorities across the EU on the implementation and application of the new provisions;

    b) foster their convergent transposition; and

    c) create more transparency for market participants.

6. The guidelines presented in the consultation paper do not aim to be a comprehensive set of rules but rather to complement the new CRD provisions, in particular Articles 63a and 66 (1a), where additional guidance appears necessary or appropriate because the directive text is either too principles based for an immediate application or does not explicitly address a relevant issue at all.

7. As far as possible the consultation paper builds on and is consistent with CEBS's "Proposal for a common EU definition of Tier 1 hybrids".

Impact assessment

8. In line with the 3L3 Guidelines CEBS has conducted a high-level qualitative impact assessment, focussing in particular on those parts of the consultation paper that will potentially have the largest impact or go beyond the scope of the CRD provisions.

9. Article 63a (6) explicitly requests CEBS to elaborate guidelines for the convergence of supervisory practices with regard to hybrid instruments. The impact assessment was therefore less concerned with the question of whether guidelines are needed but with how these guidelines should look, i.e. which issues should be addressed in what way. The focus was on those parts of the consultation paper that have either potentially the highest impact on supervisors and/or institutions or which go beyond the scope of the CRD, like the buy back of hybrid instruments and requirements for hybrid instruments issued via an Special Purpose Vehicle (SPV).

10. The overall background of the CRD amendments and the consultation paper is to fill an existing regulatory gap in the EU. So far, national approaches were largely based on the so-called Sydney Press Release issued by the Basel Committee on Banking Supervision in 1998, but varied significantly in practice. The new rules implement an EU-wide regime which will improve transparency and legal certainty and strengthen the overall quality of institutions' own funds by setting out minimum requirements and limits for the eligibility of hybrid instruments as original own funds and the possibility of their redemption.

11. On permanence, CEBS has assessed the costs and benefits of its guidance relating to the assessment of a moderate incentive to redeem and on the buy back of hybrid instruments. Incentives to redeem potentially compromise the permanence of a hybrid instrument; the CRD nevertheless allows for a limited inclusion of hybrids with a moderate incentive to redeem in an institution's original own funds. Guidance was deemed necessary to clarify which features can be considered as moderate in this sense. The guidance builds largely on existing common regulatory and market practice and will only create marginal costs while, on the other hand, ensuring that only hybrids which are sufficiently permanent are eligible as original own funds. The CRD is silent on the buy back of hybrids which may also affect the permanence of the instruments. In order to limit this effect CEBS sees a need to apply the same rules and timely restrictions as for a call or redemption of the instrument. The resulting limitations in institutions' flexibility are outweighed by the increase in permanence and thus in the quality of the instrument, with its positive effects on solvency.

12. On flexibility of payment, the impact assessment focuses on the practices for supervisors to require cancellation of payment and the Alternative Coupon Satisfaction Mechanisms (ACSM). On the practices for supervisors, the proposed guidelines are based on the current practices of supervisory authorities and will therefore have minimal costs for the institution. Regarding ACSM, the CRD states that the competent authorities may subject ACSM to some conditions. The guidance is meant to ensure that ACSM accepted by competent authorities do not compromise the instrument's capacity to absorb losses. The guidance may have a cost for a limited number of institutions using this mechanism in order to achieve tax deductibility.

13. On loss absorbency, CEBS assessed the costs and benefits of issuing either guidelines detailing strict mechanisms and triggers for loss absorbency or more principles-based guidelines in order to create a common understanding and to enable the industry to elaborate adequate mechanisms meeting these guidelines. CEBS concluded that the second option will achieve the same objective as the first option while, at the same time, giving competent authorities and industry some flexibility in defining compliant mechanisms.

14. On limits, CEBS has decided to elaborate detailed guidelines on convertible instruments that may be taken into account up to 50% of original own funds. This is to ensure that such instruments will in any case meet the high-quality standards required for this class of hybrids. The compliance with these requirements will potentially increase the costs for respective hybrid instruments. It will, on the other hand, allow institutions to include a large share of hybrid instruments into their original own funds, without lowering the overall quality of capital.

15. Finally, on issuances via SPV the guidelines supplement the CRD in clarifying that such hybrids have to comply with the same rules and meet the same requirements as hybrids directly issued by an institution if they are to be included in the original own funds on a consolidated basis. This

does not create any additional costs for institutions but safeguards the quality of indirectly issued hybrids.

Public consultation

16. With regard to the highly practical relevance the guidelines set out in this consultation paper will have for the industry, CEBS is keen to continue the useful dialogue with the industry stemming from earlier stages of CEBS's work on hybrid instruments. In accordance with CEBS's consultation guidelines (CP 01 rev) this consultation paper is therefore published on CEBS's website for a three months public consultation until 23 September 2009. CEBS is interested in stakeholders' views on the whole consultation paper. However, where specific input is requested, questions have been inserted.

17. In addition to the written consultation, a public hearing will be organized on 8 September 2009.

Executive summary

18. The guidelines are structured in five main parts covering the topics of permanence, flexibility of payments, loss absorbency, limits and SPV issuances. The focus is on particular aspects where CEBS sees a need for further guidance in order to achieve a convergent implementation and application of the new CRD provisions. The guidelines also provide additional guidance on a few issues which are not explicitly addressed by the CRD (e.g. buy backs and SPV issuances).

19. Regarding **permanence**, guidance is provided on incentives to redeem, the approval process for redemption and the buy back of hybrid instruments.

20. Instruments with moderate incentives to redeem (so-called innovative instruments) are limited to 15% of an institution's original own funds. An incentive to redeem in this sense is, in principle, any feature that, in the perception of market participants, provides for an expectation of the hybrid instrument being redeemed at the call date, notably an interest-rate step-up or a principal stock settlement clause, in conjunction with a call option. In this context, competent authorities should carefully assess any specific feature used in combination with a call option.

21. The existence of an incentive to redeem will be determined at the issue date. Instruments with an incentive to redeem which are not called shall therefore remain in the 15% bucket and not be re-classified as non-innovative instruments.

22. The redemption of a hybrid instrument requires prior supervisory approval. The approval will be granted if an institution wishing to redeem an instrument can demonstrate that it is neither at present, nor in the foreseeable future, materially in danger of not meeting its capital

requirements and that after the redemption it will still have adequate capital buffers above the regulatory minimum requirements. In its decision the competent authority may also take into account the institution's liquidity positions and its profitability, the evaluation of the risks to which the credit institution is exposed and the evaluation of the business plan of the credit institution, assessing if circumstances arise that might jeopardize the positive business development.

23. This assessment process should also be applied when the competent authority requires the suspension of the redemption of dated instruments.

24. In general, CEBS considers the buy back of hybrid instruments to be economically equivalent to a call or redemption and believes that therefore the same supervisory approval process should apply and that buy backs should, in general, not take place before five years after the issuance.

25. Regarding **flexibility of payments** guidance is provided on the supervisory request for the cancellation of payments, other features regarding flexibility of payments and the use of Alternative Coupon Satisfaction Mechanisms (ACSM).

26. Competent authorities may require the cancellation of coupons/dividends on hybrid instruments taking into account, amongst others, the existence of available distributable items, the solvency data before and after that payment, the evaluation of the risks to which the credit institution is exposed and the evaluation of the business plan of the credit institution, assessing if circumstances arise that might jeopardize the positive business development.

27. Dividend pushers and stoppers are acceptable if the issuer has a large degree of flexibility to cancel payments. They shall, however, be waived if an institution does no longer comply with the capital requirements set out in Article 75 or if the competent authority requires the cancellation of payments based on the financial and solvency situation of the institution.

28. The use of ACSM is only acceptable if it achieves the same economic result as a cancellation of the coupon (i.e. there is no decrease in capital) and when the issuer has full discretion over the payment of the coupons or dividends at all times. To meet this condition, the deferred coupons should be satisfied without delay using already authorized un-issued instruments referred to in Article 57(a) that have an aggregate fair value as a maximum equal to the amount for the coupon/dividend. If circumstances arise preventing the ACSM to work as originally envisaged, the payment of coupon or dividend shall be cancelled.

29. Regarding **loss absorbency** guidance is provided on the objectives of loss absorbency and loss absorbency mechanisms.

30. In general terms, institutions' own funds absorb losses in order to enable an institution to continue as a going concern and, in case of liquidation, to protect depositors in the winding up.

31. Various features can contribute to the loss absorbency of a hybrid instrument. Their relevance depends on the particular situation of an institution. In liquidation the loss absorbency of an instrument depends on its degree of subordination. Original own funds hybrids are senior only to instruments referred to in Article 57(a). Clear information on their ranking should be provided by the issuer.

32. On an ongoing basis, and in particular in stress situations, the instrument must absorb losses to help the institution to continue operations as a going concern. The instrument should help to prevent the institution's insolvency and it should not hinder its recapitalization where necessary to keep it ongoing by helping the institution to rebuild its financial position.

33. An instrument helps to prevent insolvency if the following conditions are met:

   a) the instrument is permanent, in particular, in stress situations the redemption of principal must not be permitted;

   b) the issuer has the flexibility to cancel coupon/dividend payment;

   c) the holder of the instrument must not be in a position to petition for insolvency of the issuer; and

   d) the instrument is not taken into account for the purposes of determining whether the institution is insolvent.

34. The hybrid instrument must contain a meaningful statutory or contractual mechanism that will make the recapitalisation more likely by reducing the potential future outflows to the hybrid holders at a certain prudent and timely enough trigger point. Possible mechanisms are, for example, the possibility of permanently or temporarily writing down the principal or of converting the hybrid into an instrument referred to in Article 57(a). The mechanism to be used must be disclosed in an appropriate way. A combination of these mechanisms or other mechanisms may be applied, provided the competent authority is satisfied that it is capable of achieving the objective set out above.

35. The issuer or the competent authority shall be able to operate the mechanisms when the losses lead to a significant reduction of the retained earnings and other reserves with the consequence of causing a severe deterioration of the solvency level.

36. The triggering of loss absorbency mechanisms should be considered in conjunction with other measures the issuer has at his disposal to remedy the situation, e.g. a share capital increase.

37. Regarding **limits**, guidance is provided on features required for a hybrid instrument to be included in an institution's original own funds beyond the 35% limit as well as the possibility to exceed the limits in an emergency situation.

38. Hybrid instruments can be included in the highest bucket (up to 50% of original own funds) if they have to be converted into items referred to in Article 57(a) either during an emergency situation or at any time at the initiative of the competent authority.

39. An emergency situation in this sense is given, in particular, when the institution makes significant losses and it does not comply with the capital requirements as set out by the competent authority.

40. Even though an institution still meets the minimum Pillar 1 requirements set out according to Article 75, the competent authority may deem the amount of or the composition of its own funds as not adequate to cover risks assessed under the Pillar 2 framework and require the conversion. The maximum number of instruments referred to in Article 57(a) to be delivered at conversion should be determined at the issue date. The number may be reduced if the share price increases but not vice versa.

41. Article 66(4) authorizes competent authorities to permit institutions to exceed the overall 50% limit set out for Tier 1 hybrid instruments, as well as the limits set for the different categories of hybrid instruments. The permission may only be granted on a temporary basis until the emergency situation is over. Mergers and acquisitions are not to be considered emergency situations in this sense unless their purpose is to reorganize or rescue an institution in distress.

42. The CRD is silent regarding **hybrid instruments issued through an SPV**. CEBS believes that such instruments shall comply with the conditions for the qualification as original own funds as if the SPV was itself an institution seeking to include the instruments into its original own funds.

43. Investors in the hybrid instrument shall retain at least the same degree of subordination in insolvency and on an ongoing basis as if the instrument was issued directly by the parent institution. They must, however, not be in a position to place the SPV into insolvency nor should they, in the case of the collapse of the SPV structure, have a better claim against the institution than holders of the same type of instrument directly issued by the institution.

44. The scope of application of this consultation paper, in particular of the triggers, the solvency ratios or the supervisory assessment is, as appropriate, the solo and the consolidated level.

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General remarks

45. Article 63a sets out explicit provisions regarding the minimum requirements for a hybrid instrument to be eligible as original own funds.

46. These requirements and the features introduced to meet them should be clearly reflected in the contractual terms of the hybrid instrument. As far as they are met by statutory provisions the contractual terms should refer to them.

47. Any later amendments to the contract should be assessed against these requirements. It should, in particular, be examined whether the amendments may create an incentive to redeem or may in any other way affect a feature relevant for the limit applicable according to Article 66 (1a).

48. The scope of application of this consultation paper, in particular of the triggers, the solvency ratios or the supervisory assessment is, as appropriate, the solo and the consolidated level.

A. Permanence

> Article 63a (2)
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> "*2. The instruments shall be undated or have an original maturity of at least 30 years. Those instruments may include one or more call options at the sole discretion of the issuer, but they shall not be redeemed before five years after the date of issue. If the statutory or contractual provisions governing undated instruments provide for a moderate incentive for the credit institution to redeem as determined by the competent authorities, such incentive shall not occur before ten years after the date of issue. The statutory or contractual provisions governing dated instruments shall not allow for any incentive to redeem other than the maturity date.*
>
> *Dated and undated instruments may be called or redeemed only with the prior consent of the competent authorities. The competent authorities may grant permission provided the request is made at the initiative of the credit institution and either financial or solvency conditions of the credit institution are not unduly affected. The competent authorities may require institutions to replace the instrument by items of the same or better quality referred to in point (a) or (ca) of Article 57.*
>
> *The competent authorities shall require the suspension of the redemption for dated instruments if the credit institution does not comply with the capital requirements set out in Article 75 and may require the suspension of the redemption at other times based on the financial and solvency situation of credit institutions.*

> *The competent authority may grant permission at any time for an early redemption of dated and undated instruments in the event that there is a change in the applicable tax treatment or regulatory classification of such instruments which was unforeseen at the date of issue*."

49. The permanent nature of original own funds instruments ensures that they are available in order to provide capital support to institutions when needed. It is therefore necessary that there is no contractual or statutory obligation for the issuer to redeem such hybrid instruments. As an exception, dated instruments with an original maturity of at least 30 years whose redemption might be suspended, and instruments that contain a moderate incentive to redeem, may together be recognized up to 15% of original own funds.

50. Paragraph 2 of Article 63(a) addresses the main conditions on permanence that a hybrid instrument must fulfil in order to be included in original own funds. In substance, the principles underlying these conditions are:

    a) There shall be no contractual or statutory obligation to redeem or buy back the instrument. Even dated instruments (with a maturity of 30 years or more) shall, if necessary and under certain conditions, be extended after the maturity date.

    b) In order to be eligible for inclusion in original own funds, a hybrid instrument may only include a moderate economic incentive for the issuer to redeem the instrument.

    c) The issuer can only redeem or buy back hybrid instruments with prior supervisory approval and if the financial and solvency conditions of the institution are not unduly affected.

51. In order to achieve the objective of a common understanding and convergence of supervisory practices, CEBS considers it is particularly important to provide guidelines on incentives to redeem, the approval process for redemption, and the buy back of hybrids.

I. <u>Incentives to redeem - Article 63a (2), subparagraph (1), sentence 3</u>

"If the statutory or contractual provisions governing undated instruments provide for a moderate incentive for the credit institution to redeem as determined by the competent authorities, such incentive shall not occur before ten years after the date of issue."

52. Incentives to redeem may place (economic, reputational or similar) pressures on an issuer to call and refinance a hybrid instrument even though the issuer is experiencing some deterioration in its financial position. The issuer might feel obliged to initiate the call, although the refinancing may lead to a weaker capital structure or may reduce future financial

flexibility. Instruments with moderate incentives to redeem are therefore limited to 15% of original own funds (Article 66 (1a)(c) CRD).

53. Incentives to redeem can be defined as those features that, in the perception of market participants, provide for an expectation of the hybrid instrument being redeemed at the call date. Interest rate step-ups and principal stock settlements, in conjunction with a call option, are considered as incentives to redeem. However, any other feature which might lead to an instrument being redeemed may also be considered an incentive to redeem. In this context, competent authorities should carefully assess any specific feature used in combination with a call option. In order to be considered as an incentive to redeem it is not necessary that the call option and the step-up or any other specific feature have the same date of exercise.

54. Step-ups are permitted, in conjunction with a call option only if they are considered moderate, i.e. if they result in an increase over the initial rate that is no greater than, either:

- 100 basis points, less the swap spread between the initial index basis and the stepped up index basis; or

- 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped up index basis.

55. The terms of the instrument shall provide for no more than one rate step-up over the life of the instrument. The swap spread shall be fixed at the pricing date and reflect the difference in pricing on that date between the initial reference security or rate and the stepped-up reference security or rate.

56. A principal stock settlement mechanism in conjunction with a call option shall contain a cap on the conversion ratio in order to be considered a moderate incentive to redeem. The cap on the conversion ratio at the date of redemption shall not be more than 150% of the conversion ratio at the time of the issue. A principal stock settlement feature should not be confused with mandatory convertible securities (MCS). MCS do not provide the issuer with an incentive to redeem because there is no call option and the instrument would be issued to equity or equity-linked investors who will receive instruments referred to in Article 57(a) on conversion after a specified period (e.g. three years).

57. In principle, an option for the issuer to deliver shares which is not explicitly linked to a call option (e.g. to achieve loss absorbency as set out in Section D) should not per se be regarded as an incentive to redeem. However, competent authorities shall analyse the structure of any such feature on a case-by-case basis, at the date of issue, in order to determine whether it nonetheless shall be considered as an incentive to redeem.

Question 1:

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.

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

No reclassification of instruments with an incentive to redeem

58. The existence of an incentive to redeem will be determined at the issue date. A decision on this cannot be reversed. Instruments with incentives to redeem that are not called are to remain in the 15% bucket and not be re-classified as non-innovative instruments.

II. Supervisory consent to a call or redemption of a hybrid instrument - Article 63a (2), subparagraph (2), sentences 1 and 2 and subparagraph (3)

"*Dated and undated instruments may be called or redeemed only with the prior consent of the competent authorities. The competent authorities may grant permission provided the request is made at the initiative of the credit institution and either financial or solvency conditions of the credit institution are not unduly affected.*

The competent authorities shall require the suspension of the redemption for dated instruments if the credit institution does not comply with the capital requirements set out in Article 75 and may require the suspension of the redemption at other times based on the financial and solvency situation of credit institutions.

The competent authorities may grant permission at any time for an early redemption of dated and undated instruments in the event that there is a change in the applicable tax treatment or regulatory classification which was unforeseen at the date of issue."

General

59. The underlying objective of the requirement of permanence is that the paid-up funds on which the institution builds up its risk positions are available to support the entity on an ongoing basis. Redemptions are therefore subject to strict conditions and to prior supervisory approval. This section sets out the conditions for the approval process.

60. As a general principle, institutions which plan to call or redeem a hybrid instrument shall remain compliant with all regulatory requirements at that date and in the foreseeable future.

Application for call or redemption

61. The issuer is required to submit an application before calling or redeeming a hybrid instrument, including for dated instruments. This application must be accompanied by all required/necessary information allowing the competent authority to conduct its assessment on the potential impact of the redemption on the financial and solvency positions of the issuer.

62. The issuer shall transmit the application and the necessary information to its competent authority as soon as it has made its decision to redeem a hybrid. Following Article 123 each institution is required to have in place a sound, effective Internal Capital Adequacy Assessment Process (ICAAP). This notably implies that the issuer is required to properly assess the amount and quality of own funds (internal and regulatory) it needs to adequately cover the risks to which it is or might be exposed. Therefore, the issuer shall schedule the submission of its application to call or redeem a hybrid capital instrument included in original own funds well in advance of the call or redemption date. It is possible that the assessment process by competent authorities is linked with the Supervisory Review and Evaluation Process (SREP).

63. If the competent authority receiving the application is not the EU consolidating supervisor, which may be the case if the issuer is a subsidiary domiciled in another Member State, it must duly inform the consolidating supervisor of the content of the application, if the issue is also included in own funds at the consolidated level.

64. As far as it is not already available to the competent authority the institution shall, together with its application for calling or redeeming a hybrid instrument, at a minimum, submit the following additional information:

a) a well-founded explanation why the credit institution intends to call or redeem the instrument;

b) current solvency data including the level and composition of original own funds before and after the exercise of the call or redemption and a confirmation that the credit institution continues to comply with all other regulatory requirements after calling or redeeming the hybrid instrument;

c) information on the planned development of the data under item b for the following x (e.g. 3-5) years based on its business plan including the planned development of the balance sheet and the profit and loss account; and

d) the evaluation of the risks to which the credit institution is or might be exposed and whether the level of own funds ensures, or not, the coverage of such risks, including stress tests on main risks showing potential loss under different scenarios.

65. Competent authorities may ask for additional information if necessary, particularly on the institution's liquidity position, or other information such as the hybrid instrument's term sheet.

66. Competent authorities may also ask the institution to demonstrate that it can re-access the hybrids market, notably if the instrument is to be replaced by another hybrid instrument. In this context, the institution shall also submit information on the replacement's impact on its profitability.

67. In case the hybrid instrument has already been replaced by capital of at least the same or better quality the competent authorities may require less information in the context of the application.

The prior consent of the competent authorities

68. Competent authorities shall not permit the call or the redemption of a hybrid instrument if, based on the information provided by the institution or based on other supervisory information, it is or will be materially putting the financial and solvency situation of the institution in jeopardy in the foreseeable future.

69. The institution shall still have adequate capital buffers sufficiently above the regulatory minimum capital requirements after the call or redemption and in the foreseeable future.

70. Where relevant, competent authorities shall take into account the impact on the institution's liquidity position or its profitability when allowing the call or the redemption.

III. Supervisory guidance on buybacks of hybrid capital instruments in the market

71. The possibility to call and redeem the instrument is excluded in the first five years after the date of issue (Article 63a (2), subparagraph (1), sentence 2). A call or redemption feature will be described in a legal or contractual provision allowing the issuer to call the (full) issue amount of the instrument. Such formal call or redemption is distinguished from (partial) buy-backs in the market at market terms equivalent to buy-backs of e.g. common or preferred shares.

72. However, in economical and prudential terms buy-backs are equivalent to a call or redemption: hybrids may no longer be at the institution's disposal when it needs them most. Therefore, competent authorities shall apply the

same process to the buy-back of a hybrid instrument as to a call or redemption. This means that

a) buy backs shall only take place at the initiative of the issuer;

b) buy backs shall not take place before five years after the issuance date and only with prior supervisory approval; and

c) if the institution replaces the hybrid instrument it wants to buy back with capital of at least the same or better quality, e.g. in order to improve the quality of the institution's own funds or its profitability, buy backs may take place before five years after the issuance date provided that the new instrument has already been issued and subject to supervisory approval.

Holdings in own hybrid instruments by the issuer

73. The guidance above does not prevent competent authorities from permitting limited activities for market making or market smoothing purposes (in those cases, usually the amount of hybrids remain outstanding). Institutions shall in this case have in place adequate policies for these transactions in order to avoid material holdings in own hybrid instruments. Therefore, it is proposed that at any time repurchased instruments held by the institution shall not account for more than 5% of the relevant issuance.

74. For solvency purposes, only the net amount of a hybrid instrument outstanding in the market (i.e. issue amount less own holdings) may be taken into account[6].

Question 2:

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.

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

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[6] CEBS understand that the exemption set out in Annex VII, part D, paragraph 3 of Directive 2006/49/EC is not applicable to such holdings.

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.

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.

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?

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.

B. Flexibility of payments

Article 63a (3)

"3. The statutory or contractual provisions governing the instrument shall allow the credit institution to cancel, when necessary, the payment of interest or dividends for an unlimited period of time, on a non-cumulative basis.

However, the credit institution shall cancel such payments if it does not comply with the capital requirements set out in Article 75

The competent authorities may require the cancellation of such payments based on the financial and solvency situation of the credit institution. Any such cancellation shall not prejudice the right of the credit institution to substitute the payment of interest or dividend by a payment in the form of an instrument referred to in point (a) of Article 57, provided that any such mechanism allows the credit institution to preserve financial resources. Such substitution may be subject to specific conditions established by the competent authorities."

75. Flexibility of payments is closely interlinked with loss absorbency: non-cumulative cancellation of the payment of coupons/dividends in stressed

situations increases the capacity of the instrument to absorb losses on an ongoing basis.

76. On an ongoing basis, the instruments must permit an institution to preserve cash by not paying out coupons/dividends if the financial situation of the institution requires it, without risk of investors invoking default and triggering legal insolvency.

77. Therefore, the conditions of the instrument must enable the institution to cancel coupons/dividend payments, when necessary, on a non-cumulative basis. The institution must assess at any time and therefore have discretion to decide whether it is able to pay coupons/dividend based on its financial situation. Any coupon or distribution not paid by the issuer is forfeited and no longer due and payable by the issuer. Also, the institution must have full access to the waived payment.

78. Payments of coupons or dividends on hybrids can only be paid out of distributable items.

I. Supervisory request for the cancellation of payments

79. Article 63a (3) subparagraph 3 first sentence foresees the cancellation of coupons/dividends under supervisory request. Competent authorities' intervention in the decision of whether or not to pay a coupon/dividend on hybrid instruments is based on their own assessment of the financial and solvency situation of an institution.

80. According to subparagraph 2 of that same Article, payment of coupons/dividends must be cancelled if an institution does not comply with the capital requirements set according to Art. 75. Consequently, regulatory intervention would be expected at an earlier stage based on the assessment of capital requirements and other prudential/financial measures and of the risks incurred by an institution.

81. Hence, competent authorities may require the cancellation of coupons/dividends on hybrid instruments taking into account, amongst others, the following:

a) The solvency data before and after that payment, namely if such payment, or other foreseeable internal and external events/circumstances, may increase the risk situation of the credit institution by causing a breach of capital requirements.

b) Information on the planned development of the data under item a) for the following x (e.g. 3-5) years based on its business plan, including the planned development of the balance sheet and the profit and loss account.

c) The evaluation of the risks to which the credit institution is or might be exposed and whether the level of own funds ensures, or not, the coverage of such risks, including stress tests on main risks showing potential loss under different scenarios.

II. Flexibility of payments – other features of hybrid instruments (e.g. dividend pushers and stoppers)

82. The ranking between shareholders and hybrids holders is an aspect to take into consideration in these types of instruments, and consequently some issues include dividend pushers and stoppers. A dividend pusher or stopper may be considered as acceptable if the issuers have a large degree of flexibility to cancel payments.

83. Under normal circumstances, a dividend pusher requires the issuer to pay its coupons/dividends on hybrids if it has paid a coupon/dividends on a more junior instrument, for example its ordinary shares. Dividend pushers are acceptable in order to preserve the rank of subordination between shareholders and hybrid investors. Nevertheless, they must be waived at least when either one of the following events occurs between the date the coupon is pushed and the date it is to be paid:

    a) the credit institution does not any longer comply with the capital requirements set according to Art. 75 (Article 63a (3), subparagraph (2)); or

    b) the competent authorities require the cancellation of such payments based on the financial and solvency situation of the credit institution (Article 63a (3), subparagraph (3) first sentence).

    Under those circumstances, payment of the coupons/dividends will be forfeited and no longer be due and payable by the issuer. They should also be waived if the major part of the dividend to shareholders is not paid in cash but in shares.

84. A dividend stopper prevents the issuer from paying dividends in a period in which the issuer omits payments to hybrid holders. It is considered to be a restriction on the flexibility of payments on common stocks bearing in mind that experience indicates that institutions seem to be more willing to cancel dividends on common stock, which constitutes the most junior claim and on which distributions are totally discretionary, than they are on hybrids.

85. Dividend pushers and stoppers should also operate in a way that does not hinder recapitalisation (see part C.)

Question 3:

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.

III. Substitution of payment of interest or dividend by a payment in the form of an instrument referred to in Article 57(a): Alternative Coupon Satisfaction Mechanisms (ACSM)

86.This subsection refers to Alternative Coupon Satisfaction Mechanisms (ACSM) or similar mechanisms which oblige the issuer to substitute the payment of interest or dividend by a payment in the form of an instrument referred to in Article 57(a).

87.Because of tax reasons, some instruments already issued contain ACSM (or a similar structure) whereby deferred payments are not cancelled but must be settled at a pre-specified future trigger point through the issuance of preferred or common shares.

88.ACSM come in a variety of different structures whose impact upon the institution's financial resources differ according to the details of their structure and the type of deferral they entail. Structures that imply non-cash settlements in form of equity capital are, in their economic substance, a dilution of the share capital of the existing shareholders. The total risk bearing capital is not increased by the issuance of new shares. The consequences of using the ACSM can therefore be considered neutral. They may, however, give rise to some prudential concerns notably if for instance the institution is not able to issue shares in time to settle the deferred coupons in kind. For instance, the deferred coupon can accumulate in the absence of settlement with shares (e.g. the issuer has not found investors in the market) and therefore the deferred coupons will not serve to cover losses on a going concern basis.

89.Moreover, a sufficient amount of shares must be issued and sold to pay the full cash amount of the deferred coupon. There is a potential dilution effect that may create additional difficulties, even if this risk is limited to the amount of the coupon, in an emergency situation, notably if the issuer must be recapitalized.

90.Therefore an ACSM is only acceptable if it achieves the same economic result as a cancellation of the coupon (i.e. there is no decrease in capital) and when the issuer has full discretion over the payment of the coupons or dividends at all times. To meet this condition, the deferred coupons should be satisfied without delay using newly issued instruments, referred to in Article 57(a) that have an aggregate fair value as a maximum equal to the amount for the coupon/dividend. For this purpose, the issuer must already have authorised but un-issued instruments. The obligation of the institution is limited to the issue of those instruments but the institution must not be committed to find new investors for these instruments. The instruments may be, afterwards, sold in the market by the hybrids holders but if the sales proceeds are less than the coupon, the issuer must not be obliged to issue further new instruments to cover the loss incurred by the hybrid holder.

91. If circumstances arise preventing the ACSM to work as originally envisaged the payment of coupon or dividend shall be cancelled.

92. The ACSM should also operate in a way that does not hinder recapitalization of the issuer (see part C.). The issuer or the competent authority shall be able to cancel the use of ACSM when necessary, notably when the mechanism of loss absorbency, as described in part C., is triggered.

Question 4:

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?

C. Loss absorbency

Article 63a (4) and (5)

"4. The statutory or contractual provisions governing the instrument shall provide for principal, unpaid interest or dividends to be such as to absorb losses and to not hinder the recapitalisation of the credit institution through appropriate mechanisms, as elaborated by the Committee of European Banking Supervisors under paragraph 6.

5. In the event of the bankruptcy or liquidation of the credit institution, the instruments shall rank after the items referred to in Article 63(2)."

93. In addition to Article 63a(4) and (5), Article 63(2), requires that the "instruments referred to in point (ca) of Article 57 shall comply with the requirements set out in points (a), (c), (d) and (e) of this Article." Points (c) and (d) state that "the lender's claims on the credit institution shall be wholly subordinated to those of all non-subordinated creditors" and "the documents governing the issue of the securities shall provide for debt and unpaid interest to be such as to absorb losses, whilst leaving the credit institution in a position to continue trading", respectively.

94. Thus, the CRD requires that hybrids must be able to absorb losses on a going concern basis and in the case of liquidation. Nevertheless, the Directive gives no further explanation of how the loss absorbency requirement on a going concern basis, in particular, in stress situations, is to be understood. To this end, and given the terms of the rule, CEBS

guidance needs to focus on possible loss absorbency mechanisms and on the requirement of “not hindering recapitalization”.

I. Objective of loss absorbency

95. In general terms, institutions’ own funds absorb losses

    a) to enable an institution to continue as a going concern and,

    b) in case of liquidation, to protect all depositors in a winding up.

96. The issue of going concern is relevant in stress situations - such as within a reorganisation process - when the bank suffers severe losses or loses the confidence of its creditors to such an extent that it may be at risk of not being able to continue its business. Loss absorbency on a going concern basis in these situations means that an institution is able to incur a loss but remain solvent and viable, even if distributable reserves have already been depleted. In the described situations, loss absorbency features will help to rebuild its financial position.

97. Therefore, the concept of an institution being a going concern goes beyond the auditing definition which states that a company is a going concern if it can meet its obligations as they fall due and its assets exceed its liabilities.

II. Loss absorbency mechanisms

98. Various characteristics have evolved to provide loss absorbency of the principal amount of a hybrid instrument. These include subordination, flexibility to cancel coupon/dividend payment and full access to waived payments, principal write-down features, convertibility into higher forms of capital and the fact that the instruments must not be taken into account for the purposes of determining whether the institution is insolvent.

99. The relevance of these loss absorbency mechanisms varies depending on the actual situation of an institution. Subordination, for example, is most important in liquidation to ensure that hybrid holders’ claims are not met before all more senior claims are satisfied. The write-down of the principal or the conversion of hybrids into ordinary shares at an appropriate trigger point, on the other hand, enables loss absorbency on a going-concern basis and may help the institution to recover.

Ability to absorb losses in liquidation

100. The existence of losses that make the institution unviable according to prudential banking and/or commercial regulation triggers its liquidation. In this case the trigger for loss absorbency mechanism to be activated is the winding-up of the issuer.

101. The capacity of an instrument to absorb losses in the case of liquidation will depend on its degree of subordination.

102. On the basis of the CRD an instrument must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids collectively are senior only to capital instruments referred to in Article 57(a).

103. Even if there are no provisions in the CRD on the order of priority among the hybrid instruments themselves, different levels of subordination would reduce the transparency on the ability of these instruments to cover losses, notably if the levels of subordination also have an influence on the priority of payment of dividends/coupons. This lack of transparency may also create additional operational and legal risks, and therefore, clear information on their ranking should be provided by the issuer.

104. The instrument must neither be secured nor covered by a guarantee of the issuer or a related entity, nor other arrangements that legally or economically enhance the seniority of the claim vis-à-vis the institution.

Ability to absorb losses in going concern

105. On an ongoing basis and in particular in stress situations, the instrument must absorb losses to help the institution to continue operations as a going concern which means:

a) that it should help to prevent its insolvency; and

b) that it should not hinder the recapitalization of the institution if the recapitalization is necessary to keep it ongoing and will help the institution to rebuild its financial position.

<u>Prevention of insolvency</u>

106. The instrument helps to prevent insolvency if the following conditions are met:

a) the instrument is permanent, in particular, in stress situations the redemption of principal must not be permitted (see Part A.);

b) the issuer has the flexibility to cancel the coupon/dividend payment (see Part B.);

c) the holder of the instrument must not be in a position to petition for insolvency of the issuer; and

d) the instrument would not be taken into account for the purposes of determining whether the institution is insolvent.

<u>Not be in a position to petition for insolvency</u>

107. Insolvency is generally triggered by either a payment default by the issuer or, depending on the legal framework, by the fact that liabilities exceed assets. In order to avoid a payment default, it is important that the contractually or statutory covenants make sure that there is no triggering of default by any non-payment as there is no obligation to redeem the instrument or to pay a coupon/dividend: The holder of the instrument must not have the right to trigger insolvency.

<u>Not taken into account for the purposes of determining insolvency</u>

108. The high level of subordination and the fact that there is no obligation to redeem the principal or to pay a coupon/dividend may, depending on the legal framework, not be sufficient to consider that the instrument is not a liability for the purposes of determining whether the institution is insolvent. When the insolvency law is based on a balance sheet test (assets must exceed liabilities), it is necessary to assess whether the instrument would be taken into account under the legal framework for the purposes of determining insolvency.

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 is transformed into equity 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.

<u>Not hindering the recapitalization (make the recapitalisation of the issuer more likely)</u>

110. When the institution suffers losses and/or loses the confidence of its creditors to such an extent that it may be at risk of not being able to continue its business, it will need to be recapitalized. This will be the case when the losses lead to a significant reduction of the retained earnings and other reserves with the consequence of causing a severe deterioration of the solvency level, expressed in terms of the original own funds ratio or any other regulatory ratio that the issuer must maintain as determined by the relevant competent authority.

111. The solvency ratio is easy to monitor and provides a clear indication of an institution's financial situation. Irrespective of the capital requirements set out by Article 75, each institution according to its business model complies with a certain solvency level it must maintain to be viable. The viability

measured as ability to raise funds is very much dependent on the market perception but may already be endangered at a solvency level well above the minimum requirement. However, the need for recapitalization will, at the latest, arise when the amount of losses to be compensated is so high that it will wipe out the reserves[7] of the institution and even its share capital or its capital in terms of Article 57(a).

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.

113. Any direct or indirect economic benefit may undermine the ability of the instrument to enable the issuer to restore its financial situation. Thus, a balance between new shareholders and hybrid holders' rights is likely to be necessary in order to make the recapitalization of the issuer more likely.

114. The hybrid instrument must contain a meaningful statutory or contractual mechanism that will make the recapitalisation more likely by reducing the potential future outflows to the hybrid holders at a prudent and timely enough trigger point. Possible mechanisms are for example:

a) The possibility of writing down the principal permanently at a trigger point. If the nominal amount of the principal is permanently written down then the holders of that instrument absorb losses effectively. A meaningful mechanism for a write down would, for example, be pari passu with the shareholders or holders of instruments referred to in Art. 57(a).

b) The possibility of writing down the principal temporarily at a trigger point. The temporary write-down of the principal of an original own funds hybrid reduces future expenses to the extent that future coupons are cancelled while the principal amount is written down until the full principal amount is written back up again. A meaningful mechanism for a write down and/or a (later) write up would, for example, be pari passu with the shareholders or holders of instruments referred to in Article 57(a).

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[7] In some jurisdictions the reserves contain for instance non distributable reserves, like legal reserves. The need to wipe out this class of reserve could be a trigger point to start recapitalization measures.

During the write down period, the coupon should be cancelled and dividend stoppers and pushers should operate in a way that does not hinder recapitalization. Regarding dividend pushers, they must be waived at least when a breach of the minimum capital requirements occurs between the date the coupon is pushed and the date it is to be paid, or if deemed necessary by the respective competent authority (see Part B.).

c) The conversion into an instrument referred to in Article 57(a) at an appropriate trigger point. If the original own funds hybrid converts into shares or any other instruments referred to in Article 57(a), then the hybrid investors may incur losses at the point of conversion depending on the amount and the features of shares or of such other instruments they receive.

115. A combination of these mechanisms or other mechanisms may be applied provided the competent authority is satisfied that it is capable of achieving the objective set out above. The effects of the mechanism will be more meaningful if it happens immediately after losses cause a significant deterioration of the financial as well as the solvency situation and even before the share capital is exhausted. With regard to the trigger point, the issuer or the competent authority shall be able to operate the mechanisms when the losses lead to a significant reduction of the retained earnings and other reserves with the consequence of causing a significant deterioration of the solvency level, which does not necessarily mean a breach of the required solvency level, expressed in terms of a original own funds ratio or any other relevant ratio that the issuer must maintain to be viable.

116. When this trigger is about to be reached, the issuer and the competent authority will consider how loss absorption mechanisms interact with other remedies, e.g. a share capital increase or the implementation of any other measures adopted by issuer. To complement these measures and to restore the issuer's financial situation, the issuer or the competent authority shall be able to activate the aforementioned mechanisms within a manageable timeframe and certainly when a breach of the minimum capital requirement set out in Art. 75 (currently 4% Tier 1 ratio and 8% total capital ratio) is about to happen.

117. The mechanism to be used, including the trigger point, must be clearly defined in the contract, disclosed and transparent to the market in an appropriate way, for example as part of the pillar 3 requirements/disclosures. In addition, it must be legally certain.

Question 5:

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.

5.2	**Do you agree with the definition of loss absorbency in going concern? If not why and what alternative would you propose?**
5.3	**Do the guidelines provide sufficient flexibility for institutions to design mechanisms that fulfil the objective of loss absorbency in going concern? What alternative would you propose? Does this flexibility raise level playing field issues?**
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?**

D. Limits

Article 66 (1a)

"1a. Notwithstanding paragraph 1, the total of the items in point (ca) of Article 57 shall be subject to the following limits:

(a) instruments that must be converted during emergency situations and may be converted at the initiative of the competent authority, at any time, based on the financial and solvency situation of the issuer into items referred to in point (a) of Article 57 within a pre-determined range (…) shall in total not exceed a maximum of 50% of the items in points (a) to (ca) minus (i), (j) and (k) of Article 57;

(b) within the limit referred to in point (a) of this paragraph, all other instruments shall not exceed a maximum of 35% of the items in points (a) to (ca) minus (i), (j) and (k) of Article 57;

(c) within the limits referred to in points (a) and (b) of this paragraph, dated instruments and any instrument, whose statutory or contractual provisions provide for an incentive for the credit institution to redeem shall not exceed a maximum of 15% of the items in points (a) to (ca) minus (i), (j) and (k) of Article 57;

(d) the amount of items exceeding the limits set out in points (a), (b) and (c) shall be subject to the limit set out in paragraph 1."

Article 66 (4)

4. The competent authorities may authorise credit institutions to exceed the limits laid down in paragraphs 1 and 1a temporarily during emergency situations."

118. With regard to hybrids and more specifically in relation to the limits for their eligibility as original own funds, the objectives of the directive are to harmonize the rules within the EU and to improve the quality of own funds. The second aspect is in particular reflected by the introduction of a tiered limit system and by linking the inclusion of an individual instrument to a certain limit/bucket with its quality.

119. These guidelines aim at enabling competent authorities to clearly assign every hybrid instrument to one of the three limits.

120. The first bucket (up to 15%) includes all instruments that have an incentive to redeem as defined in Part B as well as dated instruments.

121. With regard to the other two buckets (up to 35% and up to 50%), CEBS clarifies below the requirements that must be fulfilled by a hybrid instrument to be included beyond the 35% limit and up to 50 % of original own funds. To be in line with the objectives of harmonizing the rules and improving the quality of own funds, the features defined by CEBS for these instruments are designed to be simple to understand and to apply, and to accept in this bucket only hybrid instruments that have similar characteristics (permanence, flexibility of payment, loss absorbency) as instruments referred to in Article 57(a). CEBS is also taking into account the fact that the Directive amending the CRD is based largely on CEBS's advice of April 2008. When describing option 2 in CEBS's advice[8], the intention was to include in this higher bucket only instruments that are most similar to ordinary shares in their capital qualities.

122. Hybrids without incentives to redeem but not fulfilling these requirements will be limited up to 35% of original own funds.

I. <u>Features of hybrids instruments that may be included beyond the 35% limit</u>

123. According to the CRD, only hybrids convertible into instruments referred to in Art 57(a) are eligible beyond the 35% limit. CEBS understands that the intention is to ensure that these hybrids shall have the same permanence as an instrument referred to in Article 57(a). The presence of a call option for these instruments may reduce their permanence. Consequently, only convertible instruments that cannot be redeemed in cash but can only be converted into instruments referred to in Article 57(a) will be included in this bucket.

124. The conversion clause may foresee a mandatory conversion at a predetermined date or allow a conversion at any time. In any case, and according to Article 66(1)(a), the conversion shall become effective under the following conditions:

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[8] See paragraphs 110 and 111 of CEBS's proposal for a common EU definition of Tier 1 hybrids

a) mandatorily during emergency situations, and

b) at the discretion of the competent authority, at any time, based on the financial and solvency situation of the issuer.

Mandatory conversion

125. The term “emergency situation” should be clearly defined in the terms of the contract and trigger events should be identified.

126. In such a situation hybrids’ conversion into instruments referred to in Article 57(a) shall be mandatory in order to help the institution to remain solvent.

127. A trigger event is, at least, the breach of regulatory limits set by the competent authorities according to Article 75 (i.e. at least 4% Tier 1 capital ratio and 8% total capital ratio). Where competent authorities have set higher limits, either on a general basis (i.e. for all institutions) or for a single institution according to Article 136, reference is made to such higher limits.

Optional conversion

128. The competent authority must have the option to trigger the conversion of the hybrid if necessary with regard to the financial and solvency situation of the institution. Hence, there shall be no contractual clause that prevents the competent authority from exercising this option while the issuer may have the option to convert at any time.

129. The competent authority will require the conversion based on the “financial and solvency situation of the issuer”. In this regard the same considerations apply as stated above in connection with the supervisory approval to call/redeem an instrument or the trigger to cancel payments of coupons/dividends.

130. Even though an institution still meets the minimum Pillar 1 requirements set out according to Article 75, the competent authority may deem the amount of or the composition of its own funds as not adequate to cover risks assessed under the Pillar 2 framework and require the conversion.

131. The CRD does not explicitly address a conversion option to be exercised by the issuer or a mandatory conversion at a certain point in time. Such clauses are, however, deemed to be consistent with the CRD provisions and an issuer should have the flexibility to convert at any time. At the same time, also the investor should not be prevented from converting at any time.

Conversion ratio

132. Regardless of the reason for the conversion hybrids shall be converted into items referred to in Article 57(a) within a predetermined range.

133. The objective of the predetermination of the number of instruments referred to in Article 57(a) into which hybrids will be converted is to ensure that the instruments included beyond the 35% limit will share losses from the trigger point on, i.e. the downside risk, pari passu with shareholders since the issuance.

134. In order to achieve this objective, the maximum number of instruments referred in to Article 57(a) to be delivered should be determined on the basis of the market value of these instruments at issue date (in order to equal the nominal value of the instrument). The mechanism of conversion may reduce this number if the share price increases but not increase it if the share price decreases.

135. The obligation to have a predetermined conversion ratio does not prevent some technical adjustments of the pre-fixed conversion ratio in case of extraordinary operations on company capital (i.e. mergers, acquisitions, breakup, reorganization, grouping of shares, etc.)[9].

II. Emergency situations under Article 66 (4)

136. On basis of Article 66(1), limits must be respected at all times but Article 66 (4) authorises competent authorities to permit institutions to exceed the overall 50% limit of hybrid instruments in the original own funds. The competent authorities may also authorise exceeding the limits set according to the quality of the hybrid instruments i.e. 15% and 35%. The authorisation to exceed the limits also covers the limits set to the additional own funds.

137. The competent authority's power to authorise exceeding the limits is confined by the duration of the emergency situation at hand. The authorisation shall be temporary and the institution shall submit a plan for replenishing its capital ratios.

138. Mergers and acquisitions are, in principle, excluded from the scope of emergency situation unless their purpose is to reorganize or rescue an institution in distress.

Question 6:

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

[9] For example, some term sheets provide that the conversion ratio may be adjusted in accordance to the adjustment value published by the official market to be applied on derivatives having the share as underlying.

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?

E. Hybrid instrument issued through an SPV

139. A Special Purpose Vehicle (SPV) is a subsidiary of an institution that issues hybrid instruments that can be included within the institution's own funds. SPVs are consolidated within the accounts of their parent institution. SPVs are often set up exclusively to issue such capital instruments, but in some cases they may also undertake other business. As noted below, where an SPV undertakes business other than hybrid instrument issuance[10], the hybrid instruments must be ring-fenced so that it does not have an enhanced claim in insolvency.

140. An indirectly-issued instrument shall comply with the conditions for qualification as original own funds, as if the SPV was itself an institution seeking to include that capital in its original own funds, as set out in Article 63a (see Parts A-D above).

141. Original own funds instruments issued via an SPV should be either convertible into directly issued instruments of the same or better quality or subject to a temporary or permanent write-down upon the occurrence of certain trigger events. These trigger events should include the breach or foreseeable breach of the institutions' capital requirements or a serious deterioration in its capital position (see Part C above).

142. In an SPV structure, the connected loan to the parent must be subordinated. It can be cumulative, if it achieves the same result as a non-cumulative instrument, but any surplus income in relation to the coupon in the SPV must be immediately up-streamed to the parent institution[11]. In addition, it can also be dated. However, the terms of the loan should be such that its call date or redemption (if any) must not arise before that on the instrument issued by the SPV.

143. Investors in the hybrid instrument shall retain at least the same degree of subordination in insolvency and on an ongoing basis, as if the instrument was issued directly by the parent. Guarantees from any other part of the group shall not be given that afford hybrid investors a preferential claim and shall not, as a result, allow acceleration of repayment to investors. If the SPV undertakes activities in addition to the issue of hybrid instruments,

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[10] This is not the case for operative subsidiaries which are not within the scope of these guidelines.

[11] According to the general rule that when the loan is cumulative, it may not be counted for as Tier 1 by the institution at solo level.

the hybrid capital shall be ring-fenced so that the claims of the hybrids holders are not enhanced in insolvency.

144. An issuer should try to minimise cross-border and legal risk if using an SPV. In order to reduce the risk of SPV issues being subject to potential cross border legal conflicts, institutions that issue hybrid instruments in a foreign jurisdiction must demonstrate that they have mitigated any associated legal risks.

145. Investors must not be in a position to place the SPV into insolvency.

146. Events of default may be limited by requiring that the SPV:

a) Issues only instruments where the terms do not give investors the right to place the firm into insolvency. For example, non-payment of a coupon should not create an event of default.

b) Does not issue or receive guarantees from which an event of default may arise.

c) Is adequately capitalised to meet its needs as a going concern.

d) Carries out only the activities for which it was created.

e) Has only as many staff as it needs and these carry out only the duties necessary for the operation of the SPV (thus reducing exposure to operational risk).

f) Is set up in such a way that there is agreement with the holders of the instrument that it will not be placed into voluntary insolvency.

147. In the event of collapse of the SPV structure, the holders of the instrument shall have no better claim against the institution than holders of the same type of instrument directly issued by the institution. Therefore, where the loss absorbency mechanism involves a conversion into a directly-issued instrument, the instrument issued by the SPV should be cancelled and replaced with an equivalent instrument issued by the institution. There shall also be no obstacle to the institution's issue of replacement securities.

Question 7:

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.