

**JOINT ASSOCIATIONS' RESPONSE TO
EUROPEAN COMMISSION CONSULTATION ON
CRD POTENTIAL CHANGES**

HYBRID CAPITAL INSTRUMENTS



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HYBRID CAPITAL INSTRUMENTS

We support a principles based approach

The joint trade associations support a principles based, substance over form approach to the regulatory oversight of hybrid instruments in order to drive greater convergence and the greater use of these instruments that a level playing field will bring. We were concerned that the underlying three principles of the 1998 Sydney Press Release (SPR) had been unnecessarily embellished by CEBS during its work on hybrid capital during 2007. So we are glad to see that these proposals have stepped back from overly prescriptive requirements.

The ability to issue dated instruments is welcome

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 firms 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.

Therefore we are pleased that long-dated instruments with a call date, subject to supervisory oversight of any repayment and suitable lock-in provisions, will be permitted in order to allow firms to manage this volatility.

Hindering recapitalisation

The ability of a hybrid instrument to 'not hinder' recapitalisation will be impossible to prove before the fact, although we prefer this wording to previous CEBS's proposal that their structure should make recapitalisation more likely. Those required to give legal opinions about the possibility of a particular structure hindering recapitalisation will find this impossible to do. Therefore we have suggested the deletion of this requirement, confident that the proposed regulatory veto of payments and redemptions will in itself achieve this objective.

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 so that a breathing space is created whilst a recapitalisation plan can be developed.

Requiring permanent write-down, as has been previously suggested, as a route to facilitating recapitalisation, 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.

Suspension permits the prevention of redemption and the payment of coupons but ensures that the investment remains in the hands of the hybrid investors rather than becoming part of shareholders' resources. In this way hybrid investors would fairly benefit from any potential upside once the firm had set back on the path back to good health alongside the ordinary shareholders. Mandatory write down or conversion into ordinary shares is not necessary.

Alternative coupon settlement mechanisms

We appreciate the inclusion of the ACSM concept but note that the most commonly used form of ACSM is based on the sale of shares to raise funds to pay for a distribution rather than the direct issuance of shares to hybrid holders.

So the proposed limitation of ACSM to the substitution of ordinary or preference shares for payments in cash of coupons or dividends to the hybrid holders themselves does not reflect market practice. The majority of hybrid buyers are fixed income investors so may be prevented by their investment criteria from holding the substituted ordinary or preference shares. We have therefore suggested wording that caters for this market reality without prejudicing a firm's capital ratios.

Early calls

We appreciate the explicit acceptance of early calls for tax and regulatory reasons and have added further wording relating to other such circumstances, such as accounting changes that may negatively impact the economics of a hybrid and result in a firm wishing to redeem.

No further core capital limits needed

We do not agree that it is necessary to improve even further the quality of capital based on a pre determined proportion of minimum capital requirements.

No additional limits on core capital are needed. We do not agree that it is necessary to improve even further the quality of capital based on a pre determined proportion of minimum capital requirements as was proposed by CEBS. Any such change may conflict with existing Tier 2 and Tier 3 limits and potentially disqualify significant amounts of such capital currently used.

Changes to Directive 2006/48/EC

Article 57, point (a)	
<p>(a) capital within the meaning of Article 22 of Directive 86/635/EEC, in so far as it has been paid up, plus the related share premium accounts, it fully absorbs losses in going concern situations, and in the event of the bankruptcy or liquidation of the credit institution, it ranks after all other claims but excluding cumulative preferential shares;</p>	<p>a) capital within the meaning of Art 22 of Directive 86/635/EEC, in so far as it has been paid up, plus the related share premium accounts, it fully absorbs losses in going concern situations, and in the event of the bankruptcy or liquidation of the credit institution, it ranks after all other claims but excluding cumulative preferential shares;</p>
Justification	
<p><u>Identification of loss absorbency capability</u></p> <p>The addition of these extra words in relation to loss absorbency means they need to be interpreted which could lead to inconsistency. As Art. 22 refers to the most junior form of capital possible this loss absorption capacity is not in doubt.</p>	
<p><u>Only the most junior instruments count</u></p> <p>Any Article 22 instrument that has preference over dividend payments should not qualify as core capital – a key feature of which is the ability to share in a firm’s losses.</p>	
<p><u>Convertible instruments</u></p> <p>As the CRD definition follows the accounting definition an instrument such as an such as a mandatory convertible which settles into common shares would not qualify as capital.</p> <p>As long as the number of common shares to be delivered is not fixed but subject to a future outcome the accounting standard requires such an instrument to be booked as a liability (IFRS 32 / Paragraph 21-24). The liability will be booked out against equity when the settlement with common shares of the mandatory convertible occurs. (Typically these instruments have maturities between 3 to 5 years). Despite that the funds paid in by the</p>	

investor are of a permanent quality and cannot be used differently than to pay up the nominal value of common shares and increase the share premium account such an instrument does not fulfil the definition and would be disregarded as capital as it also does not fulfil the maturity conditions of the other instruments mentioned in Articles 63 .

Therefore, we suggest that the Commission consider alternative formulations to the above wording. One alternative that would be worthy of wider exposure would be:

a) capital within the meaning of Article 22 of Directive 86/635/EEC, in so **far as it has been paid up or funds have been received to pay up**, plus the related share premium accounts, it fully absorbs losses in going concern situations in the event of the bankruptcy or liquidation of the credit institution it ranks after all other creditors claims and it includes non-cumulative preferential shares but excludes cumulative preferential shares.

Article 63, point (a)

(a) The instrument shall be undated for have a maturity of at least [30] years]. It may include a call option at the sole discretion of the issuer, but it shall not be redeemed before five years after the issue date.

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 issue 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 affected. The competent authorities may require institutions to replace the instrument by items referred to in points (a) or items of the same or better quality referred to in point (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].

The competent authority may grant permission for an early redemption of dated and undated instruments in the event that

(a) The instrument shall be undated or have a maturity of at least 30 years. It may include a call options at the sole discretion of the issuer, but it shall not be redeemed before five years after the issue date.

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 issue date.

~~[Dated and undated]~~ Instruments may be called or redeemed only with the prior ~~approval~~ ~~consent~~ of the competent authorities. The competent authorities may grant permission provided the request is made at the initiative of the credit institution. ~~Where the instrument is wholly owned or issued by a subsidiary of the credit institution such permission may not unreasonably be withheld, and either financial or solvency conditions of the credit institution are not affected. The competent authorities may require institutions to replace the instrument by items referred to in points (a) or items of the same or better quality referred to in point (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].

there is a change in national tax treatment or regulatory classification which was unforeseen at the issuance date."

The competent authority may grant permission for an early redemption of ~~dated and undated~~ instruments at any time, including prior to the fifth anniversary of the issue date, in the event that there is a change in national applicable tax or accounting treatment or rating or regulatory classification or other adverse external development, which was unforeseen at the issuance date."

Justification

Minimum maturity

A 30 year minimum maturity mirrors US and rating agency requirements which are well understood by investors whilst being of a sufficiently long term.

Requiring an instrument to be undated would ensure that there is no doubt about the permanent nature of a hybrid instrument but 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.

So dated going concern capital would be a very beneficial development that would assist firms in managing their capital requirement,

Dated capital with a lock-in would enable our members to fine tune their available capital more closely to their capital requirements which is likely to become more volatile under Basel II.

This would contribute to the optimisation of their cost of capital as we expect that dated instruments would attract a different type of investor, which may have pricing benefits.

Call options

The opportunity for call options should not be limited to one time only.

Only undated instruments to have a step-up

The proposed requirement that the instrument containing a step up must be undated is super-equivalent to the Sydney Press release and removes flexibility.

Approval or consent

We prefer the word approval, rather than consent as we believe acceptance of a firm's capital plan as part of the Pillar 2 process is sufficient –seeking of consent after the presentation of the capital plan has been reviewed as part of the SREP is not necessary and will duplicate regulatory and firm effort unnecessarily.

Intra-group instruments

Other than in exceptional circumstance the competent authority should automatically approve the redemption of intra-group instruments.

Reference to financial and solvency conditions

A redemption will always have an impact on financial & solvency conditions of the institution. Financial & solvency conditions are not defined so these terms should be deleted.

Dated instruments but subject to lock-in

We welcome the ability to issue dated instruments and recognise that the quid pro quo for this is that regulators may suspend redemption at the initial maturity date if capital requirements are unlikely to be met as a result.

Replacement with same or better quality capital

The prior regulatory approval that is referred to at the start of this sub paragraph could be made conditional on replacement. So this sentence is superfluous.

National or applicable tax law?

The tax law that is relevant is the one applicable to the instrument, not the national law of the competent authority – our proposed wording is clearer.

Article 63a, point (b)

(b) The statutory or contractual provisions governing the instrument shall allow the credit institution to cancel, when necessary, the payment of interest and dividends for an unlimited period of time, on a non-cumulative basis. Notwithstanding the above, the credit institution shall be obliged to 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. 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 Article 57 point (a), provided that any such mechanism allows the credit institution to preserve financial resources. Such substitution may be subject to specific conditions required by the competent authorities.

(b) The statutory or contractual provisions governing the instrument shall allow the credit institution ~~to cancel~~, when necessary, ~~to waive or defer~~ the payment ~~in cash~~ of interest ~~and or~~ dividends for an unlimited period of time, on a non-cumulative basis. Notwithstanding the above, the credit institution shall be obliged to ~~cancel~~ waive such payments if it does not comply with the capital requirements set out in Article 75. The competent authorities may require the waiver ~~cancellation~~ of such payments based on the financial and solvency situation of the credit institution. Such waiver ~~cancellation~~ shall not prejudice the right of the credit institution to substitute the payment in cash of interest or dividend by a payment using the proceeds of the sale of an ~~in the form of an~~ instrument referred to in ~~Article 57 point (a)~~ Article 22 of Directive 86/635/EEC, provided that any such mechanism allows the credit institution to preserve financial resources. Such substitution may be subject to specific conditions required by the competent authorities.

Justification

Cancellation

Use of the word 'cancel' may cause tax problems in some jurisdictions. We prefer the use of

the words 'waive' as used in the Sydney Press Release.

Payments in cash

Payments in cash should be prevented. Payments in other forms, including raising cash through the issue of some form of Tier one capital: (not only strictly defined common shares) that are sold in the market, should be permitted.

Article 63a, point (c)

(c) The statutory or contractual provisions governing the instrument shall provide for principal, unpaid interest and dividend to be such as to absorb losses and to not hinder the recapitalisation of the credit institution.

(c) The statutory or contractual provisions governing the instrument shall provide for principal, unpaid interest ~~and or~~ dividend to be such as to absorb losses ~~and to not hinder the recapitalisation of the credit institution.~~

Justification

Hindering recapitalisation

Experience suggests that hybrids do not hamper recapitalisation but the inclusion of this wording would require the production of a legal opinion, which would be virtually impossible to draft. Whether or not an instrument will 'hinder recapitalisation' may be impossible to assess at the issue date and will depend on the facts at the time such recapitalisation is required.

We believe that Tier 1 capital other than equity is also loss absorbing on an ongoing basis 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 upon conversion, thus reducing the total amount of Tier 1 capital

We strongly oppose the incorporation of mandatory write-down features as previously proposed by CEBS.

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.

So we are pleased to see that the Commission has not proposed requiring such a feature. Nor should CEBS if requested by the Commission to provide further guidance on the topic of hybrid capital.

Article 66, paragraph 1a (a)

1a. Without prejudice to the first paragraph, the total of the items in point (ca) of Article 57 shall be subject to the following limits:

(a) Instruments that will be converted during emergency situations into a pre-determined fixed number of items referred to in point (a) of Article 57 shall not exceed a maximum of 50% of the items in points (a) to (ca) minus (i) to (k) of Article 57;

1a. Without prejudice to the first paragraph, the total of the items in point (ca) of Article 57 shall be subject to the following limits:

(a) Instruments that will be converted during emergency situations into a pre-determined ~~fixed number~~ within a fixed price range of items referred to in Art 57 and other items referred to in Art 22 of Directive 86/635/EEC but excluding cumulative preferential shares ~~point (a) of Article 57~~ shall not exceed a maximum of 50% of the items in points (a) to (ca) minus (i) to (k) of Article 57;

Justification

Emergency situations?

'Emergency' we assume by emergency the Commission is contemplating not just systemic problems but also idiosyncratic circumstance impacting a specific firm.

Range or fixed number?

We think a pre determined price range for the shares provides more flexibility.

Substitution of article 22 of Directive 86/635/EEC

The Article 22 wording is more specific

Article 66, paragraph 1a (c)

(c) Within the limit referred to in points (a) and (b) above, 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) to (k) of Article 57.

(c) Within the limit referred to in points (a) and (b) above, ~~dated instruments and the~~ any instruments, 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) to (k) of Article 57

Justification

Dated instruments should not be included in the 15%

The SPR 15% just refers to step-ups –dated instruments are not included.

Article 66, paragraph 4

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

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

Justification

Emergency situations?

'Emergency' : we assume by emergency the Commission is contemplating not just systemic problems but also idiosyncratic circumstances impacting a specific firm.

Article 154, paragraph 9

9. Instruments that, as of [the date of entry into force], according to national law were deemed equivalent to the items referred to in points (a) to (c) of Article 57 but do not fall within point (a) of Article 57 or do not comply with the criteria set out in Article 63a, shall be deemed to fall within point (ca) of Article 57 until [the date of entry into force+30years], if they do not represent an amount higher than:

9. Instruments that, ~~as of~~ before [the date of entry into force], according to national law were deemed equivalent to the items referred to in points (a) to (c) of Article 57 but do not fall within point (a) of Article 57 or do not comply with the criteria set out in Article 63a, shall be deemed to fall within point (ca) of Article 57 until ~~the date of entry into force~~ plus 30years, if they do not represent an amount higher than:

Justification

'As of' or 'before'

We suggest the words 'as of' are replaced by 'before'. The use of the words 'as of' imply that compliance could be achieved by back dating, which we do not believe is the Commission's intention.

Technical criteria on disclosure

Annex XII, part 2, point 3 (a)

(a) summary information on the terms and conditions of the main features of all own funds items and components thereof, including instruments referred to in point (ca) of Article 57, instruments the statutory or contractual provisions of which provide an incentive for the credit institution to redeem them, and instruments subject to Article 154 paragraphs (8);

(a) summary information on the terms and conditions of the main features of all own funds items and components thereof, including instruments referred to in point (ca) of Article 57, instruments the statutory or contractual provisions of which provide an incentive for the credit institution to redeem them, and instruments subject to Article 154 paragraphs (8);

Justification

Instruments or measures?

Article 154 paragraph 8 refers to measures to rectify lack of compliance with Article 66 paragraph 1a, not to 'instruments'. This seems to be a drafting error.

Technical criteria on disclosure

Annex XII, part 2, point 3 (b)

(b) the amount of the original own funds, with separate disclosure of all positive items and deductions. The overall amount of instruments referred to in point (ca) of Article 57 and instruments the statutory or contractual provisions of which provide an incentive for the credit institution to redeem them, shall also be disclosed separately. These disclosures shall each specify instruments subject to Article 154 paragraphs (8);"

(b) the amount of the original own funds, with separate disclosure of all positive items and deductions. The overall amount of instruments referred to in point (ca) of Article 57 and instruments the statutory or contractual provisions of which provide an incentive for the credit institution to redeem them, shall also be disclosed separately. These disclosures shall each specify instruments subject to Article 154 paragraphs (8);"

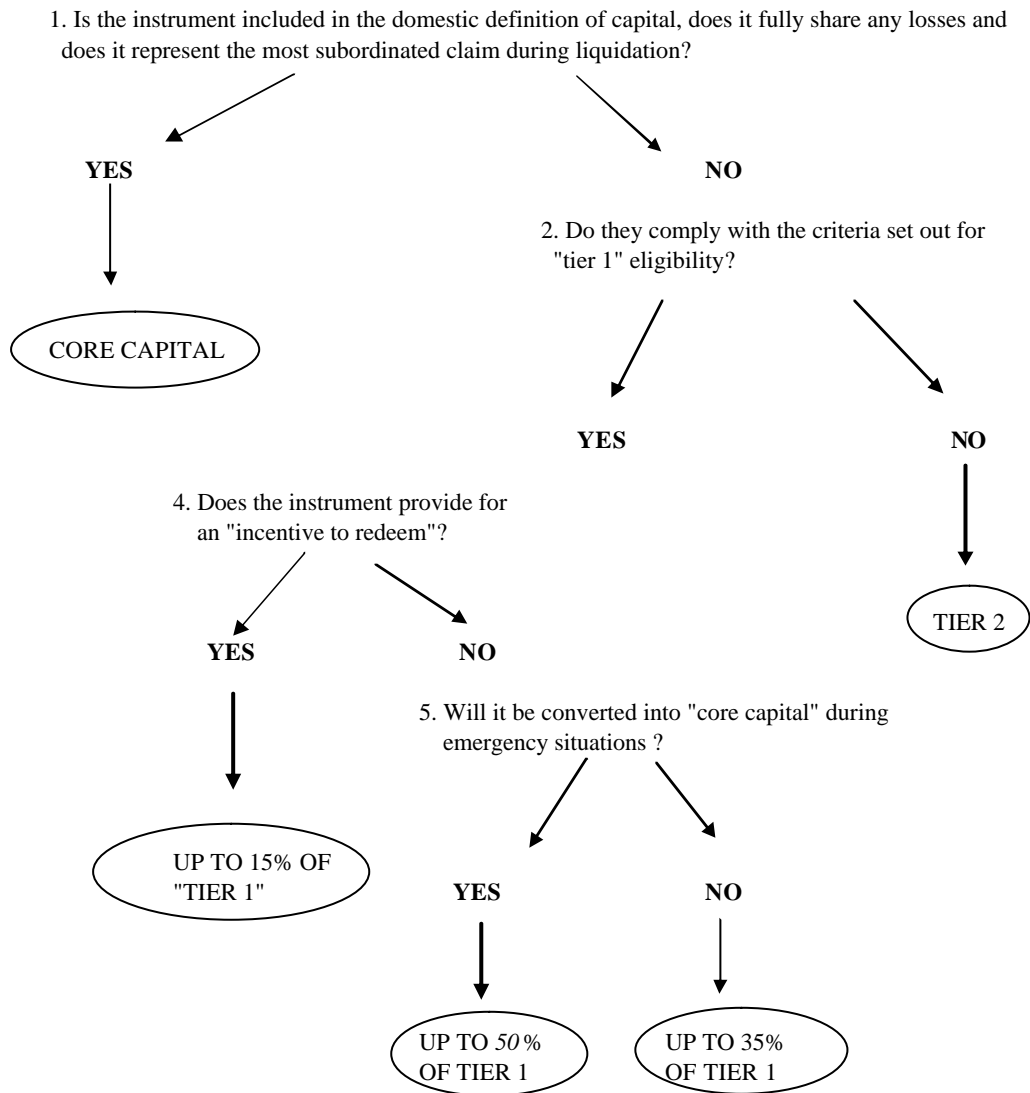
Justification

Instruments or measures?

Article 154 paragraph 8 refers to measures to rectify lack of compliance with Article 66 paragraph 1a, not to 'instruments'. This seems to be a drafting error.

The following chart depicts the assessment process by which an instrument may be assessed to determine its eligibility as well as to establish the quantitative limits to its recognition as Tier 1 capital.

DECISION CHART



Do stakeholders agree with:

(i) the Commission services' suggested eligibility criteria and the principle-based approach suggested above?

Yes

(ii) the recognition of dated instruments - with a predetermined minimum original maturity - in firms' original own funds?

Yes.

We believe a minimum original maturity of 30 years is suitable and helpfully provides firms with the greater funding flexibility they will require in the Basel II environment.

(iii) the quantitative limits suggested? In this respect, the Commission services are also interested in views whether an additional limit would be useful to improve even further the quality of capital e.g. by requiring firms' core capital (equity, reserves and retained earnings) to be higher than a pre-determined proportion (e.g. 50%) of minimum capital requirements?

No.

There is no justification for requiring core capital to be higher than a predetermined proportion of minimum capital requirements. We are concerned that such changes will have significant unintended consequences on the composition of firms' capital. Requiring a certain proportion of capital to be covered by Tier 1 is inconsistent with the Tier 2 and Tier 3 limits that exist currently in the CRD. Such changes will disqualify very significant amounts of Tier 2 and Tier 3 capital that are currently used to meet market risk and large exposure requirements.