International
Capital
Market
Association

ICMA

European Banking Authority
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3 July 2012

Dear Sirs

REFERENCE EBA/CP/2012/02
European Banking Authority ("EBA") Consultation Paper on Draft Regulatory Technical Standards ("RTS") on Own Funds - Part One

The ICMA[1] is a pan-European self regulatory organisation and an influential voice for the global capital market. It has a membership of over 400 firms and represents a broad range of capital market interests, including global investment banks and smaller regional banks, as well as asset managers, exchanges and other venues, central banks, law firms and other professional advisers. The ICMA's market conventions and standards have been the pillar of the international debt market for over 40 years.

The ICMA notes that the EBA has developed the draft RTS in accordance with the mandate contained in the different articles of the CRR on the basis of the European Commission's proposals. The ICMA also notes that this consultation includes a wide range of measures to ensure a single rule book for institutions in the area of own funds, which require, among others, a specification of the characteristics of the instruments that could affect the condition of an institution in periods of market stress, and the limitations that the institution should be able to apply to the operation of these instruments to restore the capital structure of the institution. Whilst many of the important proposals are of significant interest, this response nevertheless focuses on just one specific aspect - namely Articles 20 and 21 and questions 12 and 13 - Conversion or write-down of the principal amount.

This response has been compiled in light of a range of inputs provided by those directly involved in the issuance of non-equity capital instruments on behalf of ICMA member firms. The ICMA considers that this provides a well informed, broadly based view of the proposals from the relevant perspective and consequently, respectfully requests that the EBA gives careful consideration to the points that this response raises. This response sets out a consolidated response to each of the specific questions relating to Conversion or write-down of the principal amount.

[1] For more information regarding ICMA, please go to www.icmagroup.org

Question 12 - Are the provisions on the procedures and timing surrounding a trigger event and the nature of the write-down sufficiently clear? Are there issues which need to be elaborated further?
Question 13 - How would you assess the impact of the provisions to be applied to temporary write-downs and write-ups?

General remarks
As a general point, because of the cap on the return of additional tier 1, it will always be a fixed income product (albeit with equity-like characteristics) and, as such, equity holders should not be relied upon to support it. These fixed income investors also invest in the senior debt and all other fixed income structured products of a bank and as such are vital to the liquidity position of the bank. In this vein, there needs to be a balance drawn between regulatory requirements for a capital conservation instrument on the one hand, and an ability to make the instrument attractive to fixed income investors without them being subordinated to common equity holders (and, as a result, reversing the capital hierarchy) on the other.

The prohibition on distributions on a temporary write-down, together with the fact that distributions may still be paid on common equity and additional tier 1 instruments with a permanent write-down, the restriction on write-up to current year profits and the proportionally lower rate of write-up, all as explored in more detail below, may be a more challenging proposition to fixed income investors on whom the banks rely to invest in these instruments; it may have the effect of driving them to invest in less prohibitive products with profiles which are not so degenerative in absolute terms on the occurrence of a certain event, which in turn would reduce the issuance capacity for additional tier 1 instruments.

The ICMA however agrees with the general approach of the RTS i.e. after an institution has written-down additional tier 1 and subsequently enters the recovery phase, and the prevailing situation allows it in line with the capital restoration plan, there should be a priority on write-up of additional tier 1. This approach benefits shareholders and other investors due to the fact that the 1.5% additional tier 1 layer, within the minimum capital ratios defined by CRR/CRD IV, either needs to be filled by additional tier 1 or, if not possible, by Common Equity Tier 1 ("**CET1**"). In other words, if the write-up is not prioritised and the additional tier 1 layer is not fully utilised, a greater burden is put on ordinary shareholders as the institution is required to issue more CET1 in excess of the CET1 minimum requirements, which would result firstly in a higher dilution of existing or new shareholders and secondly in possible restrictions on dividends due to the combined capital buffer not being met, thereby leading to hindrance of recapitalisation.

Distributions
During a temporary write-down, distributions are no longer payable on the principal amount until the nominal amount of the instrument is fully reinstated. Payments on additional Tier 1 with permanent write-down may be resumed immediately when the situation of the institution allows for this, and while holders thereof will have given up permanently the written-down portion, in practice, this risk of permanent write-down will be compensated by a higher coupon (i.e. cost for the institution) at issuance. Conversely, holders of additional tier 1 instruments subject to a temporary write-down will see a reduction in the market value of the instruments, which will not only reflect coupon cancellation, but will also reflect the market's view on the likelihood of further loss absorption through breach of the 5.125% CET1 trigger.

Notwithstanding this, the prohibition on distributions on a temporary write-down makes it potentially very unfair vis-a-vis permanent write down, where payments can still be made on the reduced amount *not* subject to the permanent write-down. In addition, with the rationale of the write-down being to boost core equity levels, common equity is not written down once the trigger level is reached, which makes the holders of additional tier 1 capital more subordinated than common equity holders who are still capable of being paid distributions - so while they may suffer the downside, they will also benefit from the upside in a way that additional tier 1 holders may not, thereby reversing the capital hierarchy. Ideally, common equity holders should suffer the first loss when a bank reaches the trigger point.

However, in order to ensure a level playing field in terms of suffering loss, distributions should not be payable on common equity or additional tier 1 capital in either a temporary or a permanent write-down situation. Alternatively, it would be more palatable to investors if a prohibition on payment of distributions were to apply equally to the nominal amount of instruments subject to a temporary write-down (in the same way as to instruments subject to a permanent write-down) so that distributions could still be made on the reduced amount *not* subject to the write-down in each case (although this still means that holders of the instruments would still be more subordinated than common equity holders). Holders of additional tier 1 instruments subject to a temporary write-down should in general also be in a position to receive distributions on the written-down amount once the situation of the institution allows it, without having to wait for the principal amount being written-up in full before distributions may be resumed.

Write-ups

In the case of a temporary write-down, write-ups shall be based on (current year) profits after the institution has taken a formal decision confirming the final profits. This causes problems on several accounts, not least tax deductibility for the issuer (as to which, see below). The ICMA considers that, once the situation of the institution allows it, the ability to write-up should not always necessarily be limited to current year profits (for instance, where a write-down has been due to a spike in risk weighted assets rather than in losses, which has been mitigated such that the CET1 ratio has exceeded 5.125% again) and should allow for maximum flexibility for the issuer to use all funds (including reserves) to write the instrument up again. Rather than limiting a write-up to current year profits, the benchmark used for the trigger for write-down - Common Equity Tier 1 ratio - should also be used as the trigger for writing the instrument back up again. Article 131 of CRD IV provides that there is no restriction on distributions as long as such distributions (e.g. dividends on shares and payments on additional tier 1 instruments) do not lead to a breach of the combined capital buffer. Equally, in the recovery phase, there should be no restriction on the write-up on an instrument which has been, and remains, written-down. As a capital conservation issue, banks should have full discretion not only to write-up an instrument, but also to manage their own capital, which includes granting them the maximum flexibility for payments of distributions on a temporary write-down in order to satisfy their fixed income investors and allow their positions to recover, provided that in all circumstances the requirements of Article 131 (2) CRD IV are not infringed.

The ICMA would suggest that the maximum amount to be attributed to the write-up of the instrument should be based on the higher of (i) the profit multiplied by the sum of the nominal of all Additional Tier 1 instruments before write-down that have been subject to a write-down divided by the total Tier 1 capital of the institution and (ii) the contractual interest amount of all Additional Tier 1 instruments subject to a write-down based on the reduced amount of the principal.

Rate of write-up

Currently, there is an imbalance in the rates at which a write-up can take place, as compared to the rate at which the write-down takes place (which is immediately, with no payments of distributions on any amount which has *not* been temporarily written down). A typical additional tier 1 investor would expect to be written-up at the same rate as it was written-down, but with profits only being allocated to the write-up in the same proportion as the original percentage of additional tier 1 in the capital structure, it would take a disproportionately long time for an investor to be "fully" written-up again. Meanwhile, common equity holders are receiving proportionately more of the current year profit as a distribution (which has not been suspended) which again makes the additional tier 1 holders more subordinated to common equity holders.

Without a more accelerated rate of write-up, an investor's perception of the bank may become negative, which may exacerbate a given situation. On the other hand, maximum flexibility within the actions of authorities balanced with the interests of the banks and investors when dealing with any potential write-down and subsequent write-ups will prevent overly negative perceptions by the market. The ICMA does not consider that by allowing write-ups to be based other than on current year profits, the recapitalisation of the bank would be hindered. However, if possible hindrance of recapitalisation of the bank is a concern, it could be addressed by other means, which are outside of the scope of this response.

The ICMA understands that in a situation where the combined capital buffers have been met due to a capital increase by issuing CET1 instruments (i.e. shares for joint stock companies), an immediately following write-up is not appropriate as it could disadvantage new shareholders. In this case, the institution would be expected to apply normal commercial considerations to the appropriate (discretionary) balance between the additional tier 1 write-up and the retention of earnings. This write-up also could be subject to approval by the competent authority given the fact that the institution has already breached the combined capital buffer.

Point of non-viability

As regards the point of non-viability as an additional trigger for the operation of a write-down, the ICMA appreciates that this remains outside of the scope of this consultation. However, the operation of any potential point of non-viability trigger and its interaction with the write-down trigger is nonetheless of vital importance to banks and their investors from the point of view of the pricing of risk. ICMA would therefore suggest that for clarity, the issue is dealt with under the transitional provisions of the RTS to the effect that that if an institution is in all other respects in compliance with the relevant articles on additional tier 1, in the absence of any language relating to the point of non-viability the instrument will still be treated as own funds until such time as point of non-viability language is required under CRD.

Tax treatment

An additional point on which the ICMA would be grateful for clarification is the position as regards to the tax treatment of a loss on the write-down. When the write-down occurs, it would generate a loss on additional tier 1 and a profit which would go through the bank's profit and loss account into retained earnings. This would then give rise to a tax charge on capital gains. For the purposes of determining core capital, the additional tier 1 instrument is a capital conservation instrument which from a prudential point of view when determining core capital, would not be compatible with having a tax charge deducted from it. The ICMA therefore considers that the core capital calculations should not have foreseeable tax charges (such as the above-mentioned scenario would give rise to) deducted in order to maximise the amount of the buffer. The converse notion - that for determining core capital, any such tax should be deducted - could give rise to a double-dip taxation situation, and the payments of such tax which should be applied to core capital would erode the buffer.

Concluding remarks

The ICMA appreciates the valuable contribution made by the EBA's examination of the issues articulated in this response paper and would like to thank the EBA for its careful consideration of the points made herein. The ICMA remains at your disposal to discuss any of the above points.

Yours sincerely

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