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Changes of Own Funds Requirements under the Capital Requirements Directive – Hybrid Instruments

Mathias Hanten

GLOBAL FINANCIAL MARKETS

University Jena
Carl-Zeiss-Str. 3
D-07743 Jena

University Halle
Universitätsplatz 5
D-06099 Halle

Tel.: +49 3641 942261
+49 345 5523180

E-Mail: info@gfinm.de
www.gfinm.de

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A. Context of the Amendments of the Directive 2006/48/EC

Transforming Basel II into European law, the European law maker did not amend the provisions on capital requirements. However, Art. 62 of the Directive 2006/48/EC stated that the Commission should submit a proposal with regard to a common definition of capital and in a way formed a work assignment for the Commission.

The Directive 2006/48/EC distinguished Original Own Funds on the one hand side and additional own funds on the other hand side. The definition of Original Own Funds in Art. Art. 57 of the Directive 2006/48/EC mainly referred to definitions set out in Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and referred to certain positions of the liability side of annual account. Artt. 57 and 63 of the Directive 2006/48/EC defined so – called Tier 1 and Tier 2 capital. This differentiation mirrored the quality of capital with regard to absorption of losses and subordination to other debt.

One of the open issues was the question, which scope of hybrid instruments should be eligible for inclusion in Tier 1 capital or, to use the technical term of the Directive 2006/48/EC, in "Original Own Funds". The term "Hybrids" covers to a wide range of capital instruments that combine features of debt and those of equity but are neither common stock nor equity.

The background of the still existing diverse attitudes towards Hybrids was a European multi – level landscape of hybrid capital instruments, which is based on remarkable differences in corporate law, tax law and accounting standard approaches and last but not least local regulatory aspects[1].

The hybrid instruments must, in order to fulfil their purposes, meet on the one hand side local corporate law requirements to serve as equity but should on the other hand side be treated as debt in order to enable a deduction of the financing costs for tax purposes. Thirdly, the treatment as equity or debt for purposes of the accounting standards was extremely different.

B. Procedure and Discussion

The Directive 2006/48/EC as of 30 June 2006 inter alia provided for the regulatory capital requirements for EU Credit Institutions in the scope of the Directive, without addressing

[1] CEBS, Annex III _ Draft proposals on Hybrids: Table of the limits to the inclusion of Hybrids in original own funds as disclosed in the June report 2007.

the hybrid capital issues directly. Meeting the above mentioned requirement to submit the proposal, the Commission published a proposal which was, all issues considered, adopted by the European Parliament on 6 May 2009.

The Basel Committee however, had already issued a press release in 1998 (Sydney Press Release - SRP)[2], which introduced the requirements hybrid capital instruments should meet in order to qualify as Tier 1 capital. In other words: It took more than 10 years to amend the European regulatory framework for Hybrids. The requirements the Basel Committee set up in 1998 and which have been implemented to a large extent into the legislative resolution can be summarised as follows:

- Issued and fully paid in
- Non – cumulative
- Able to absorb losses on a going concern basis
- Subordinated to other debt and pari passu with other equity
- Permanent
- No issuer's enhancements
- Redeemable only after a minimum period with the regulator's approval

End of 2007 CEBS issued a proposal for a joint EU definition of hybrid capital. In October 2008 the Commission issued a CRD proposal which has slightly been changed and adopted in Parliament as of 6 May 2009.

In a nutshell: The present legislative resolution as of 6 May 2009 covered an omnium - gatherum of items which had be dealt with prior to the parliament elections on 7 June.

The amendments of the Directive 2006/48/EC and 2006/49/EC dealt with questions of Large Exposures, allotment of home and host regulator's competencies, crisis management arrangements, derogations for bank networks from certain prudential requirements, life insurance as eligible collateral, treatment of Collective Investment Undertakings under IRB and capital requirements and risk management for securitization positions. Last but not least the amendments covered the hybrid capital instruments.

The Commission is of the opinion[3] that a common regulatory framework would address the shortcomings of the current situation by facilitating convergence between Member States and sectors, thus contributing to a more level playing field within the single market. Further, clear European regulation should improve the quality of capital from an industry and supervisory perspective while providing more choice and liquidity to investors.

Systematically, in order to extent the definition of hybrid original own

[2] www.bis.org/press/p981027.htm

[3] Impact Assessment as of 1 October 2008, SEC (2008) 2532, p. 25 et seq.

funds, the amendment inserted lit. ca) to Art. 57 of the Directive 2006/48/EC, which refers to Art. 63 par. 2 to 5 of the same Directive defining the non-hybrid original own funds and to the newly inserted Art. 63a, which defines the requirements of Hybrids.

C. Features of Hybrids

The features of such instruments can be summarised as follows

- Duration of the Instrument
- Flexibility of Payment Obligations
- Absorption of Losses

I. Duration of the Instrument

In Detail, the instruments shall either be undated or have an original maturity of 30 years. The undated instruments may include call options at the sole discretion of the issuer but shall not be redeemed before five years after the date of issue. In case the undated instrument provides for an incentive to redeem, as e.g., interest step – up, such incentives must not occur ten years after the date of issue. The dated instruments must not include any incentive to redeem other then the maturity date.

All redemptions are subject to the competent regulator's consent which may be granted provided the Credit Institution applies for the approval and the solvency and financial conditions of the applying credit institution are not unduly affected. However, the regulator may require the institution to replace the instruments by items of the same or better quality. Further, the competent regulator shall stop the redemption for the dated instruments if the credit institution does not comply with the capital requirements laid down in Art. 75 of the Directive (Minimum Limit of Own Funds) and at other times based on the financial and solvency situation of credit institutions. It is interesting to see that the Directive does elaborate on the preconditions of such regulators' orders.

Additionally the regulator may grant permission at any time for an early redemption, either for undated or dated 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.

The differentiation regarding undated and dated instruments with incentives to redeem are based on the Basel Committee definitions of innovative and non-innovative instruments as set out in the SPR.

It will be interesting to see under national law, if the investor will be entitled to apply for redemption to the regulator. With regard to the "subject to tax clause" the term "tax treatment of such instrument" is unclear. It should be considered whether general changes in the tax landscape as e.g. thin – capitalisation rules, which do not relate to the specific instrument may trigger the clause. Further it is interesting to

analyse as to whether or not the payment on hybrid instruments, which are eligible for Original Own Funds fit in the definition of 'Interest', e.g. in Art. 11 of the OECD Model Convention with Respect to Taxes on Income and on Capital.[4]

II. Flexibility of Payment Obligations
Pursuant to Art. 63a par. 3, the provisions governing the instruments shall allow the credit institutions to cancel, whenever necessary, the payment of interest and dividends for an unlimited time on a non-cumulative basis. The credit institution must cancel the payments in case it does not comply with the capital requirements set out in Art. 75 of the Directive 2006/48/EC, which is 8 % of the total of the risk – weighted exposure amounts.

However, the cancellation shall not prejudice the right of the credit institution to substitute the payment of interest or dividend by issuing instruments in the scope of Art. 22 of the Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions - Item 9 Subscribed Capital - provided that such mechanisms allow the credit institution to preserve financial resources. These instruments may provide for preferential rights for dividend payments on a non-cumulative basis (ACSM) and are a tax requirement in certain Member States; the substitution may be subject to specific conditions established by the competent national authorities but must provide for absorbing losses and must not hinder recapitalisation. For details, of transposition the Parliament's legislative resolution refers to CEBS' guidelines for the convergence of supervisory practises with regard to these instruments.

At the moment CEBS takes the view that the issuance of ACSM requires the credit full discretion of the credit institution to pay out dividends, the equivalent of the payment must be based on newly issued shares and the newly issued share must be delivered directly to the investor.

In all other cases, the credit institution does not need full discretion to cancel the payment of dividend or interest but the statutory or contractual provisions of the instrument shall allow the credit institution to cancel the payment whenever necessary. However, the competent authorities may require cancellation of such payments based on the solvency and financial situations.

A number of national law makers have introduced legal measure to enable the regulator to prohibit payments to the investors in order to stabilise the equity situation of credit institutions in distress.

III. Absorption of Losses
The absorption of losses is the central requirement Hybrids have to meet to serve as original own funds. Art. 63a

[4] http://www.oecd.org

par. 4 of the legislative resolution requires that the statutory or contractual provisions governing the hybrid instrument shall provide for principal, unpaid interest or dividend to be such to absorb losses and not to hinder the recapitalisation of the credit institution. Art. 63a par. 5 sets forth that the Hybrids must, in the event of bankruptcy or liquidation rank after the items referred to in Art. 63 par. 2 of the Directive 2006/48/EC which implies other own funds in the sense of Tier 2 capital.

The absorption of losses going concern requires that the Hybrids contribute to the avoidance of insolvency and must not hinder recapitalisation. Though the legislative resolution does not actually describe the features, which have to be set to meet this requirement, share conversion and principal write – down are obvious potential mechanisms, which must not be hindered.[5] However, the requirements for the absorption of losses in case of going concern must be further detailed by CEBS to ensure a convergence of regulations throughout the Member States. The cancellation of payment of interest and dividend will certainly not suffice.

In the case of insolvency it is still not entirely clear up to which degree the hybrid must rank after other liabilities. Recital 3 of the legislative resolution makes clear that instruments, which do not rank pari passu with ordinary shares during liquidation or which do not absorb losses on a going concern basis pari passu with ordinary shares are still included in the category of Hybrids. This element – no requirement of pari passu with ordinary shares – saved the existence of a number of most relevant hybrid instruments, as e.g. silent participations.

IV. Tier 2 as Last Resort

In case the requirements of Art. 63 of the legislative resolution are not met, the Hybrids can still be considered as other own funds in the scope of Art. 63 par. 2 lit. a) and c) to e) if the instruments may not be reimbursed on the bearer's initiative or without the prior agreement of the competent authority (lit. a)), the lender's claims are fully subordinated to those of all non-subordinated creditors (lit. c)), absorb losses in the case of going concern (lit. d)) and are only to be taken into account in the amount of fully subscribed (lit. e)).

D. Limits

Art. 66 regulates the limits and totals of the different kinds of own funds. The relations of original own funds and other own funds (100%/50%) will be kept. The referential figure of original own funds will be enlarged by the newly accepted Hybrids. For the innovative instruments, i.e., carrying an incentive to redemption, the limit of 15% of the original own funds shall apply as already set out in the Basel Sydney Press Release as of 1998. Further, instruments, which

[5] cf. Sinclair/Crisostomo, Capital Market Law Journal 2008, 458, passim.

must be converted during emergency situations or may be converted at the initiative of the regulator into capital in the meaning of Art. 22 of the Directive 86/635/EEC (paid-in capital) shall in total not exceed a maximum of 50% of the original own funds. All other hybrid instruments shall not exceed 35 % of the mentioned assessment basis.

E. Grandfathering Rules

Those Hybrids, which do not meet the requirements set forth in the legislative resolution are subject to certain – quite generous - grandfathering rules. 10 years after 31 December 2010 the amount of Hybrids which do not comply with the new standards shall not exceed 20% of the amount of original own funds. 20 years after 31 December 2010 those Hybrids shall not exceed 10 % of the latter limit. 30 years after 31 December 2010 the non – eligible Hybrids shall either be paid back or shall not be eligible as original own funds any more. In respect to these grandfathering rules, concern with regard to present stabilisation measures under the different Financial Markets Stabilisation measures[6] are without cause. Those stabilisation measures – under aspects of admissible state aid come to an end prior to the phase-out of the grandfathering rules[7].

F. Disclosure Requirements

Annex XII of the Directive 2006/48/EC will be amended by additional disclosure requirements which imply a summary information on the terms and conditions of the main features of all own fund items and components thereof including the hybrid instruments and those instruments which provide for an incentive for the credit institution to redeem the instruments and the instruments subject to grandfathering rules. Further the amendment requires the disclosure of the amount of original own funds with disclosure of all positive items and deductions including the amount of hybrid instruments and the amounts subject to grandfathering rules.

Mathias Hanten is a lawyer and partner of DLA Piper UK LLP, admitted to the Frankfurt bar. He has dealt with a wide range of regulatory issues in banking, investment management and capital markets.
From the beginning of his career, he has focused on regulatory licenses in all financial services industries, outsourcing agreements, portfolio management contracts and deposit protection issues. Further, he advised in regulatory issues of cross-border M & A and restructuring transactions.
From time to time, he acts in contentious cases vs. public institutions in the financial markets sectors as e.g. the German Investor Compensation Scheme (EdW) in the Phoenix case.
Besides the core regulatory and legal work, Mathias Hanten served as board member in various non-profit institutions in the position of a CFO, advises in the private banking area, e.g., family offices and serves as member of the Supervisory Board of a non-listed AG, which

[6] E.g. Nodoushani, ZBB 2009, 110, 113

[7] Cf. http://ec.europa.eu/competition/state_aid/legislation/specific_rules.html.

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On the academic front, he teaches banking law at the University of Applied Sciences Trier and frequently gives speeches on regulatory and legal topics. His publication list contains a wide range of articles and commentaries on the mentioned issues.
Prior to working as a lawyer in private practise, Mathias Hanten held the position of a Senior Manager in one of the Big Four audit firms in the Tax and Legal Department and as an in-house legal counsel with an American investment bank. He studied law in Freiburg, Bonn, Cologne and St. Gallen and received his PhD from Freiburg University and his Master's degree from the University of St. Gallen. Prior to taking up university studies, Mathias Hanten went through a banking apprenticeship with a German commercial bank.