DE NEDERLANDSCHE BANK N.V.

Supervisory Regulation on the Recognition of Hybrid Instruments as Regulatory Capital Components

Regulation of De Nederlandsche Bank N.V. of 11 December 2007, no. Juza/2007/00450/CLR, providing for the conditions under which hybrid instruments may be recognised as regulatory capital components as referred to in Articles 90 to 98 of the Decree on Prudential Rules for Financial Undertakings (Besluit prudentiële regels Wft) *and for the repeal of the Supervisory Regulation on Innovative Financial Instruments and Intangible Assets* (Regeling innovatieve financiële instrumenten en immateriële activa) (*Supervisory Regulation on the Recognition of Hybrid Instruments as Regulatory Capital Components*)

De Nederlandsche Bank N.V.;
Having consulted the representative organisations pursuant to section 1:28 of the Financial Supervision Act (*Wet op het financieel toezicht*);
Having regard to Article 89(2), under (a), of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*);

DECIDES:

Chapter 1 Definitions

Article 1:1

For the purposes of this Regulation, the following terms shall be defined as follows:
(a) *Decree*: the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*);
(b) *cumulative preference share*: a share entitling the holder to a fixed dividend per year, including years during which dividend payments on that share were deferred;
(c) *direct issue*: the issue of a hybrid instrument by the financial undertaking which includes or will include that hybrid instrument in its regulatory capital as referred to in Articles 90 to 98 of the Decree;
(d) *De Nederlandsche Bank*: De Nederlandsche Bank N.V.;
(e) *financial undertaking*: a bank, a management company of an undertaking for collective investment in transferable securities, an investment firm, a clearing institution or an electronic money institution as referred to in Article 90 of the Decree or an insurer as referred to in Article 95(1) of the Decree;
(f) *hybrid instrument*:
(i) an innovative financial instrument, or
(ii) a non-innovative financial instrument;
(g) *indirect issue*: the issue of a hybrid instrument by an entity other than the financial undertaking which includes or will include that hybrid instrument in its regulatory capital as referred to in Articles 90 to 98 of the Decree, provided that the financial undertaking and that entity together form a group within the meaning of Article 24b of Volume 2 of the Dutch Civil Code (*Burgerlijk Wetboek*);
(h) *innovative financial instrument*: a financial instrument which, considering its features, may in a material sense be equated with a regulatory capital component as

referred to in Articles 90 to 98 of the Decree, but which contains one or more features that may create an incentive to redeem;
(i) *non-cumulative preference share*: a share entitling the holder to a fixed dividend per year, except for years during which dividend payments on that share were cancelled;
(j) *non-innovative financial instrument*: a financial instrument which, considering its features, may in a material sense be equated with a regulatory capital component as referred to in Articles 90 to 98 of the Decree, and which does not contain features that may create an incentive to redeem, and
(k) *trigger point*:
(i) the point in time when actual regulatory capital, whether or not on a consolidated or subconsolidated basis, of a bank, an investment firm or a clearing institution falls below the minimum amount as referred to in Article 60(1) of the Decree;
(ii) the point in time when actual regulatory capital, whether or not on a consolidated or subconsolidated basis, of a management company of an undertaking for collective investment in transferable securities falls below the minimum amount as referred to in Article 63(1) of the Decree;
(iii) the point in time when actual regulatory capital, whether or not on a consolidated or subconsolidated basis, of an electronic money institution falls below the minimum amount as referred to in Article 64 of the Decree, or
(iv) the point in time when the actual solvency margin, whether or not on a consolidated or subconsolidated basis, of an insurer falls below the minimum amount as referred to in Article 65, 66, 67 or 68 of the Decree.

Chapter 2 Recognition as tier 1 capital

Section 2.1 General provisions regarding hybrid instruments

Article 2:1

1. In the calculation of tier 1 capital as referred to in Article 91(1) of the Decree or, as applicable, the calculation of the actual solvency margin as referred to in Article 95(1) of the Decree to the extent that the actual solvency margin exceeds the minimum amount as referred to in Article 65, 66, 67 or 68 of the Decree, the following instruments may, whether or not on a consolidated or subconsolidated basis, be included as regulatory capital components as referred to in Article 91(2) of the Decree or, as applicable, Article 95(2) of the Decree:
(a) innovative financial instruments, provided that the conditions set out in this Chapter are satisfied;
(b) non-innovative financial instruments, provided that the conditions set out in this Section and Section 2.3 are satisfied.
2. In the calculation referred to in the opening sentence of paragraph 1 above, financial undertakings shall:
(a) include innovative financial instruments as regulatory capital components as referred to in Article 91(2) of the Decree or, as applicable, Article 95(2) of the Decree to a maximum of 15%;
(b) include non-innovative financial instruments together with innovative financial instruments as regulatory capital components as referred to in Article 91(2) of the Decree or, as applicable, Article 95(2) of the Decree to a maximum of 50%;
(c) count non-cumulative perpetual preference shares which contain one or more features that may create an incentive to redeem towards the limit referred to under (a) above, and

(d) count non-cumulative perpetual preference shares which contain no features that may create an incentive to redeem, together with the shares referred to under (c) above, towards the limit referred to under (b) above.

Article 2:2
For the purposes of the calculation referred to in Article 2:1(1), hybrid instruments shall only be included as regulatory capital components if:
(a) the funds ensuing from the hybrid instruments have been provided by third parties on a permanent basis;
(b) they have been issued and are fully paid-up;
(c) they enable the financial undertaking to absorb losses on a going-concern basis;
(d) the financial undertaking has full discretion over the amount and timing of distributions in respect of the hybrid instruments;
(e) the relevant claims of the creditors are fully junior to those of other creditors, including at any rate the creditors referred to in Article 92(3), under (c)(i), of the Decree or, as applicable, Article 96, under (b), of the Decree, and provided that the financial undertaking or an associated entity has no actual possibility or contractual power to enhance the seniority of the hybrid instrument relative to these other creditors;
(f) they do not involve any cumulative preferences, including any contractual power or actual possibility for the holders to receive cancelled or deferred dividend or coupon interest payments at a later stage, and
(g) they do not involve any call option, including any contractual or actual possibility for an entity that is associated with the financial undertaking within a group within the meaning of Article 24b of Volume 2 of the Dutch Civil Code (*Burgerlijk Wetboek*) to acquire hybrid instruments.

Article 2:3
The condition referred to in Article 2:2, under (d), shall be satisfied if:
(a) there is no obligation to make distributions in respect of the hybrid instrument; this does not include an obligation to make distributions on account of a prior dividend payment on ordinary shares outside periods during which a trigger point arises;
(b) distributions can only be made out of distributable items;
(c) the amounts of the distributions have been fixed in advance and cannot be revised because of a change in the financial undertaking's credit standing, and
(d) unpaid amounts are at the free disposal of the financial undertaking.

Article 2:4
A contractual power or actual possibility on the part of the financial undertaking to issue a capital component to settle one or more deferred dividend or coupon interest payments in respect of a hybrid instrument at the resumption of the normal dividend or coupon interest payments shall not be contrary to the provisions of Article 2:2, under (f), if:
(a) settlement is effected using a capital component as referred to in Article 91(2) of the Decree or, as applicable, Article 95(2) of the Decree which is non-callable and non-redeemable;
(b) from the hybrid instrument's time of issue until its maturity, the financial undertaking, in order to make the settlement, reserves capital components from the available authorisations for new share issues, at least equivalent to one future dividend or coupon interest payment, plus any payments deferred earlier, converted to the capital component used to make the settlement;

(c) the financial undertaking informs the holders of ordinary shares of the contractual power or the actual possibility referred to in the opening sentence and of the reservation referred to under (b) above, and
(d) the value of the payment in the form of the capital component referred to in the preceding subparagraphs of this Article, if and to the extent that it relates to a period of obligatory deferral, does not exceed the nominal value of the original dividend or coupon interest payments.

Article 2:5
1. A call option on a hybrid instrument shall not be contrary to the provisions of Article 2:2, under (g), if the call option is only capable of being exercised on the financial undertaking's initiative after a minimum of five years from the date of issue and with the approval of De Nederlandsche Bank.
2. The approval of De Nederlandsche Bank as referred to in paragraph 1 above is contingent on replacement capital being available or becoming available forthwith after the exercise of the call option, in the form of another financial instrument of equal or better quality.
3. Notwithstanding the provisions of paragraph 2 above, De Nederlandsche Bank may also grant approval if no replacement capital is or becomes available forthwith if it holds that the amount of the financial undertaking's remaining capital, from which the hybrid instrument will be withdrawn upon the exercise of the call option, continues to exceed by a prudent margin the minimum amount of regulatory capital as referred to in Articles 60, 63 and 64 of the Decree or, as applicable, the minimum amount of the solvency margin as referred to in Articles 65 to 68 of the Decree.

Section 2.2 Special provisions regarding innovative financial instruments

Article 2:6
Innovative financial instruments shall at any rate include any financial instrument that satisfies the conditions set out in Article 2:2 and that has been issued with an interest rate step-up under the terms of issue. A financial instrument with an interest rate step-up shall only be included in the calculation referred to in Article 2:1(1), opening sentence, if its terms of issue stipulate that:
(a) the interest rate step-up right may be exercised only once over the life of the financial instrument;
(b) the interest rate step-up right may be exercised after at least 10 calendar years after the date of issue, and
(c) the interest rate step-up over and above the initial rate of interest shall not exceed either 100 basis points or 50% of the initial credit spread, in either case adjusted for the effect of a change in the relevant interest rate bases.

Section 2.3 Special provisions regarding proceeds from issues and loss absorption

Article 2:7
1. If a hybrid instrument has been issued indirectly and the proceeds from the issue have not been made available directly and immediately to the financial undertaking, the financial undertaking shall, in view of the provisions of Article 2:2, under (a), take measures to ensure that the proceeds from the issue are made available to it no later than at or immediately after a trigger point.

2. If a hybrid instrument has been issued indirectly and the proceeds from the issue have been made available to the financial undertaking in the form of an intra-group loan, the condition referred to in Article 2:2, under (c), shall only be satisfied if:
(a) at a trigger point or when the amount of equity on the financial undertaking's company balance sheet has become negative, the financial undertaking has the right to convert the intra-group loan into a directly issued capital component as referred to in Article 91(2), under (a) to (e), of the Decree or, as applicable, Article 95(2), under (a), of the Decree, or into a hybrid instrument within the meaning of this Regulation that is recognised as such a capital component and included as equity in the financial undertaking's company balance sheet, and
(b) the conditions attaching to the intra-group loan are equivalent to the conditions attaching to the indirectly issued hybrid instrument, provided that, for the purposes of Article 2:2, under (c), the intra-group loan has a maturity of at least 30 years and its redemption at maturity requires the prior approval of De Nederlandsche Bank.
3. In the event that it is *de facto* impossible to perform the automatic conversion as referred to in paragraph 2, under (a), above, the financial undertaking shall submit another way of effecting the conversion to De Nederlandsche Bank for its approval.

Article 2:8
1. If a hybrid instrument has been issued directly and the proceeds from the issue are included as a debt in the financial undertaking's company balance sheet, the terms of issue shall provide for the possibility to convert, at or immediately after a trigger point, the debt on the company balance sheet into a capital component as referred to in Article 91(2), under (a), (b), (c) (d) or (e), of the Decree or, as applicable, Article 95(2), under (a), of the Decree or into a hybrid instrument that is recognised as such a capital component and included as equity in the financial undertaking's company balance sheet.
2. In the event that it is *de facto* impossible to perform the automatic conversion as referred to in paragraph 1 above, the financial undertaking shall submit another way of effecting the conversion to De Nederlandsche Bank for its approval.

Chapter 3 Recognition as tier 2 capital

Article 3:1
Hybrid instruments which satisfy the conditions set out in Chapter 2 but which cannot be recognised as capital components as referred to in Article 91(2) of the Decree solely as a result of the limits referred to in Article 2:1(2) shall be eligible as capital components as referred to in Article 92(2) of the Decree.

Article 3:2
Capital components as referred to in Article 92(2) of the Decree or, as applicable, Article 96, under (c), of the Decree which involve a call option or an interest rate step-up shall only satisfy the requirements of said Articles of the Decree if:
(a) in the event of a call option, the call option satisfies the requirements set out in Article 2:5;
(b) in the event of an interest rate step-up, the interest rate step-up satisfies the requirements referred to in Article 2:6.

Article 3:3

Capital components as referred to in Article 92(3) of the Decree or, as applicable, Article 96, under (a) and (b), of the Decree which involve a call option or an interest rate step-up shall only satisfy the requirements of said Articles of the Decree, if
(a) in the event of a call option, the call option can be exercised only on the financial undertaking's initiative and with the approval of De Nederlandsche Bank;
(b) in the event of an interest rate step-up, the interest rate step-up satisfies the requirements referred to in Article 2:6, provided that:
(i) the number of calendar years as referred to in Article 2:6, under (b), is at least five;
(ii) the maximum values, set out in Article 2:6, under (c), of the interest rate step-up are halved in the event of effectuation after five years and can be interpolated linearly in the event of effectuation of the interest rate step-up between five and ten years;
(c) the reduction referred to in Article 92(3), under (c)(iv), of the Decree, is applied at the latest from the point in time when a call option as referred to under (a) above is almost certain to be exercised and using the expected date of exercise as the date of redemption.

Chapter 4 Procedural provisions

Article 4:1
1. Hybrid instruments shall only be eligible for the purposes of this Regulation if their issue has been submitted, either beforehand or later, to De Nederlandsche Bank for assessment, together with documentation showing that the applicable requirements under this Regulation are satisfied.
2. Recognition of hybrid instruments as regulatory capital components under this Regulation shall only be possible as from the point in time when De Nederlandsche Bank has declared in writing that the instruments concerned satisfy the requirements under this Regulation.

Article 4:2
1. De Nederlandsche Bank may depart *ex officio* from the limit of 50% referred to in Article 2:1(2), under (b), regarding the recognition of hybrid instruments as regulatory capital components.
2. For the purposes of paragraph 1 above, De Nederlandsche Bank shall at any rate allow for the development and the pace of the changes in the volume and composition of the tier 1 capital referred to in Article 91 of the Decree or, as applicable, of the actual solvency margin referred to in Article 95 of the Decree, if the hybrid instruments which have been issued, either directly or indirectly, exceed or may exceed a threshold value of 25% of this capital.

Article 4:3
De Nederlandsche Bank may *ex officio* impose additional conditions on a financial undertaking which does not have capital divided into shares or which does not have freely marketable shares and which, as a result, might not be able to effect the envisaged conversion referred to in Article 2:7(2), under (a), or Article 2:8(1).

Chapter 5 Transitional and final provisions

Article 5:1
1. Instruments which have been designated in writing by De Nederlandsche Bank as innovative tier 1 capital components or as lower tier 2 capital components pursuant to

sections 4003–02, 4003–04.1, 4003–04.6, 4003–05.3 to 4003–06.4 and annex 4003–b1 of the Credit System Supervision Manual (*Handboek Wtk*) of De Nederlandsche Bank shall qualify automatically as hybrid instruments within the meaning of the present Regulation.
2. Instruments which have been designated in writing by De Nederlandsche Bank as innovative financial instruments pursuant to the Supervisory Regulation on Innovative Financial Instruments and Intangible Assets (*Regeling innovatieve financiële instrumenten en immateriële activa*) shall qualify automatically as hybrid instruments within the meaning of the present Regulation.
3. Instruments issued by insurers before the entry into force of the present Regulation shall only be eligible for the purposes of the present Regulation if De Nederlandsche Bank has consented thereto in writing in response to a request made pursuant to Article 4:1. A request as referred to in the preceding sentence shall be submitted on 31 May 2008 at the latest. If De Nederlandsche Banks gives its written consent, that consent shall have retroactive effect until 31 December 2007.

Article 5:2
The Supervisory Regulation on Innovative Financial Instruments and Intangible Assets (*Regeling innovatieve financiële instrumenten en immateriële activa*)[1] is hereby repealed.

Article 5:3
This Supervisory Regulation shall enter into force on 31 December 2007.

Article 5:4
This Supervisory Regulation shall be cited as the Supervisory Regulation on the Recognition of Hybrid Instruments as Regulatory Capital Components (*Regeling gelijkstelling hybride instrumenten met eigenvermogensbestanddelen*).

This Supervisory Regulation and the appurtenant explanatory notes shall be published in the *Staatscourant* (Government Gazette) .

De Nederlandsche Bank N.V.,

/s/ A.J. Kellermann
Executive Director

[1] *Staatscourant* (Government Gazette) 2007, no. 1, p. 22.

EXPLANATORY NOTES – GENERAL

Legal basis

Pursuant to Article 89(2) of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*) (hereinafter referred to as the Decree), De Nederlandsche Bank N.V. (hereinafter referred to as De Nederlandsche Bank) must set rules regarding:
(a) the recognition of (innovative) financial instruments as regulatory capital components as referred to in Articles 90 to 98 of the Decree, and
(b) the recognition (or non-recognition) of certain assets as intangible assets.
The present Supervisory Regulation only implements the obligation to set rules as contained in Article 89(2), under (a), of the Decree. The obligation to set rules as contained in Article 89(2), under (b), of the Decree is implemented in a separate Supervisory Regulation of De Nederlandsche Bank (*Supervisory Regulation permitting Non-Deduction of Intangible Assets from Regulatory Capital* – Regeling uitsluiting solvabiliteitsaftrek immateriële activa).

Scope and extension

The present Supervisory Regulation has been derived from sections 4003–02, 4003–04.1, 4003–04.6, 4003–05.3 to 4003–06.4 and annex 4003–b1 of the Credit System Supervision Manual (*Handboek Wtk*) of De Nederlandsche Bank, and constitutes a continuation of existing policy. Article 89(2), under (a), of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*) provides the basis for this continuation of the existing rules regarding innovative financial instruments as set out in the above sections of the Credit System Supervision Manual (*Handboek Wtk*). However, a number of editorial changes have been made. The rules for banks, management companies of undertakings for collective investment in transferable securities (UCITS), investment firms, clearing institutions and electronic money institutions regarding the recognition of hybrid instruments as regulatory capital components in the calculation of tier 1 and tier 2 capital have been adapted in terms of scope and terminology to the report dated 13 March 2007 of the Committee of European Banking Supervisors (CEBS) on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA).[2] This notably concerns the concepts of 'innovative financial instruments' and 'non-innovative financial instruments' and the inclusion in the limits of non-cumulative perpetual preference shares.

For the rest, the basic principle underlying the present Regulation is substance over form. Whether an instrument is hybrid or not, whether an issue is direct or indirect and whether or not there are incentives to redeem is assessed on the basis of substantive criteria. An instrument's exact design or name is secondary to its substance.

Consultations

In conformity with section 1:28 of the Financial Supervision Act (*Wet op het financieel toezicht*), consultations have been held about the present Regulation with the representative organisations of the sector concerned. The comments obtained from the consultations have been incorporated into the text of and the explanatory notes to this Regulation.

Innovations

[2] Can be found at: http://www.c-ebs.org/press/13032007.htm.

(i) Scope extended to include insurers

The first innovation concerns the extension of the scope of the above standards to include insurers. Under the regulations regarding the solvency margin[3], insurers were permitted to include hybrid instruments to cover the minimum amount of the solvency margin, if and to the extent that such hybrids satisfied the requirements set out in those regulations. This possibility still exists but it has now been provided for in the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*).

The extension of the scope of this Regulation concerns the fact that hybrid instruments may now also be included in the calculation of so-termed "excess capital" – the capital in excess of the required minimum amount of the solvency margin. The manner in which hybrid instruments may be included in the calculation of excess capital is parallel to the manner in which banks may include hybrid instruments in the calculation of tier 1 capital.

The Regulation provides for parallelism because equality between banks and insurers cannot be achieved. The fact is that the regulations in force for insurers provide for a different structure of capital and limits. In the case of banks, there is a hierarchy of three forms of capital (tier 1, tier 2 and other capital). In the case of insurers, there are three categories of capital, one if which is a general category within which financial instruments may be included in full and two specific categories within which financial instruments may be included to the extent of at most 50% and at most 25% to cover the lower of the minimum solvency margin and the actual solvency margin. Hence, although the capital structures of banks and insurers overlap in some respects, they are not the same. Thus, the manner of recognising hybrid instruments, though comparable in a material sense, is not the same either. Below, a numerical example is given for insurers. The insurer in the example has a minimum solvency margin of 100 and an actual solvency margin of 300. The maximum of hybrid instruments that may be recognised in the calculation of the minimum solvency margin follows from the provisions of the Decree. The maximum of hybrid instruments that may be recognised in the calculation of the actual solvency margin follows from the provisions of the present Regulation.

EXAMPLE	
Minimum solvency margin	
Suppose: net minimum solvency margin (Articles 65 to 68 of the Decree) =	100
As to the composition of this margin, the following requirements apply (existing policy):	
Type M1: instruments satisfying the requirements of Article 95(2) of the Decree, less the items referred to in Article 95(3) of the Decree (= minimum requirement of 50%) =	50
Type M2: instruments satisfying the provisions of Article 98(1), under (b), or Article 98(2), under (b), of the Decree (= maximum limit of 50%) =	50
Type M3: instruments satisfying the provisions of Article 98(1), under (c), or Article 98(2), under (c), of the Decree (inner limit of 25% = maximum; also part of the maximum limit of type M2) =	25
Excess capital	

[3] See, for instance, *Staatsblad* (Bulletin of Acts, Orders and Decrees) 1994, 449 and 1995, 555.

Suppose: total actual solvency margin (Article 95(1) of the Decree) =	300
Deduction: instruments included in actual solvency margin which have been recognised, pursuant to Article 98 of the Decree, in the calculation to cover the minimum solvency requirement ('tier 1+2 items') =	-100
Net actual solvency margin consisting of instruments satisfying the requirements of Article 95(2) of the Decree or hybrid instruments recognised as such instruments (excess capital) =	200
As to the composition of this margin, the following requirements apply (new policy):	
Type S1: instruments satisfying the requirements of Article 95(2) of the Decree (excluding non-cumulative perpetual preference shares), being the minimum requirement of 50% =	100
Type S2: hybrid instruments recognised as instruments under Article 95(2) of the Decree + non-cumulative perpetual preference shares, being the maximum limit of 50% =	100
Type S3: hybrid instruments recognised as instruments under Article 95(2) + non-cumulative perpetual preference shares which may involve an incentive to redeem (inner limit of 15% = maximum; also part of the maximum limit of type S2) =	30

(ii) Automatic shift to tier 2 capital

Another new element is constituted by Article 3:1, which provides that, if hybrid instruments are not eligible as regulatory capital components as referred to in Article 91(2) of the Decree (that is, as tier 1 capital) because the limits referred to in Article 2:1(2) are exceeded, they are automatically eligible as regulatory capital components as referred to in Article 92(2) of the Decree (that is, as upper tier 2 capital).

The moment at which this automatic shift takes place depends on the time of issue. If a planned issue has been submitted to De Nederlandsche Bank for assessment in conformity with Article 4:1 and if it becomes evident at that point in time (that is, at issuance) that the limits referred to in Article 2:1(2) are exceeded, the instrument is shifted to tier 2 capital. It should be noted in this respect that the 15% limit set in Article 2:1(2), under (a), only applies at issuance. A later increase in value does not lead to a shift to tier 2, but shall only be taken into account in the calculations regarding new issues. The 50% limit set in Article 2:1(2), under (b), applies at all times and may not be exceeded, not even after issue.

(iii) Explicit rules regarding holder's market-price-related conversion right

As noted above, where banks are concerned, the present Regulation seeks to set new rules without any substantive changes in underlying policy. However, practice has shown that the rules about market-price-related conversion rights for holders (Article 7 of the Policy Rule in respect of Innovative Tier 1 Capital Instruments (*Beleidsregel inzake innovatieve tier 1 kapitaalinstrumenten*) are no longer relevant in practice, since such conversion rights are no longer granted upon the issue of hybrid instruments. In view of the general tendency towards increasingly principle-based formulations, this detailed arrangement, not being necessary any more, has not been taken over in the present Regulation. This does not, however, mean that it is no longer permitted to issue hybrid instruments with a market-price-related conversion right. If such an instrument

were to be issued, De Nederlandsche Bank will apply the other principle-based standards from the present Regulation to assess whether such an instrument satisfies the requirements set in this Regulation.

Administrative costs

General

Administrative costs are the costs incurred by the business sector in order to comply with the information requirements ensuing from public sector legislation and regulation. The information requirements concern obligations under which the business sector must provide information about its acts and behaviour in respect of a standard that is considered valuable from a societal viewpoint. It is essential that the information must be available, and be able to be produced, at a certain point in time. In terms of the present Regulation, this means that each obligation to show that the requirements set in this Regulation are satisfied constitutes an information requirement.

The only information requirement contained in the present Regulation concerns the obligation set out in Article 4:1 to the effect that each planned issue of a hybrid instrument must be submitted to De Nederlandsche Bank for assessment. This Article provides that, when a request for assessment is made, documentation must be available and be submitted. The exact type of information that must be provided depends on the sort of hybrid instrument to which the request relates. Hence, the documentation may concern any of the requirements set in Articles 2:3 to 3:3 of the present Regulation.

The only constant factor in respect of this information requirement is that each financial undertaking must at any rate show that the general requirements set in Articles 2:1 and 2:2 are satisfied. Depending on the specifics of the case, supplementary information may be required. Considering this background, the calculation of the administrative costs has been based on the 'standard' amount of administrative costs plus an additional amount in the event of special features. The standard amount will in most cases apply to repeats, that is, issues having the same features as issues submitted earlier to De Nederlandsche Bank and approved by it.

Standard amount

The standard amount comprises those costs which are incurred to show that the limits set in Article 2:1 and the qualifying requirements set in Article 2:2 are satisfied:

- **Limits**: compliance with the limits is fairly easy to prove. A financial undertaking only has to show the amount of hybrid instruments (in money terms) which it plans to issue and the amount of its tier 1 or tier 2 capital. The amount of the capital can simply be copied from the reporting forms that are submitted periodically; hence, these data are already available. The amount of hybrid instruments to be issued depends entirely on the choices made by the financial undertaking, so that these data need not be compiled separately either.
- **Qualifying requirements**: whether the qualifying requirements are satisfied is evident from the terms of issue as contained in the prospectus. The financial undertaking must prepare a prospectus anyway pursuant to other legislation and regulations, so that the relevant data are already available.

Consequently, for each issue, collecting the standard information will not take more than one hour. According to various explanatory notes to the Financial Supervision Act (*Wet op het financieel toezicht*), the number of financial undertakings that may be

confronted with this obligation is as follows: 79 banks, 201 investment firms, 17 clearing institutions, 1 electronic money institution and 476 insurers, making a total of 774 financial undertakings.
The costs of collecting and providing the information have been set at € 90 per hour. Consequently, the total 'standard' administrative costs are: 1 (hour) * 774 (financial undertakings) * € 90 = € 69,660.

Additional costs on account of special features
In the event that an issue has a special feature (such as an interest rate step-up), the financial undertaking concerned must take special measures to ensure that the effect of the special feature is reduced to the extent possible. Although taking these measures may involve considerable costs, these are not administrative costs, since the costs are incurred not to comply with regulations but to show that the regulations are being complied with.
This means that, even if an issue has special features, the administrative costs are low. The only administrative costs that must be incurred are those involved in making available the terms of issue or the contractual terms showing that the special regulations are also satisfied. On average, this will take half an hour on top of the time required to provide the 'standard' documentation.

Hence, collecting and submitting these additional data will not take more than half an hour.
The total number of financial undertakings that may be faced with this information requirement is 774.
The costs of collecting and providing the information have been set at € 90 per hour. Consequently, the total 'additional' administrative costs are 0.5 (hour) * 774 (financial undertakings) * € 90 = € 34,830.

EXPLANATORY NOTES TO INDIVIDUAL ARTICLES

Article 1:1
Under (c) and (g)
Hybrid instruments may be issued in either of two ways: directly or indirectly. This distinction is of importance for the manner in which the proceeds from the issue become available to the financial undertaking which includes the hybrid instruments in the calculation of its regulatory capital. In practice, indirect issues are usually effected by a special purpose vehicle (SPV) over which the financial undertaking has actual control; hence, the financial undertaking and the SPV are joined in a group within the meaning of Article 24b of Volume 2 of the Dutch Civil Code (*Burgerlijk Wetboek*).

Under (e)
Hybrid instruments may be issued by banks, management companies of undertakings for collective investment in transferable securities (UCITS), investment firms, clearing institutions and electronic money institutions. This is a continuation of the policy as it was in force under the Credit System Supervision Manual 1992 (*Handboek Wtk 1992*) (Policy rule in respect of innovative tier 1 capital instruments (*Beleidsregel inzake innovatieve tier 1 kapitaalinstrumenten*)) and the Supervisory Regulation on Innovative Financial Instruments and Intangible Assets (*Regeling innovatieve financiële instrumenten en immateriële activa*) (Staatscourant (*Government Gazette*) 2007, no. 1).

In view of the cross-sectoral nature of Article 89(2), under (a), of the Decree (which constitutes the legal basis of the present Supervisory Regulation), hybrid instruments may now also be issued by insurers.

Under (f), (h) and (j)
Hybrid instruments are distinguished into innovative and non-innovative financial instruments. This manner of defining and classifying hybrid instruments has been taken over from recent CEBS reports about own funds, in which hybrid instruments are divided into innovative instruments (with an incentive to redeem), non-innovative instruments (without an incentive to redeem) and non-cumulative perpetual preference shares.[4] Because Article 91(2), under (a), of the Decree and Article 95(2), under (a), of the Decree count non-cumulative perpetual preference shares towards regulatory capital, these shares are not – contrary to the CEBS classification – covered by the definition of hybrid instruments. They are, however, included in the calculation of the limits.

Apart from the distinctive criterion of whether or not there is an incentive to redeem, innovative and non-innovative financial instruments are too diverse to be defined exactly, which explains the unspecific open wording of the definitions of these concepts. The principal qualifying criterion is the 'likeness' of these instruments to 'genuine' regulatory capital. In principle, any instrument which possesses the essential characteristics listed in Article 2:2 qualifies as a hybrid instrument, with the proviso that, in respect of innovative financial instruments, additional conditions may be imposed in order to limit the effects of the inherent incentives to redeem (see Section 2.2 of the present Supervisory Regulation).
The three principal characteristics of hybrid instruments are:

1. **Permanence**: the funds are made available to the financial undertaking on a permanent basis (no temporary funds);
2. **Loss absorption capacity**: the hybrid instrument enables the financial undertaking to absorb losses on a going-concern basis, and
3. **Flexibility of payments**: the hybrid instrument affords the financial undertaking full flexibility and discretion regarding the amount and timing of distributions to the instrument's holder.

These characteristics must, in principle, be present, although, in appropriate cases, limited or temporary exceptions may be permitted, subject to conditions.

Article 1:1, under (k), and Article 2:1(1), opening sentence
In Articles 1:1, under (k), and 2:1(1), opening sentence, the (banking) terms 'consolidated' and 'subconsolidated' are used. Because these terms are not used in the context of the supervision of insurers, a brief explanation is given below. Insurance supervision centres on individual insurers; in addition, the Financial Supervision Act (*Wet op het financieel toezicht*) and the Decree on the Prudential Supervision of Financial Groups (*Besluit prudentieel toezicht financiële groepen Wft*) provide for supplementary supervision of insurance groups and supervision of financial conglomerates. The terms 'consolidated' and 'subconsolidated' are solely used to indicate that the rules regarding the recognition of hybrid instruments as regulatory capital components may apply to both individual entities and group holding companies.

[4] CEBS, *Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA)*, 13 March 2007, section 20 (notably under c). See: http://www.c-ebs.org/Advice/reportonhybrids1303.pdf.pdf.

This does not mean that consolidated supervision would be in evidence in the insurance sector, as it is in the banking sector.

Article 2:1(1)
Article 2:1(1) sets out the main rule for the recognition of hybrid instruments as regulatory capital components. Financial undertakings as referred to in the present Supervisory Regulation may include hybrid instruments in the calculation of their (net) tier 1 capital. The same applies to insurers, with the proviso that, in that case, the calculation concerns the (net) actual solvency margin to the extent that it exceeds the amount of the minimum solvency margin (excess capital). This is without prejudice to the application of Article 98 of the Decree regarding the recognition of instruments (which meet the requirements set in that Article) to cover the minimum solvency requirement (also see the numerical example in the general section of the explanatory notes).

Article 2:1(2)
Article 2:1(2) stipulates the limits which apply to the inclusion of hybrid instruments in the calculation of (net) tier 1 capital as referred to in Article 91 of the Decree or, as applicable, the (net) actual solvency margin as referred to in Article 95 of the Decree. For that purpose, Article 2:1(2) introduces a system of limits. A hybrid instrument may be included up to a maximum of 15% (limit for innovative instruments) or 50% (innovative and non-innovative financial instruments combined), with the proviso that non-cumulative preference shares always count towards these limits.

Please note that hybrid instruments cannot automatically be included in the calculation of the minimum amount of the solvency margin as referred to in Articles 65, 66, 67 or 68 of the Decree. Apart from instruments satisfying the requirements of Article 98(1), under (a), of the Decree or, as applicable, Article 98(2), under (a), of the Decree, only those hybrid instruments are eligible to cover this minimum amount which satisfy the requirements of Article 98(1), under (b) and (c), of the Decree or, as applicable, Article 98(2), under (b) and (c), of the Decree. It should be noted, however, that in actual practice hybrid instruments virtually always meet these requirements.

Article 2:2
The conditions listed in Article 2:2 constitute the seven essential characteristics which financial instruments which do not qualify as regulatory capital components as referred to in Article 91(2) of the Decree or, as applicable, Article 95(2) of the Decree must possess in order to be recognised as hybrid instruments.
Where Article 2:2, under (e), of the present Regulation is concerned, the junior status applies relative to each creditor whose claim is not related to the issue of a hybrid instrument. Hence, Article 2:2, under (e), does not refer to seniority among the holders of hybrid instruments themselves.

Article 2:3
Control over the amount and timing of distributions in respect of the hybrid instrument is one of the essential conditions for a financial instrument to qualify as a hybrid instrument. Article 2:3 sets out when this criterion is fulfilled.
Article 2:3, under (a), states in effect that a dividend or coupon interest payment on the hybrid instrument may be coupled with a prior payment of dividend on ordinary share

capital, for as long as a trigger point (Article 1:1, under (k)) has not arisen. However, there must not be any contractual power or actual possibility for the holder yet to receive deferred payments in cash on the hybrid instrument at a later time.

Article 2:4
Article 2:4 sets out when no cumulative preference is in evidence. Because Article 2:4 provides for an exception to the basic principle set out in Article 2:2, under (f), its application is subject to strict conditions. These conditions are set in respect of the so-termed alternative coupon satisfaction (or settlement) mechanism (ACSM). One important condition is that a deferred payment may be settled only by the issue of a non-callable and non-redeemable instrument (Article 2:4, under (a)). The requirement to effect prior reservation, as set out in Article 2:4, under (b), is imposed in order to achieve that sufficient instruments will be available for immediate issue at the time when the ACSM must be effectuated. The deferred dividend or coupon interest payment may not bear interest for the period of obligatory deferral (Article 2:4, under (d)).

In cases other than ACSM, the substance of the specific case will have to be judged in order to decide whether a cumulative preference is in evidence. One major material condition is that there must not be any contractual power or actual possibility for the holder yet to receive deferred payments in cash on the instrument at a later time.

Article 2:5
Another essential condition that must be satisfied by an instrument in order to be recognised as tier 1 capital is permanence. Hence, the instrument must not involve a call option. The second part of Article 2:2, under (g), provides which call options are not permitted anyway. Article 2:5 provides for two exceptions:
- a call option is permitted if, immediately upon its exercise, replacement capital is available or becomes available forthwith, and
- a call option is permitted if its exercise does not lead to a decrease in regulatory capital or in the solvency margin to below the minimum amounts listed in the Decree.

These two exceptions are underlain by the consideration that the requirement of permanence is met in a material sense. However, given the fact that this is an exception, these criteria will be interpreted and applied strictly. In any event, the substance of the specific case is always decisive.

The wording ‘by a prudent margin’ used in Article 2:5(3) has been used because any decision as to whether the remaining capital – after the exercise of a call option – is sufficient in the light of the financial undertaking’s risk profile is always a matter of judgment and calls for an integral assessment, which cannot be reduced to a number of standard formulations. In some cases, a ‘prudent margin’ might already be in evidence if the capital just exceeds the minimum required capital or, as applicable, the minimum required solvency margin. In other cases, however, approval might be withheld, for instance because of the presence of risks, whether or not temporary, which justify a higher capital level than the required minimum.

Article 2:6
The condition that is most commonly attached to innovative financial instruments with an incentive to redeem consists of an interest rate step-up. Article 2:6 provides for

special rules (over and above those set out in the remainder of Chapter 2) in order to ensure that the incentive to redeem detracts as little as possible from the quality of the innovative financial instrument. Hence, the interest rate step-up right is limited in terms of the number of times that it may be exercised (Article 2:6, under (a)), in terms of the point in time when it may be exercised (Article 2:6, under (b)) and in terms of magnitude (Article 2:6, under (c)).

An instrument not involving an interest rate step-up may also constitute an innovative financial instrument. In order to make sure whether this is the case, a financial undertaking may ask De Nederlandsche Bank to assess whether a financial instrument which it intends to issue qualifies as an innovative financial instrument within the meaning of the present Supervisory Regulation. This possibility is, of course, intended for special cases or for innovations. In 'standard' cases, primary responsibility for compliance with the present Regulation is borne by the financial undertaking itself, after which De Nederlandsche Bank performs an assessment pursuant to Article 4:1.

Article 2:7

In the case of indirect issue, the hybrid instrument is issued not by the financial undertaking which includes the instrument in the calculation of its regulatory capital but by another entity (often an SPV). If, in the case of indirect issue, the proceeds from the issue are not transferred directly to the financial undertaking, the latter must ensure that these proceeds will be available to it when necessary. In this respect, a number of requirements are applicable:

- in terms of both permanence and loss absorption, the transfer of the proceeds to the financial undertaking must be effected at or immediately after actual regulatory capital drops below the minimum amounts stated in the Decree (trigger point) or the amount of equity on the company balance sheet turns negative, and
- this implies that the financial undertaking must exercise control over the issuing entity in order to prevent a situation where a financial undertaking would have no power to actually enforce the measures taken by it. This is also evident from the definition of the term 'indirect issue' (Article 1:1, under (g)).

For the rest, Article 2:7(1) has been deliberately formulated in an open manner. Article 2:7 (as well as Article 2:8) are also intended to encourage adequate composition and distribution of capital among the group entities (including the holding company).

The proceeds from an issue by an SPV may be transferred to the financial undertaking in a variety of ways. In practice, the proceeds from an issue are often passed on to the financial undertaking in the form of a deeply subordinated long-term intra-group loan. For such a situation, Article 2:7(2) provides that:

- the financial undertaking must ensure that the terms of the loan include a conversion right under which the loan may be converted into a regular regulatory capital component or into a hybrid instrument recognised as such a capital component and included as regulatory capital on the financial undertaking's company balance sheet;
- in addition, the conditions attaching to the loan must be (at least) equivalent in a material sense to the conditions of issue of the indirectly issued hybrid instrument.

Article 2:8

Article 2:8 sets out similar provisions for a direct issue if the proceeds from the issue are included as a debt in the company balance sheet. With a view to loss absorption on

a going-concern basis in the financial undertaking's company balance sheet, the basic rule is that the hybrid instrument included as a debt must be converted automatically into an instrument included as a regulatory capital component in the company balance sheet when a trigger point arises. If this is *de facto* impossible, the conversion may be arranged for in a different manner. Whether automatic conversion is impossible will be assessed by De Nederlandsche Bank, as will the financial undertaking's proposal for a different arrangement. A similar procedure is in force for indirect issue (Article 2:7(3)).

Article 3:1
The inclusion of hybrid instruments in the calculation of tier 1 capital is limited to the percentages listed in Article 2:1. Article 3:1 provides that, if these limits are exceeded, the 'excess' of hybrid instruments may be included automatically in the calculation of upper tier 2 capital.

The provisions of Article 3:1 may be implemented only if the excess of hybrid instruments meets *all* the requirements set in Chapter 2, so as to prevent these requirements from being circumvented by including hybrid instruments in the calculation of upper tier 2 capital instead of tier 1 capital, thus failing to satisfy the relevant requirements set in Article 92(2) of the Decree and in the provisions of this Chapter of the present Regulation. An excess over the limits is the only argument for automatically shifting hybrid instruments to upper tier 2 capital.

Articles 3:2 and 3:3
Because, for tier 2 capital, other requirements are necessary in order to reduce the incentives to redeem which may ensue from call options and interest rate step-ups, Articles 3:2 and 3:3 provide for supplementary requirements. In order to warrant uniformity, the arrangements reflect those of Articles 2:5 and 2:6 to the extent possible.

Application of Article 3:3
The notional write-down arrangement must be started no later than five years before the point in time when the interest rate step-up will be effectuated. For all call options – whether or not combined with an interest rate step-up – the regulations imply that, if during the life of the debt instrument it becomes evident that the call option is almost certain to be exercised, the notional write-down arrangement must be applied as from the point in time when this becomes evident, the expected date of exercise of the call option being regarded as the date of redemption.

Chapter 4
The Articles in Chapter 4 concern the existing procedural rules from Section 2.3 of the Supervisory Regulation on Innovative Financial Instruments and Intangible Assets (*Regeling innovatieve financiële instrumenten en immateriële activa*), as previously included in articles 8 to 10 of section 4003-b1 of the Credit System Supervision Manual (*Handboek Wtk*).

Article 5:1
Article 5:1(1) and (2) provides that instruments which, before the entry into force of the present Supervisory Regulation, had been designated by De Nederlandsche Bank in writing as hybrid instruments under the Credit System Supervision Manual (*Handboek Wtk*) or the (temporary) Supervisory Regulation on Innovative Financial Instruments and Intangible Assets (*Regeling innovatieve financiële instrumenten en immateriële*

activa) will retain that status after the entry into force of the present Supervisory Regulation, in order to prevent the successive regulations regarding the recognition of hybrid instruments from putting the sector to unnecessary expense.

Pursuant to Article 5:1(3), instruments issued by insurers may also be eligible for grandfathering. Because instruments structured by insurers in the past as hybrid instruments have not been assessed by De Nederlandsche Bank, they must still be so assessed. The deadline for submitting requests for assessment is in line with the terms set in Article 2(2) of the Supervisory Regulation on Reporting Forms for Financial Undertakings (*Regeling staten financiële ondernemingen Wft*). The deadline is 31 May 2008.
The request must be submitted in conformity with the procedure set out in Article 4:1 (submission of documentation). De Nederlandsche Bank assesses the instruments so submitted to it on the basis of the standards from the old banking regulations (as referred to in Article 5:1(1) and (2) of the present Supervisory Regulation), by analogy with which the instruments have been structured. If the request is granted, the approval will (on account of grandfathering) be retroactive to the date of entry into force of the present Supervisory Regulation.

Article 5:3
The date of entry into force of 31 December 2007 does not mean that banks are confronted with new rules as to the quality of instruments as far as the reporting forms for 2007 are concerned.

Correspondence table

Articles from: Supervisory Regulation on the Recognition of Hybrid Instruments as Regulatory Capital Components (*Regeling gelijkstelling hybride instrumenten met eigenvermogens-bestanddelen*)	**Articles from**: Supervisory Regulation on Innovative Financial Instruments and Intangible Assets (*Regeling innovatieve financiële instrumenten en immateriële activa*)	**Articles from:** Credit System Supervision Manual (*Handboek Wtk*) 4003 and 4003–b1	**Notes**
Chapter 1			
1:1, under (a)	1:1, under (a)	not applicable	–
1:1, under (b)	–	not applicable	-
1:1, under (c)	1:1, under (b)	1(1)	–
1:1, under (d)	1:1, under (c)	not applicable	–
1:1, under (e)	1:1, under (d)	not applicable	The definition has been broadened to include insurers (cross-sectoral)
1:1, under (f)	1:1, under (f)	–	–
1:1, under (g)	1:1, under (e)	1(1) 4(2)	–
1:1, under (h)	–	under 4003b1–01, opening sentence	Definition is in line with CEBS report of 13 March 2007
1:1, under (i)	–	not applicable	-
1:1, under (j)	–	not applicable	Definition is in line with CEBS report of 13 March 2007
1:1, under (k)	1:1, under (g)	4(1), third sentence	–

Chapter 2			
2:1(1), opening sentence	2:1(1), opening sentence	1(4)	–
2:1(1), under (a) and (b)	–	–	In the previous regulations, no distinction was made between innovative and non-innovative financial instruments
2:1(2), under (a) and (b)	2:2(1), under (a) 2:7(1)	3(1) 6(1)	–
2:1(2), under (c) and (d)	–	–	As in the old regulation, non-cumulative perpetual preference shares are included in the limits. It should be noted that non-cumulative perpetual preference shares themselves have not been subjected to a limit (Article 91(2), under (a), of the Decree)
2:2, under (a) to (f)	2:1(1) 2:2(1)	2	–
2:2, under (g)	2:10	7(3)	–
2:3	2:2(1) and (2)	3(3) and (4)	–
2:4	2:9	7(2)	–
2:5	2:1(1), under (g), and 2:1 (4)	2(7)	–
2:6	2:6	5	–
2:7(1)	2:2(2)	3(2) and 4(1)	–
2:7(2)	2:4	4(3) and (4)	Negative equity added compared to Credit System Supervision Manual (*Handboek Wtk*) (ditto Article 2:8)
2:8	2:5	4a	Negative equity added compared to Credit System Supervision Manual (*Handboek Wtk*) (ditto Article 2:7)
–	**Note**: Articles 2:3, 2:7(2) to (4), 2:8, 2:14 and Section 2.3 have been deleted	**Note**: Articles 3(5) and (6), 7(1) and 8(3) have been deleted (*disclosure*)	The rules regarding a market-price-related conversion right for holders have been deleted (see under (iii) in the general explanatory notes)
Chapter 3			
3:1	–	–	The automatic shift to tier 2 capital is new
3:2 and 3:3	–	4003–06.3, 4003–06.3.1 and 4003–06.3.2	Articles 3:2 and 3:3 concern old rules regarding calls and step-ups on lower tier 2 capital. Also provided for in respect of upper tier 2

			capital based on uncodified practice
–	**Note**: Article 3:1 will be included in separate regulation (Supervisory Regulation permitting Non-Deduction of Intangible Assets from Regulatory Capital (*Regeling uitsluiting solvabiliteitsaftrek immateriële activa*))	–	–
Chapter 4			
4:1	2:11	9(1)	-
4:2	2:12	8(1) and (2)	-
4:3	2:13	10, second paragraph	-
Chapter 5			
5:1	4:1	10, first paragraph	-

De Nederlandsche Bank N.V.,

/s/ A.J. Kellermann
Executive Director