



EUROPEAN COMMISSION
Internal Market and Services DG

Director-General

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José Maria Roldán Alegre, Chairman of the
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Dear José Maria,

Subject: Call for Advice (No. 4) to CEBS on the review of the definition of own funds

I am very pleased to send to you the Commission's fourth official call for technical advice from the Committee of European Banking Supervisors.

The Basel Committee on Banking Supervision (Basel Committee) has committed to a long term review of the definition of own funds. At the meeting of the Banking Advisory Committee now the European Banking Committee (EBC) on 24 November 2004, it was agreed that the EBC would undertake a review of the definition of own funds in order that European market specificities may be properly represented in the course of the Basel negotiations. The review is fundamentally about developing enduring, economically meaningful definitions for own funds instruments. This long-term view would avoid a situation in which (as is the case today) legislation cannot match the pace at which new instruments are developed in the market nor control the follow-through effects of changes to accounting rules.

I would be grateful if CEBS could carry out a number of pieces of work to inform the Commission. Specifically, to conduct a survey of the implementation of current rules on own funds across Member States and a quantitative analysis of the types of capital held by credit institutions within the Member States and to consider an analysis of new capital instruments and the development of guiding principles behind own funds.

Yours sincerely,



Alex Schaub

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Encl. Call for advice No 4



EUROPEAN COMMISSION

Internal Market and Services DG

FINANCIAL INSTITUTIONS

Banking and financial conglomerates

Brussels, 9 March 2005

CALL FOR TECHNICAL ADVICE (No.4) FROM THE COMMITTEE OF EUROPEAN BANKING SUPERVISORS (CEBS)

Subject: *Definition of Own Funds*

1. Background

The Basel Committee on Banking Supervision (Basel Committee) has committed to a long term review of the definition of own funds. At the meeting of the Banking Advisory Committee (BAC) on 24 November 2004, it was agreed that the BAC would undertake a review of the definition of own funds in order that European market specificities may be properly represented in the course of the Basel negotiations.

A BAC working group on own funds has been established to conduct this work and the necessary work-streams have been identified. The Working Group is charged with working in parallel with the Basel Committee to ensure that developments within the Basel Committee can be properly responded to and that the European legal framework does not diverge unless where necessary from that of the Basel Committee.

The remit of the Working Group includes but is not limited to:

- consideration of the basic principles and criteria which lie behind capital instruments suitable for inclusion in own funds;
- interaction with accounting rules;
- interaction with other Directives;
- the scope of future rules.

2. Specific call for technical advice

To complement and further inform the work to be carried out by the Working Group the Commission is seeking the technical advice of CEBS on a number of issues listed below. CEBS may however also wish to put forward additional issues on its own initiative.

A. A survey of the implementation of current rules on own funds across Member States

A fundamental aim of this review is to establish an understanding of the specificities of the European market in terms of own funds. The BAC-GTIAD conducted a survey in 2001 which considered the implementation of the current rules on own funds across member states. In light of market developments in recent years the information contained within this report requires refreshing. Information needs also to be collected from the countries that entered the EU in 2004.

CEBS is asked to update the BAC-GTIAD survey in light of market developments and to include the ten new Member States in this update. CEBS is invited to exercise judgement in deciding whether or not to depart from the format and content of the 2001 report; the need for substantial departures in either format or content should be communicated to the Working Group on Own Funds.

B. An analysis of the capital instruments recently created by industry

Given the fast pace at which industry innovates new capital instruments, it is important that any new rules on own funds are sufficiently flexible that they may be applied in a prudentially sound way to instruments developed by industry going forward.

CEBS is therefore asked to carry out an analysis of the capital instruments recently launched by industry, and to set out its views on the lessons to be learned from this about trends in the quality of regulatory capital. This analysis should include new instruments that national supervisors have recently been asked to consider for own funds purposes. New trends, market conventions and industry expectations should also be considered.

C. The development of guiding principles behind own funds

The Working Group on Own Funds is agreed that a fundamental function of capital is to allow credit institutions to absorb losses. CEBS is asked to elaborate on this view and to reflect on what fundamental purposes own funds and capital should serve.

The Working Group has also agreed that one useful approach in developing principles behind own funds is to identify the limitations of any given instrument for loss absorption purposes. As a starting point, the working group proposes to analyse any such limitations while keeping in consideration the two key elements of capital – principal and interest – and the three typical "life stages" of a credit institution: going concern, in times of stress and in a winding up scenario. CEBS is also asked to elaborate on such limitations on the basis of the elements noted above and to include, as appropriate, other aspects of capital such as:

- quality of capital currently permitted for inclusion in own funds and the interplay between, and importance of, tiers in own funds;
- interaction of own funds rules with accounting standards;
- the scope of the review involving possible co-ordination with CEIOPS;
- the potential relationship/harmonisation with other directives and other cross-sectoral concerns.

D. A quantitative analysis of the types of capital held by credit institutions within the Member States

In order that the Working Group can understand the quantitative impact on credit institutions across member states of any substantial changes to the own funds rules, it will be useful to ascertain the approximate breakdown of the different types of capital currently held in Europe.

CEBS is therefore asked to conduct a quantitative analysis of the types of capital held by credit institutions within Member States. The degree of depth and detail necessary for this analysis is for CEBS to decide but should be balanced with the need to assess in a sufficiently confident manner the effect of any proposed substantial changes.

4. Timetable

CEBS is invited to provide the updated analysis of the implementation of the rules (A) and to conduct the survey of recently launched capital instruments (B) by August 2006. Work should begin as soon as possible also on the development of guiding principles (C) and on the quantitative analysis of the type of capital held by credit institutions (D). A suitable timetable for C and D will be reviewed and further specified in spring 2006.

MAIN RELEVANT LEGAL PROVISIONS

DIRECTIVE 2000/12/EC

CHAPTER 2

TECHNICAL INSTRUMENTS OF PRUDENTIAL SUPERVISION

Section 1

Own funds

Article 34

General principles

1. Wherever a Member State lays down by law, regulation or administrative action a provision in implementation of Community legislation concerning the prudential supervision of an operative credit institution which uses the term or refers to the concept of own funds, it shall bring this term or concept into line with the definition given in paragraphs 2, 3 and 4 and Articles 35 to 38.

2. Subject to the limits imposed in Article 38, the unconsolidated own funds of credit institutions shall consist of the following items:

(1) capital within the meaning of Article 22 of Directive 86/635/EEC, in so far as it has been paid up, plus share premium accounts but excluding cumulative preferential shares;

(2) reserves within the meaning of Article 23 of Directive 86/635/EEC and profits and losses brought forward as a result of the application of the final profit or loss. The Member States may permit inclusion of interim profits before a formal decision has been taken only if these profits have been verified by persons responsible for the auditing of the accounts and if it is proved to the satisfaction of the competent authorities that the amount thereof has been evaluated in accordance with the principles set out in Directive 86/635/EEC and is net of any foreseeable charge or dividend;

(3) funds for general banking risks within the meaning of Article 38 of Directive 86/635/EEC;

(4) revaluation reserves within the meaning of Article 33 of Directive 78/660/EEC;

(5) value adjustments within the meaning of Article 37(2) of Directive 86/635/EEC;

(6) other items within the meaning of Article 35;

(7) the commitments of the members of credit institutions set up as cooperative societies and the joint and several commitments of the borrowers of certain institutions organised as funds, as referred to in Article 36(1);

(8) fixed-term cumulative preferential shares and subordinated loan capital as referred to in Article 36(3).

The following items shall be deducted in accordance with Article 38:

(9) own shares at book value held by a credit institution;

(10) intangible assets within the meaning of Article 4(9) ("Assets") of Directive 86/635/EEC;

(11) material losses of the current financial year;

(12) holdings in other credit and financial institutions amounting to more than 10 % of their capital, subordinated claims and the instruments referred to in Article 35 which a credit institution holds in respect of credit and financial institutions in which it has holdings exceeding 10 % of the capital in each case.

Where shares in another credit or financial institution are held temporarily for the purposes of a financial assistance operation designed to reorganise and save that institution, the competent authority may waive this provision;

(13) holdings in other credit and financial institutions of up to 10 % of their capital, the subordinated claims and the instruments referred to in Article 35 which a credit institution holds in respect of credit and financial institutions other than those referred to in point (12) in respect of the amount of the total of such holdings, subordinated claims and instruments which exceed 10 % of that credit institution's own funds calculated before the deduction of items in point (12) and in this point.

Pending subsequent coordination of the provisions on consolidation, Member States may provide that, for the calculation of unconsolidated own funds, parent companies subject to supervision on a consolidated basis need not deduct their holdings in other credit institutions or financial institutions which are included in the consolidation. This provision shall apply to all the prudential rules harmonised by Community acts.

3. The concept of own funds as defined in points (1) to (8) of paragraph 2 embodies a maximum number of items and amounts. The use of those items and the fixing of lower ceilings, and the deduction of items other than those listed in points (9) to (13) of paragraph 2 shall be left to the discretion of the Member States. Member States shall nevertheless be obliged to consider increased convergence with a view to a common definition of own funds.

To that end, the Commission shall, by 1 January 1996 at the latest, submit a report to the European Parliament and to the Council on the application of this Article and Articles 35 to 39, accompanied, where appropriate, by such proposals for amendment as it shall deem necessary. Not later than 1 January 1998, the European Parliament and the Council shall, acting in accordance with the procedure laid down in Article 251 of the Treaty and after consultation of the Economic and Social Committee, examine the definition of own funds with a view to the uniform application of the common definition.

4. The items listed in points (1) to (5) of paragraph 2 must be available to a credit institution for unrestricted and immediate use to cover risks or losses as soon as these occur. The amount must be net of any foreseeable tax charge at the moment of its calculation or be suitably adjusted in so far as such tax charges reduce the amount up to which these items may be applied to cover risks or losses.

Article 35

Other items

1. The concept of own funds used by a Member State may include other items provided that, whatever their legal or accounting designations might be, they have the following characteristics:

- (a) they are freely available to the credit institution to cover normal banking risks where revenue or capital losses have not yet been identified;
- (b) their existence is disclosed in internal accounting records;
- (c) their amount is determined by the management of the credit institution, verified by independent auditors, made known to the competent authorities and placed under the supervision of the latter.

2. Securities of indeterminate duration and other instruments that fulfil the following conditions may also be accepted as other items:

- (a) they may not be reimbursed on the bearer's initiative or without the prior agreement of the competent authority;
- (b) the debt agreement must provide for the credit institution to have the option of deferring the payment of interest on the debt;
- (c) the lender's claims on the credit institution must be wholly subordinated to those of all non-subordinated creditors;
- (d) the documents governing the issue of the securities must provide for debt and unpaid interest to be such as to absorb losses, whilst leaving the credit institution in a position to continue trading;
- (e) only fully paid-up amounts shall be taken into account.

To these may be added cumulative preferential shares other than those referred to in point 8 of Article 34(2).

Article 36

Other provisions concerning own funds

1. The commitments of the members of credit institutions set up as cooperative societies referred to in point 7 of Article 34(2), shall comprise those societies' uncalled capital; together with the legal commitments of the members of those cooperative societies to make additional non-refundable payments should the credit institution incur a loss, in which case it must be possible to demand those

payments without delay.

The joint and several commitments of borrowers in the case of credit institutions organised as funds shall be treated in the same way as the preceding items.

All such items may be included in own funds in so far as they are counted as the own funds of institutions of this category under national law.

2. Member States shall not include in the own funds of public credit institutions guarantees which they or their local authorities extend to such entities.

3. Member States or the competent authorities may include fixed-term cumulative preferential shares referred to in point (8) of Article 34(2) and subordinated loan capital referred to in that provision in own funds, if binding agreements exist under which, in the event of the bankruptcy or liquidation of the credit institution, they rank after the claims of all other creditors and are not to be repaid until all other debts outstanding at the time have been settled.

Subordinated loan capital must also fulfil the following criteria:

(a) only fully paid-up funds may be taken into account;

(b) the loans involved must have an original maturity of at least five years, after which they may be repaid; if the maturity of the debt is not fixed, they shall be repayable only subject to five years' notice unless the loans are no longer considered as own funds or unless the prior consent of the competent authorities is specifically required for early repayment. The competent authorities may grant permission for the early repayment of such loans provided the request is made at the initiative of the issuer and the solvency of the credit institution in question is not affected;

(c) the extent to which they may rank as own funds must be gradually reduced during at least the last five years before the repayment date;

(d) the loan agreement must not include any clause providing that in specified circumstances, other than the winding-up of the credit institution, the debt will become repayable before the agreed repayment date.

Article 37

Calculation of own funds on a consolidated basis

1. Where the calculation is to be made on a consolidated basis, the consolidated amounts relating to the items listed under Article 34(2) shall be used in accordance with the rules laid down in Articles 52 to 56. Moreover, the following may, when they are credit ("negative") items, be regarded as consolidated reserves for the calculation of own funds:

- any minority interests within the meaning of Article 21 of Directive 83/349/EEC, where the global integration method is used,

- the first consolidation difference within the meaning of Articles 19, 30 and 31 of Directive 83/349/EEC,

- the translation differences included in consolidated reserves in accordance with Article 39(6) of Directive 86/635/EEC,

- any difference resulting from the inclusion of certain participating interests in accordance with the method prescribed in Article 33 of Directive 83/349/EEC.

2. Where the above are debit ("positive") items, they must be deducted in the calculation of consolidated own funds.

Article 38

Deductions and limits

1. The items referred to in points (4) to (8) of Article 34(2), shall be subject to the following limits:

(a) the total of the items in points (4) to (8) may not exceed a maximum of 100 % of the items in points (1) plus (2) and (3) minus (9), (10) and (11);

(b) the total of the items in points (7) and (8) may not exceed a maximum of 50 % of the items in points (1) plus (2) and (3) minus (9), (10) and (11);

(c) the total of the items in points (12) and (13) shall be deducted from the total of the items.

2. The competent authorities may authorise credit institutions to exceed the limit laid down in paragraph 1 in temporary and exceptional circumstances.

Article 39

Provision of proof to the competent authorities

Compliance with the conditions laid down in Article 34(2), (3) and (4) and Articles 35 to 38 must be proved to the satisfaction of the competent authorities.