8 April, 2011

Questions and answers

Q: **Why has the EBA chosen to use Core Tier 1 (CT1) as a benchmark this year?**

A: The EBA wanted to define criteria for capital that is simple, issued directly by the institution itself and able to meet the criteria of permanence, flexibility of payments and loss absorption in going concern situations.

Q: **Are all government support measures included in the EBA Core Tier 1**?

A: The EBA Core Tier 1 definition only includes instruments subscribed by public authorities under government support schemes and put in place under exceptional circumstances. Furthermore, a distinction is made in terms of disclosure between ordinary shares subscribed by governments and other government support measures.

Q: Why have you set a 5% threshold?

A: The 5% CT1 benchmark is not a legal minimum requirement. However, supervisors across the EU have reached an agreement that a higher threshold than the legal minimum is necessary in assessing the resilience of banks in adverse circumstances if credibility and confidence in the banking sector is to be restored. Whilst it is not a legal minimum it is expected that any bank failing to meet the benchmark or showing specific weaknesses in the stress test will agree with the relevant supervisors the appropriate remedial measures and execute them in due time.

Q: How are participations treated?

A: The deduction of participations is applied (50% from Tier 1) in line with the current prescriptions of the CRD (art. 57; art. 66). In the EBA stress this will be deducted from Ct1. It is possible under existing transitional arrangements of the CRD to apply different treatment in different countries (art. 154.4) regarding the deduction of insurance participations. Therefore the amount of participations not deducted from CT1 will be clearly disclosed.

Q: How are secondary contracts treated?

A: Secondary contracts or any other arrangements with the subscriber of the original instrument which are deemed to undermine the quality of the original instrument itself (e.g. dividends and voting rights) shall lead to the exclusion of the original instrument from CT1.

Q: **Why didn't the EBA choose to adopt the Basel 3 definition of Common Equity Tier 1**?

A: Although the EBA did choose to use a conservative definition of capital for the purpose of the stress test exercise, it did not choose to anticipate the definition agreed by the Basel Committee of Banking Supervisors under the recently revised framework, commonly known as Basel 3. The Basel 3 definition will be implemented in 2013 only and is subject to transitional arrangements in order to ensure a smooth changeover to the new regime.

Q: **What is the difference between the Basel 3 definition of Common Equity Tier 1 and the EBA definition of Core Tier 1**?

A: The wording of Core Tier 1 should not be confused with the Basel 3 Common equity Tier 1 since the two concepts are somewhat different in the detail, although not that far removed conceptually and in their impact. The difference is mainly on the deductions which are operated. The EBA Core Tier 1 definition is based on the current concept of "total original own funds for general solvency purposes" whose calculation is provided in the revised framework on Common Reporting (COREP) from which hybrid instruments are deducted. Certain elements of the two definitions converge (this is the case for example for the deduction of goodwill). Other elements diverge (this is the case for example of the deductions of deferred tax assets or participations in financial institutions). Another example is that there is no adjustment applied to remove unrealised gains or losses from Common Equity Tier 1 under the Basel 3 definition, whereas prudential filters are applied in the EBA definition. Both definitions are nevertheless very close in terms of positive elements of common equity (i.e. before applicable deductions and adjustments).

Q: **Is the EBA definition of Core Tier 1 more or less severe than the Basel 3 definition of common equity Tier 1**?

A: There is no single answer. In some ways, the EBA definition may be considered as stricter for example because it requires the deduction of participations in financial institutions from Core Tier 1 as from now, without the transitional arrangements found in Basel III. On the other hand, it does not address issues such as deferred tax assets. The Basel 3 definition will be fully implemented only after the end of the transitional period (2018).

Q: **Is the EBA definition fully harmonised across all the banks in the sample**?

A: The EBA definition is based on the application of current CRD concepts of positive elements of Common Equity Tier 1 and hybrid instruments (which are removed from the definition). This definition has to be used in conjunction with CEBS/EBA guidelines in this field. In some areas, the CRD leaves room for interpretation or some leeway to Member States in the implementation of some of the provisions included in the directive. The elements of capital disclosed for the stress test exercise are consistent with the data published by banks for 2010.

Q: **What is the purpose of disclosing elements of capital other than Core Tier 1 elements?**

A: A detailed disclosure ensures transparency of the stress test exercise and allows market participants to make additional calculations if deemed necessary, in particular with respect to the Basel 3 definition of Common Equity Tier 1. It also provides information on backstop measures.