Swedish Bankers´ Association
Svenska Bankföreningen

POSITION PAPER
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Committee of European Banking Supervisors
By email to:
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CEBS Consultation paper on Draft Implementation Guidelines regarding instruments referred to in Article 57(a) of Directive 2006/48/EC recast (CP33)

The Swedish Bankers' Association welcomes the opportunity to comment on the proposal on implementation guidelines on capital instruments.

We appreciate the principles based approach chosen by CEBS, but it is our opinion that CEBS goes beyond the documented intention of the CRD II. Since the Commission and the Basel Committee is currently working on the same issue we see these guidelines as short-lived and therefore we would ask CEBS to not go beyond what is required by CRD II. Instead further amendments should be done as soon as the new requirements are finalised. We would also like to further stress the importance of the following issues.

Grandfathering rules
In the consultation paper there are no grandfathering rules. It is our opinion that these have to be elaborated since markets and banks are confused by interaction of

- CRD II which states grandfathering rules for hybrids from end of 2010,
- The announcement from the Basel Committee that grandfathering is for instruments issued until the 17th December 2009, even though there are no final rules until the end of 2010, and
- CP 33 which has no grandfathering rules at all.

Voting rights
Paragraph 38 of the document says that particular supervisory scrutiny should apply when capital is divided into classes of shares with different voting rights in order to consider whether such a division creates a privilege for one of the classes or affects the general loss absorbency capacity. During the CEBS hearing in London on the 23rd of February, it was stated that merely a difference in voting rights was not considered to create a privilege for one of the classes or affect the general loss absorbency capacity. It is our opinion that this view should be clarified in the final document. This is important for us since in Sweden it is common to have shares that are identical apart from the difference in voting rights were the A-shares might have 1 voting right per share and the B-shares might have 0.1 voting rights per share.

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Buy-backs
Paragraph 46 of the document says that both redemption and buy-backs are subject to a prior supervisory approval. This goes further than both the CRD II and the current consultative document CRD IV and the consultative paper from the Basel Committee.

The guideline in paragraph 47 states that buy-backs should not be announced to holders before the institution has obtained the prior approval from the competent authorities. It's difficult to understand how this guideline would interact with national corporate law which states that a decision to buy back own shares are decided by the shareholders' general meeting. In connection with this decision is the mandate to buy-back and its size announced.

Paragraph 48 of the document says that when redemption and buy-backs are deemed to take place with a sufficient certainty the corresponding estimated amounts to be redeemed or bought back shall be deducted from original own funds while waiting for the effective redemption or buy-back to occur. We are of the opinion that there should be a deduction ones the shares have been bought-back. This is important to avoid unwelcome interpretation issues regarding "sufficient certainty" and "estimated amount". It should in any event be clarified that an announcement in itself is not regarded as "sufficient certainty" and that the size of the mandate shall not be regarded as an "estimated amount".

In CRD III it is stated that at least 50 percent of any variable remuneration should be made in shares or share-linked instruments of the credit institution. It also states that at least 40 percent of the variable remuneration component should be deferred over a period which is not less than three years. Buy-backs of own shares are usually done to hedge the risk related to variable remuneration to be made in shares or share-linked instruments. It is important that this process can run smoothly without any prior approval by competent authorities.

For these reasons we do not agree that buy-backs should be subject to a prior supervisory approval.

Flexibility of payments
We assume that the intention of paragraph 69 would be that any preferential right is limited in relation to the instrument that does not have the preferential right. In this respect we find the wording *multiple* unclear and suggest that this paragraph is rephrased as follows: "...the potential preference ... that some of them may have shall be limited *in relation to* the dividend on the instrument that does not have a preferential right."

Loss absorbency in liquidation
In general, we welcome CEBS' proposed guidelines and in particular the aim of introducing a common definition of capital instruments that can be included in Core Tier 1 Capital. However, we find that CEBS' interpretation of article 57(a) as regards the requirements on loss absorbency in liquidation (criterion 9) is too far-reaching and not in line with the wording of article 57(a).

Article 57(a) states that original own funds shall consist of equity capital provided it fully absorbs losses in going concern situations, and in the event of bankruptcy or liquidation ranks after all other claims. Even though recital 4 has a somewhat ambiguous wording regarding ranking in liquidation, it cannot overtake the wording of article 57(a). Our conclusion is hence that the intention of the directive is that core capital within banks' original own funds should include all equity share instruments that are referred to in the national definition of equity

share capital, as long as they fully absorb losses on a going concern basis and represent the most subordinated claim during liquidation.

Notwithstanding the fact that CEBS' interpretation is in violation of the wording in article 57(a) there are also factual matters why this interpretation has flaws and will not be in the best interests of the stakeholders:

- The requirements described under criterion 9 are not relevant in deciding whether capital instruments contain the necessary features in order to qualify for inclusion into Core Tier 1 Capital. It is irrelevant if different classes of equity capital have different ranking in the event of a liquidation. The important factor is that the shareholders collectively are subordinated to all other claim holders, and thus jointly represent the most subordinated class or "the last line of defence" both during going concern and in liquidation. It must be up to the shareholders to decide differences between the different types of class, which are done at a shareholders' general meeting. Any such agreement amongst the shareholders leaves their joint relationship toward the rest of the claim holders unaffected, which should be the only concern of the regulators.
- To be able to attract equity capital in the event of a financial turmoil it is of greatest importance that different ways to have access to the capital market are available. To offer investors shares with prior ranking to ordinary shares in liquidation might be one way to ease the supply of equity share capital in a crisis situation. If this type of equity capital is questioned from a Core Tier 1 Capital perspective it will affect banks access to capital markets, particularly in stressed situations which will be contrary to the aim to create financial stability.
- In the event that a financial institution is in need of capital in a crisis situation and there is no other source than from the government, it would be contrary to the interest of the government (and of the tax payers) to be forced to accept a rights issue of ordinary shares. This will increase the risk that tax payers money is used to bail out the original shareholders rather than preserve stability in the financial system. It would in such a situation be preferable for a government to be able to demand shares with a preferential claim in comparison to the original shareholders in case the rescue action will end up with an orderly liquidation where the shareholders are able to realize a residual claim on the institution.

To conclude we are of the opinion that the requirements stipulated by CEBS in criterion 9 ought to be redrafted in order to better reflect that the relevant distinction in a liquidation situation is between claim holders in general on one hand and the shareholders collectively on the other. This distinction is inherent in the type of claim each of these categories represent and is the only relevant distinction in a liquidation situation.

Against this background we want to provide rephrased versions of criterion 9 and subsequent guidelines 78-79:

Criterion 9: Capital instruments must ~~be pari passu among themselves and~~ have the most subordinated claim in liquidation. They are <u>thus</u> entitled to a claim on the residual assets <u>after all other claims are satisfied</u>~~that is proportional to their share of capital and not a fixed claim for the nominal amount~~.

Guideline 78: Any instrument, other than ordinary shares, eligible for inclusion in original own funds referred to in Article 57(a), shall rank after all other claims ~~and rank pari passu with ordinary shares~~ during liquidation, thus jointly absorbing losses ~~on a pro rata basis~~ with ordinary shareholders.

Guideline 79: The holders of such an instrument should, therefore, ~~have no priority in liquidation and no fixed claim on the nominal amount of their holding. They do, however,~~ have a claim on any residual amount only after all other claims are satisfied reflecting their share in the credit institution. ~~This would mean in practice that i~~In case the institution has more than one category of capital instruments (i.e. ordinary shares and other capital instruments) with different ranking in liquidation, on a break-up basis the proceeds from the realisation of the credit institution's assets are applied firstly to satisfy all prior claims (e.g. depositors, creditors, holders of subordinated instruments) and any residual amount is distributed between the ordinary shareholders and the holders of such other capital instruments ~~on a pro rata basis~~ in accordance with the articles of association, or equivalent, of the institution.

The proposed wording of criterion 9 is of particular concern for Swedish institutions since it might risk disqualifying Swedish preferential shares as core equity capital. These shares are according to Swedish legislation equity share capital. In all essential parts such preference shares are equal to ordinary shares (subordinated to all other claims, voting rights as ordinary shares, the AGM decides on dividend payments implying the same loss-absorbing capacity as ordinary shares etc). The preference shares might have the feature that they rank prior to the ordinary shares in the event of a liquidation, but are still subordinated to all other claims, i.e. the preference shares and the ordinary shares jointly represent the most subordinated class or "the last line of defence" both during going concern and in liquidation. The differences between the ordinary shares and the preference shares are agreed on by the holders of ordinary shares at a shareholders' general meeting deciding on the issue of the preference shares. It only affects their relative liaison but more importantly, it leaves their joint relationship toward the rest of the claim holders unaffected. It should also be noted that the issue of difference in precedence among shareholders only would become relevant in the event of an actual liquidation and in the case there is still funds remaining after satisfying the claims of all other claimholders.

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