European
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Federation

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EBF COMMENTS ON THE CEBS DRAFT IMPLEMENTATION GUIDELINES ON INSTRUMENTS REFERRED TO IN ARTICLE 57 (A) OF THE CRD (CP 33)

GENERAL COMMENTS

1. We welcome the principles based approach which the proposed implementation guidelines have adopted, reflecting the intention of the legislator, laid down in CRD 2.

2. We see significant process issues as the Basel Committee is currently working on a new definition of Own Funds.

Our understanding is that the draft guidelines are meant to anticipate to what will be decided by the Basel Committee, which explains why the proposed guidelines go beyond what is strictly required under the current CRD provisions and recital 4 of CRD 2 in particular.

We believe such an approach to be inappropriate:

- the mandate that the European legislator has given to CEBS was to elaborate guidelines implementing existing legislation. What CEBS proposes is, therefore, *ultra vires*;
- anticipating on what the Basel Committee will decide would be premature as the consultation process on the Basel proposals is still ongoing;
- acting as though what the Basel Committee will decide was already enshrined in CRD 2 would mean putting EU banks at a competitive disadvantage as it would imply, amongst others, bringing forward the implementation date of the Basel proposals.

On these grounds, we believe that further amendments which may need to be made in the light of the Basel Committee's decision on the definition of Own Funds can be envisaged only once the Basel Committee's decisions will have been published.

3. The proposed CEBS guidelines are not sound from a legal point of view where they go beyond what the European legislator wished to achieve when approving CRD2.

a. Ordinary shares are defined as the benchmark for Core Tier 1 (paragraphs 17 and 34). Such an assertion does not find any support in the text of CRD2 or in recital 4. Those texts refer to the Banking Accounts Directive according to which "subscribed capital" comprises "*all amounts, regardless of their actual designations, which, in accordance with the legal structure of the institution concerned, are regarded under national law as equity capital subscribed by the shareholders or other proprietors*" (Article 22 of Directive 86/635/EC).

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Clearly, the text of Article 22 contradicts the statements made in the proposed guidelines that:

- "*according to Article 22 of Directive 86/635/EEC only equity capital can be regarded as subscribed capital*" and that "*it must not, therefore, be accounted as a liability under national accounting standards (or IFRS if a Member State uses IFRS as the relevant accounting standard*)";
- "*the capital must be contributed by the legal owners of the credit institution (shareholders or other proprietors)".* The concept of "legal owner of the credit institution" which is being used in the proposed guidelines as a decisive criterion finds no support in the text of Article 22 which refers to "shareholder and other proprietor" - (meaning proprietor of the instrument).

b. Neither the text of Article 57(A) CRD or Recital 4 provide any support for the conclusion drawn in the proposed guidelines (criterion 7) that instruments which have distributions tied to amounts paid in or capped distributions need to be excluded. Moreover, we assume that the intention of paragraph 69 is 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...*"

c. Neither the text of Article 57(A) CRD nor of Recital 4 provide any support for the conclusion drawn in the proposed guidelines (criterion 3, paragraph 45) that instruments issued via SPVs need to be excluded.

d. According to Paragraph 46 of the proposed guidelines, both redemption and buy-backs are subject to *a priori* supervisory approval. This goes beyond what the CRD2 requires.

e. The proposed interpretation of Article 57(a) as regards to the requirements on loss absorbency in liquidation (criterion 9) is not in line with the wording of Article 57(a).

4. CP 33 does not propose grandfathering rules. We believe introducing grandfathering arrangements to be crucial to ensure a smooth transition to the new standards.

Grandfathering arrangements should include State Aid arrangements, as the G-20 highlighted. Such arrangements would need to cover Government Injections of Core Capital. Moreover, the existence of such Core Capital with any privileges attached should not disqualify any other core capital instrument that would meet the requirements if such Government Injections did not exist.

It needs to be observed, finally, that markets and banks are confused by the interaction of CRD 2 (which contains a set of states grandfathering arrangements for hybrids instruments from end of 2010 onwards), CP 33 (which has no grandfathering rules) and the Basel Committee's Resilience paper (which has announced grandfathering but only for instruments issued until 16 December 2009).

DETAILED COMMENTS

1. Restriction on Financing Purchases by Third Parties of Own Shares (Criterion 2)

- It would be useful to clarify that the objective of this criterion is to discard financial engineering aiming at transforming intentionally debt into equity and, therefore, does not preclude normal banking relationships with institutional investors or retail customers (including bank employees) who may at the same time have credit facilities and a portfolio invested in bank's shares amongst other securities.

2. Buy-backs

We do not agree that it would be appropriate to make buy-backs subject to prior supervisory approval.

- The guideline referred to in Paragraph 47 states that buy-backs should not be announced to holders before the institution has obtained the prior approval from competent authorities. It is difficult to understand how this guideline would interact with national company law stating that any decision to buy back own shares (including the size of the transaction) is exclusively within the remit of the General Assembly.

- According to Paragraph 48 of the Consultation Paper, 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.

  Our position is that a deduction can be considered only once the shares have been bought-back as it is the inflow of capital that should be decisive. Moreover, what is being proposed is unavoidably likely to raise unwelcome interpretation issues (what dies "sufficient certainty" and "estimated amount" mean precisely?).

- CRD III states that at least 50% of any variable remuneration should be made in shares or share-linked instruments of the credit institution. It also states that at least 40% 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.

- The proposed guidelines do not consider market making. Market making activities should be allowed in principle, up to a certain percentage (e.g. 5%-10%) of the issued amount of a specific instrument.

3. 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.

We agree with the conclusion that voting rights are irrelevant as long as different rights do not create privileges.

4. Flexibility of payments

- According to Criterion 7 payments of dividends are paid out of distributable items and are not cumulative. The level of distribution is not in any way tied or linked to the amount paid in at issuance.

  We do not believe the requirement to not tie the distributions in any way to the amount paid in at issuance to be appropriate. There are several cases of core Tier 1 capital within European banks where the capital meets the requirements of Article 57 (a) in conjunction with recital 4 where the distributions are linked to the amount paid in at issuance. Again, this requirement would exceed the ground of the directive. In addition, the proposed requirement would exclude for the future that part of the market representing 'fixed income' investors who accept loss absorbency but require a return, if paid, to be linked to the investment.

  On these grounds distributions linked to the amount paid in issuance should be allowed. The same arguments hold true for paragraph 66 which proposes that instruments other than ordinary shares would only qualify if the dividends on these instruments replicate the behaviour of dividends on ordinary shares'. This paragraph should be eliminated as well.
- It is proposed that, if the institution has issued different instruments that are eligible under Article 57(A), the potential preference (preferential rights mentioned in Recital 4) that some of them may have shall be limited to a multiple of the dividend on the instrument that does not have a preferential right (paragraph 69). Again, we ask for deletion of this paragraph (see our arguments above).
- It is proposed that the amount of payments need to be fully discretionary. – meaning that there shall be no pre-indication on the amount that will be paid and that a fixed amount (= percentage of the nominal amount) is not acceptable (paragraph 70). The same arguments as above hold true and we therefore ask for deleting at least the second and the third sentence of the paragraph.

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