European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

***Committee of European Banking Supervisors***

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VH/B2/10-045

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**Consultation Paper on Implementing Guidelines regarding Instruments referred to in Article 57 (a) of Directive 2006/48/EC recast (CP 33)**

Dear Sir/Madam,

The European Association of Co-operative Banks (EACB) welcomes the opportunity to comment on the Implementing Guidelines regarding Instruments referred to in Article 57 (a) of Directive 2006/48/EC recast.

Please find our general and specific remarks on the following pages.

We remain at your disposal for any further questions or requests for information.

Yours sincerely,

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General Manager

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Head of Legal Department

## GENERAL REMARKS

### The nature of the guidelines

While CP 33 is to be an interpretation of the CRD (as amended by directive 2009/111/EC), based on a mandate given by that directive (Article 63a (6)), the substance of its 10 criteria seem to be almost the same as the 14 criteria of the Basel consultative document "Strengthening the resilience of the banking sector".

We appreciate that supervisors illustrate the Basel criteria, especially with regard to co-operative shares and as such allow for a better understanding of the Basel criteria and a meaningful discussion. However, we also see difficulties in implementing these guidelines as long as the Basel criteria are not definite and relevant EU legislation is not on the way: CEBS' guidelines are not binding and rather an agreement between supervisors to "comply or explain". While CEBS' guidelines may require changes of (co-operative) laws, not all national legislative institutions may be willing to accept guidelines as a basis.

Furthermore, since some terms in directive 2009/111/EC remain relatively general (e.g. fully loss-absorbing in going concern situations), national legislators may not find it evident to accept certain elements of CP 33 (e.g. "(…) equity capital provided by the legal owners (…)"; criterion 1).

### The criteria and their underlying approach discriminate against co-operative banks

The members of the EACB appreciate, that CEBS, like the Basel Committee, has chosen a principle-based approach for the definition of capital.

However, CEBS like the Basel Committee takes the view that *"ordinary shares should be the benchmark for assessing the features of instruments issued by joint stock or non joint stock companies that may be included under Article 57(a)"* (paragraphs 17 and 34). The 10 criteria for the definition of capital according to article 57 a) drafted by CEBS reproduce the picture of a share of a joint stock company, while excluding shares of co-operative banks from that category. A more neutral or even a more functional approach could be a better choice. We even wonder whether the approach, as indicated in paragraphs 17 and 34 is in line with the Directive. Policy-makers should afford parity of esteem to the co-operative and mutual model alongside the "joint stock model".

Therefore paragraphs 17 and 34 could be amended as follows:

> *17. « Ordinary shares, <u>or capital instruments of non joint stock companies equivalent in terms of capital qualities in the meaning of Article 57(a) of Directive 2006/48/EC</u>, should be the benchmark for assessing the features of instruments issued by joint stock or non joint-stock companies that may be included under Article 57 (a) »*

*34. « CEBS considers, therefore, that ordinary shares, <u>or capital instruments of non joint-stock companies equivalent in terms of capital qualities in the meaning of Article 57(a) of Directive 2006/48/EC</u>, should be the benchmark for assessing the features of instruments issued by joint stock or non joint-stock companies that may be included under Article 57 (a) »*

We ask for a real recognition of the cooperative model: all cooperative instruments (cooperative shares and certificates) should be eligible as core tier one capital as it is for ordinary shares. Cooperative banks need legal security and therefore regulation should be neutral regarding different legal models of companies.

Claims to net assets or prohibition of caps, if relevant for joint-stock companies, are not relevant for cooperative banks. They should not be applied to the cooperative instruments.

**Access to net assets and allocation of reserves to shareholders**

The criteria (especially Nr. 8 and 9) are based on the presumption that the holder has the claim to a share of the assets of the entity and that he is entitled to a percentage of the assets of the entity that remains after all higher priority claims have been satisfied. Apparently, the idea is that, in a joint stock company, only those instruments qualify, which bear the ultimate risk and which are entitled to the ultimate rewards inherent in the entity and its activities. Admittedly, without such instruments and their holders the entity could not exist. This excludes other claimants to the entity‘s assets, even if they bear risks and are entitled to rewards. However, the latter may be considered to be at least partially protected from risk by common equity instruments, and their share of the rewards is limited. Accordingly, the perspective of criterion 8 and 9 is rather a shareholder perspective.

Thus, the intention of criterion 8 (and 9) is not to ensure loss-absorption[1], but rather to make the definition of capital as narrow as possible in order to exclude, ***in a joint stock company***, any other instrument from common equity, especially sophisticated hybrid instruments.

However, such criteria lead to inappropriate results, when the business purpose and governance of an undertaking are different to those of a joint stock company. Also a co-operative bank could not exist without its shareholders, whose economic interest it has to promote. However, “the ultimate reward” inherent in a co-operative is not maximum profit, but rather the provision of a maximum of usefulness to its members, while ensuring the existence of the undertaking beyond the participation of individual members. While co-operative capital and reserves are paid in and are available to cover losses, reserves (retained earnings) in a co-operative are normally fully (sometimes only in part) indivisible: at least as long as the co-operative is going concern, if not also in liquidation, members do not have access to reserves. Members/shareholders have renounced their access to net assets in order to ensure the proper

[1] Where available, it is always the reserves that take the first losses, not the instrument. According to 57 b) reserves is a separate element of common equity anyway.

functioning of the co-operative beyond their capital involvement. Nevertheless, retained earnings are fully available for the business of the co-operative. They even form a kind of capital, exclusively dedicated to the purpose of the business. Since neither members nor anybody else has access to net assets (retained earnings), those funds are ultimately dedicated to the common business purpose even after liquidation.

Other claimants to the entity‘s assets are protected from risk by co-operative shares and capital as much as in a joint stock company: from an accounting perspective, there is absolutely no difference between the impact of losses on capital and retained earnings in a co-operative and a joint stock company[2].

This makes evident that by criterion 8 and 9 CEBS (like the Basel Committee) takes a very exclusive "shareholder (or ownership) perspective[3]" rather than a "creditor perspective". From a creditor perspective and also from a prudential perspective, the decisive question regarding capital is whether it can fulfil the function as risk capital "*providing a buffer, a cushion for the entity in terms of variances in its performance*"[4] or, in terms of article 52 a), whether it absorbs losses in going concern situations[5].

**Thus, co-operative shares are in no way of lesser quality than shares of joint stock companies. Therefore, we think that applying criterion 8 and 9 to co-operative and mutual banks would lead to absolutely inappropriate results. While we appreciate that CEBS is trying to transpose the criteria to co-operative and mutual entities, we think that it would be better to delete the second sentence of criterion 9:**

> *"Capital instruments must be pari passu among themselves and have the most subordinated claim in liquidation.*
> ~~*They are entitled to a claim on the residual assets that is proportional to their share of capital and not a fixed claim for the nominal amount."*~~

### Permanence and "Redeemability" of Co-operative Shares

The permanence criteria 4, 5 and 6 are equally based on the situation of joint stock companies, while ignoring realities regarding co-operative banks. They create problems, both for co-operative shares of the IFRIC 2 – type and for the classic ones. In fact, the redeemability of shares is a specific co-operative element, linked to the specific governance and business model of a co-operative.

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[2] This shows that criterion 8 rather intends to ensure the allocation of reserves to the shareholder.

[3] See also FASB, Preliminary Views - Financial Instruments with Characteristics of Equity November 30, 2007, p. 5, http://www.fasb.org/pv_liab_and_equity.pdf

[4] EFRAG et al: Pro-active Accounting Activities in Europe; Discussion Paper: Distinguishing between Liabilities and Equity, January 2008, page 46.

[5] As regards hybrid instruments, CEBS applies different criteria for "loss-absorbing on a going concern basis. Criterion 8 rather defines the „loss-sensitivity" of an instrument, but not loss-absorbency.

Due to the principle of “open membership”, normally any citizen may decide to become a member, use the services of a co-operative, but also leave the co-operative at any time.

As a general rule, becoming a member in a cooperative bank implies the acquisition of at least one share[6]. Face values tend to be low in order to allow as much citizens as possible to adhere. The co-operative charter or governing board often establishes a maximum number of shares that a member/shareholder may purchase. By consequence, the capital amount per member usually is fairly limited, while the number of member shareholders is comparatively high. By consequence, the capital structure is normally highly granular (low face values).

Furthermore, co-operative shares are not meant to attract commercial investors. Dividends tend to be moderate and members do not have access to net assets (see above), which means that the value of their share normally equals the face value, unless there is an even lower book value. Thus, a member may adhere to a co-operative for decades, but when leaving the co-operative the value of his share normally remains the same.

While undated, co-operative shares are usually settled by redemption to the co-operative bank. Only very few co-operative banks have their shares listed or organize a trade between members. This redemption is nothing but a surrogate for market trading. However, members’ claims are not subject to market volatility. And speculation, especially leveraged speculation by short-selling shares, is excluded.

In Europe, redemptions of member shares in any year average about 1% of outstanding shares. At the same time, the overall amount of subscribed capital remained stable or is even increasing.

Furthermore, there are many mechanisms in different Member States to ensure that the capital basis remains stable and thus a permanence of capital is ensured.

In fact, the bank’s obligation to make payments is subject to numerous regulatory restrictions. All in all two models can be distinguished.

In those co-operative banks that are subject to IFRS, the co-operative or its board have the unconditional right to decline requests for redemption. Following the adoption of IFRIC 2, many jurisdictions have implemented changes to their co-operative laws and thus provide for:

- Possibilities for an unconditional refusal of the redemption of shares (IFRIC 2 option 1)
- Or for introducing a level below which capital must not fall due to redemption (IFRIC 2 option 2)
- In some jurisdictions combinations of both elements exist.

In other co-operative banks, especially those that are not subject to IFRS, there are normally many elements that make redemption are very heavy process:

[6] In general, being a customer in a co-operative does not automatically imply membership.

- The request for redemption has to be presented within a certain delay. Payments will only take place at the end of the business year after the approval of accounts and the distribution of profits by the general assembly.
- National law or the bank's statute may require postponing the payments even for a longer period.
- Members remain liable for losses for several years after their reimbursement.
- In case of resignation members maximally receive the face value of their member shares and leaving members may loose their right to do business with the cooperative. Therefore, there are barely any inducements for members of cooperatives to resign.
- Very often the above restrictions are supplemented with supervisor's powers to limit or exclude the redemption due to capital or solvency requirements.

Thus, there are sufficient mechanisms to ensure a stable capital base.

In addition, member shares do not possess any features which could cause the condition of the institution to be weakened as a going concern during periods of market stress.

Even throughout the most severe moments of the recent crisis, the capital bases of co-operative banks remained stable. Thus, co-operative shares have to be considered equivalent to the situation of joint stock companies regarding criteria 4, 5 and 6.

**Grandfathering / Transition Periods**

We suggest that CEBS should review these guidelines with regard to the wording of article 154 (9) of the CRD: At this moment in time, when discussions on the definition of common equity are neither finalized at the European level nor at Basel, national legislators may find it inappropriate to launch regulatory changes, even more on the basis of guidelines that are not of a binding nature.

Furthermore, it should be taken into consideration that when CRD 2 was adopted, nobody could have expected that the substance of these guidelines would be as it is today.

This does not only apply to co-operative banks and their shares, but also for other banks and instruments.

We therefore encourage CEBS to take a pragmatic and understanding approach to "comply or explain" that not only does not hamper progress, but also ensures a smooth transition.

## SPECIFIC REMARKS

### A. Definition of capital in the sense of Article 57 (a) and Recital 4

**Criteria 1 to 3**

> **Question 1:**
>
> **1.1. Are the guidelines in relation to the features of capital instruments sufficiently clear, or are there issues which need to be elaborated further? Please provide concrete proposals as to how the text could be amended.**
>
> **1.2. Are there any circumstances under which indirect issuances would be justified? Please provide evidence.**

- In our view it has to be ensured that the term “legal owner” is not misunderstood. In fact, the notion of a “legal owner” may not be the same for all companies. This could be to the detriment of certain company forms, including co-operatives. Due to the fact that there is no access to net assets, some may dispute “legal ownership”. Therefore, it is crucial that the term is explained, as under paragraph 40, where it is clarified that it is a synonym for shareholders and other proprietors as defined by article 22 of directive 86/635/EC.
- We suggest clarifying in paragraph 40 that IFRS are only relevant, where they are imposed by relevant legislation or where they are used by the institution due to an option in national law.
- Since criterion 1 imposes and equity treatment under relevant accounting standards, we encourage CEBS to properly consider the substance of such accounting standards, in particular of IFRS, when defining any criteria for the (prudential) equity treatment of shares of co-operative banks. The substance of IFRIC 2, which will probably be maintained in a revised standard (to be adopted in 2011), is of core importance in this respect.
- As regards paragraph 44, it has to be taken into account that members/shareholders are doing business with the bank. In most cases, the co-operative bank also provides all kinds of loans to its members. The drafting should consider this.
- Furthermore, as regards joint stock companies, paragraph 44 should allow market-making or market-smoothing activities.
- We think that the possibility should remain for banks to issue, apart from their “prime class instruments”, other financial instruments as common equity. While we see that CEBS guidelines should exclude “structuring opportunities” as much as possible, they should not be overly restrictive either. The highly imprecise wording under paragraph 38 is not helpful in this respect. In particular, it has to be underlined that recital 4 allows multiple dividends. Furthermore, the Basel Committee’s criterion 7 only imposes limits on preferential distributions. There seems to be a significant difference,

however, between “privileges” and preferential distributions. The latter would not include multiple dividends. CEBS should avoid any “gold-plating” in this respect. In particular, there should not be any obstacles to create non-voting stock with multiple dividends.

- Furthermore, we would like to recall that in many jurisdictions company law allows entities to issue more than one type of “capital instruments” and that such concepts have worked well in the past. The existence of different categories of instruments should not be prohibited, especially when the prudential rationale of such a prohibition is not evident. Consequently, paragraphs 77 and 80 should be amended in order to allow several categories of instruments.
- Special consideration has to be given to the fact that in some countries, like the UK, it is not possible for a co-operative (or certain other types of mutual banks) to operate a banking business other than through a joint stock company subsidiary (i.e. a non-mutual company). Such banks should be able to issue instruments with limited voting-rights as core tier 1 capital to external investors in order to preserve mutual/co-operative credentials.

**B. Permanence**

**<u>Criteria 4 to 5</u>**

> **Question 2:**
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> **2.1. Are the guidelines in relation to Permanence sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals as to how the text could be amended.**
>
> **2.2. Are there any circumstances under which prior approval of competent authorities for redemptions and buy-backs would not be justified? Please provide evidence.**
>
> **2.3. Are there any circumstances under which the deduction from own funds is not justified when the issuer has publicly announced its intention to buy-back? Please provide evidence.**

- As we have pointed out in our preliminary remarks, the members of the EACB consider criterion 4, in principle, as discriminating against co-operative banks. Therefore, we highly appreciate that CEBS is taking into account the redemption of co-operative shares (paragraph 52 ss.)
- The situation of co-operatives cannot be compared to the announcement of a buy-back program of shares in joint stock companies:
    - o In the case of co-operative banks, as variable capital entities, redemption, together with the continuous issue of new shares, are surrogates for the trading of an instrument at face value.
    - o While leaving members of a co-operative bank are redeemed, new members enter and bring new capital. As a general rule, the redemption rate within European co-operative banks is around 1% per year, with, in most cases, a steady overall increase of share capital over the years. Sell-back programs, however, automatically lead to a reduction of capital.
    - o The redemption of shares in a co-operative bank does not affect the value of the remaining shares. The "market value" remains face value. Since buying and redeeming co-operative shares normally do not imply capital gains or losses they are not specifically "interesting" for members. They do not imply or create the same incentives and the same expectations as a sell-back program of shares in a joint stock company. In particular, they do not raise any expectations at capital markets.
- CEBS suggests that redemption of shares should be restricted if solvency is endangered and that competent authorities should have the possibility to refuse or to limit redemption (paragraph 55).
- In the cooperative banks, there are often internal approval processes, which provide the institution with the option to reject the holder's request. In particular if the prudential situation of the institution (paragraph 54) so

requires, such process is a proper way to ensure that the condition of the institution is not weakened when going concern during periods of market stress. As regards the approval process, we would like to point out the following:

  - o For those co-operative banks which apply full IFRS, it is crucial that a clause according to which the boards of the co-operative banks have the unconditional right to refuse redemption or a level is fixed by national law, below which capital must not fall[7] meets the condition of paragraph 54. We think that such a provision gives a maximum of discretion and power to banks regarding redemption and therefore ensures the possibility to react easily. In this context, we would like to stress again the importance of a convergence of the prudential and accounting approach. Therefore, we would like to see that CEBS confirms that paragraph 55 does not apply when cooperative banks comply with IFRIC 2.
  - o There are also some non-IFRS banks that dispose of mechanisms to refuse redemption.
  - o Finally, we would like to recall that the redemption of co-operative shares normally is a very heavy process, going beyond the business year (see page 5). During this heavy, but also rather lengthy process, supervisors have sufficient time to interfere as required under paragraph 55. Thus, it should be sufficient that statutes give the banks the power to implement supervisory decisions.

- There may be other ways to avoid weakening of the cooperative's condition during periods of market stress. With regard to the differences between jurisdictions, it should be left to the national supervisory authorities to check the appropriateness of the regulations and to report on them.
- If the proposal of the Basel Committee to build "buffers through capital conservation" is to become reality (Basel Committee, Strengthening resilience of the banking sector, Nr. 247 ss.) then there would be additional mechanisms to ensure an appropriate level of capital in co-operative banks.
- It seems that paragraph 56 does not take into account that during the business year co-operatives do not only redeem capital, but also issue capital. While redemption may be relevant, it is normally more than compensated by the entry of new members. It therefore seems crucial that a "net perspective" is taken: if that capital reduction due to redemption remains below certain limits (*de minimis*) or is offset by the issue of capital to new members (net increase of share capital) there should not be any need for supervisory approval.
- For the same reasons the reference to the CEBS Guidelines for Hybrid Capital Instruments should be reviewed in order to avoid excessive bureaucracy. Equally, any duplication of information requirements with regard to the ICAAP has to be avoided.

[7] This is the substance of the International Accounting Standards Board's IFRIC 2, which, most probably, will be implemented also in a revised IASB standard for equity/liability distinction

- As regards further details (e.g. submission of the application well in advance of the redemption date), we think that the guidelines should provide for sufficient flexibility in order to allow solutions along varying national practices.

**C. Flexibility of Payments**

**Criteria 6 to 7**

**Question 3:**

**3.1. Are the guidelines in relation to flexibility of payments sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals as to how the text could be amended.**

**3.2. Are there any circumstances under which the restrictions on payments (in particular those related to non-fixed amounts and caps) would not be justified? Please provide evidence**

- Even though it is not applicable to co-operative banks, we are strongly opposed to the prohibition of any caps related to the payment on the instruments, as stipulated under Nr.27 and 71:
  - There is no evidence that any such cap is viewed by the market as an obligation to pay such capped amount. The evidence available on caps regarding dividends on co-operative shares in some Member States rather proves the opposite: during the last ten years, the dividend payments of co-operative banks in France were always significantly below a legal cap, which is based on an average return on private bonds. In addition, there is not even any correlation between the development of that cap and the dividends paid. Similar evidence from other countries is available.
  - Besides, we do not see the prudential rationale of the prohibition of caps. To the contrary, we believe that such a cap can even have very positive prudential effects, since earnings are retained and the capital base can be strengthened.
- Therefore, we suggest that the last part of the last sentence in paragraphs 27 and 71 is deleted:

  *« A cap related to the payment on the instruments is not acceptable since it can be viewed by the market as an obligation to pay this capped amount. There is an exception for non-joint stock companies. ~~if, resulting from a provision under national law, the cap is applicable to all instruments eligible under Article 57a, so that it does not create privileges. »"~~*

- We strongly support that companies may disclose a dividend policy, provided that it only reflects the Board's current intentions (paragraph 72). This should include the possibility to make rather specific policy disclosures, especially when there are several documents.

- Moreover, we do not think that it is appropriate, as stated under criterion 7 to exclude even any link between payments and the capital paid at issuance. In most cases, investors measure and evaluate their investments also on the basis of the proportion of such payments and the invested capital. As long as no concrete expectations are raised regarding the continuity of such payments (criterion 6), especially when no profits are made, we do not see any problems.
- As mentioned before, special consideration has to be given to the fact that in some countries, like the UK, it is not possible for a co-operative (or certain other types of mutual) to operate a banking business other than through a joint stock company subsidiary (i.e. a non-mutual company). Such banks should be able to issue instruments with limited voting-rights as core tier 1 capital to external investors in order to preserve mutual/co-operative credentials Furthermore, they should be afforded the same rules as CEBS contemplates for non-joint stock companies, including the possibility to issue capped instruments. It should be left to national supervisors to determine whether or not an issue of securities creates “privileges”. In this context, the national supervisors should be able to take account of the fact that shares held by the mutual/co-operative group in the bank fulfil a different function (including control rights) compared to external investments with limited voting rights.

**D. Loss absorbency**

**<u>Criteria 9 to 10</u>**

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| **Question 4 :** |
| **4.1. Are the guidelines in relation to loss absorbency sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals as to how the text could be amended.** |
| **4.2. Are there any particular issues CEBS should consider regarding Loss absorbency features, both in going concerns and in liquidation? Please provide evidence.** |

- As pointed out under "General Remarks", we perceive criterion 8 and 9 as strongly discriminating against co-operative banks. Since these criteria only reflect the image of a joint stock company, any co-operative or mutual bank would not be able to fulfil those criteria, since members have no access to net assets. However, funds are paid in. The non-access of members to reserves even increases the loss-absorbing capacity of these reserves, while not reducing the loss-absorbing character of the share capital. They provide "*a buffer, a cushion for the entity in terms of variances in its performance*"[8], that is certainly equal, if not superior to share capital.
- Criterion 8 is even incorrect in a way, since even in a joint stock company it is hardly ever the instrument that takes the first losses, but the retained earnings (reserves), which in the CRD are an equity element of their own according to article 57 (b).
- Criterion 8 only makes sense in connection with criterion 9 (proportional claim to net assets), according to which reserves are nothing else than part of the ultimate "shareholder interest", a capital element that belongs to the share (as the premium financial instrument). This approach is based on a shareholder perspective, since it aims at excluding any instruments that could dilute the ultimate shareholder interest (or non-premium instrument). Thus criteria 8 and 9 aim at drawing the line, but not at loss-absorption.
- The criteria for loss-absorption in CP 33 are rather different from those in CEBS "Implementation Guidelines for Hybrid Capital Instruments", where it is stated:

  *"I. Objective of loss absorbency*

  *95. In general terms, institutions' own funds absorb losses:*

  *a) to enable an institution to continue as a going concern; and*

[8] EFRAG et al: Pro-active Accounting Activities in Europe; Discussion Paper: Distinguishing between Liabilities and Equity, January 2008, page 46.

*b) in the case of liquidation to protect all depositors in a winding up*.

*96. The issue of going concern is relevant in stress situations - such as within a reorganisation process - when the bank suffers severe losses or loses the confidence of its creditors to such an extent that it may be at risk of not being able to continue its business. Loss absorbency on a going concern basis in these situations means that an institution is able to incur a loss but remain solvent and viable, even if distributable reserves have already been depleted. In the situations described loss absorbency features will help to rebuild its financial position*."

- From that perspective, co-operative shares are perfectly loss-absorbing. We therefore appreciate that CEBS has taken note of this situation and adapted its criteria to the situation of co-operative banks.
- However, we think that it would be better to delete the second sentence of criterion 9.