POSITION PAPER

ESBG Response to

CEBS Consultation paper on Implementation Guidelines regarding instruments referred to in Article 57(a) of Directive 2006/48/EC recast

(CP 33)

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The European Savings Banks Group (ESBG) welcomes the opportunity to comment on CEBS' Consultation Paper on Implementation Guidelines regarding Instruments referred to in Article 57(a) of Directive 2006/48/EC recast (CP 33).

General remarks

ESBG generally welcomes the proposed CEBS guidelines and in particular the underlying objective of introducing a common definition of capital instruments that can be included in Core Tier 1 capital. However, ESBG considers that CEBS proposals bear also some important concerns, of both general and specific nature. These concerns will be explained below and ESBG invites CEBS to address them in an appropriate way in view of avoiding undesired consequences.

Risk of anticipating the outcome of ongoing discussions at Basel Committee and Commission level

The revision of the definition of own funds is one of the central topics of the ongoing regulatory efforts for repairing and strengthening the prudential framework in the EU and worldwide. It is currently the object of proposals put forward not only by CEBS, but also by the Basel Committee (consultation document BCBS 164 "Strengthening the resilience of the banking sector") and the European Commission (the consultation document from 26 February 2010 on possible further changes to the Capital Requirements Directive - CRD). These documents go much beyond the proposals incorporated in the 2009 amendments to the CRD (CRD 2) and are not yet fully developed – leaving many questions open for debate. We understand that the CEBS guidelines are a valuable input to these overall discussions on improving the quality of capital. At the same time we keep in mind that once the new rules will be adopted further revisions of the concept of own funds will need to be implemented. It is therefore particularly important that CEBS guidelines do in no way anticipate or constrain developments at the Basel Committee and Commission level.

ESBG therefore strongly underlines the need for CEBS to restrict its guidance to the framework traced by CRD 2 for own funds requirements. This imperative is in our view not consistently observed by CEBS. In our detailed comments we will point to some of the most relevant instances where ESBG considers that CEBS goes beyond its current mandate.

Inappropriateness of designating ordinary shares as the benchmark

ESBG wishes to firmly recall that the European banking landscape is characterised by pluralism and the participation of a variety of financial actors, all subject to the same regulatory framework. Such variety of actors implies a variety of corporate structures that EU regulators need to properly consider when proposing new regulatory measures. The specificity of cooperatives, mutuals and similar institutions and the need for specific rules to be drafted for them is explicitly recognised by CEBS (e.g. paragraphs

9, 23, 28). In this context it is unbalanced and detrimental to indicate ordinary shares as the benchmark for assessing the features of instruments issued by joint stock and non joint stock companies (paragraphs 17 and 34). Such designation of ordinary shares as a benchmark would also impinge on the relevance of the criteria established in article 57(a) of the CRD. Therefore, ESBG strongly calls for the references to ordinary shares as the benchmark to be deleted from CEBS guidelines.

Furthermore, ESBG invites CEBS to explicitly leave some leeway in the criteria for accommodating the specific features of certain capital instruments issued by non joint-stock companies, which are considered capital in the strictest sense by national law, but not necessarily fully comply with the CEBS criteria as currently described.

Missing reference to transitional arrangements

Transitional arrangements are a central component of the new CRD requirements on hybrid capital instruments, and are of utmost importance particularly for determining what constitutes Core Tier 1 capital. CEBS draft guidelines do not contain any statement on the transitional arrangements, although these would have been much needed. This can trigger uncertainties and further market distortions, especially in light of the conflicting messages stemming from CRD 2 (30 years with 31.12.2010 as cut-off date) and the Basel Committee consultations (transitional arrangements still need to be determined, whereas 16.12.2009 is proposed as a cut-off date).

Principles-based approach

ESBG very much supports the principles-based approach adopted by CEBS. We believe that a principles-based definition of own funds is the right way forward and is reflected in an approach consisting of a catalogue of criteria for the eligibility of capital instruments for regulatory purposes. Once a capital instrument fulfils such criteria it should be recognised as eligible own fund. In this context it is particularly important that the explanations to the criteria do not go beyond the wording of the latter. They should represent merely an illustrative annotation, but should in no way add to the substantial content of the criteria.

Remarks to the individual criteria

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

A common definition should exclusively build on article 57(a)

ESBG is generally supportive of a common supervisory approach to the definition of capital. The common approach has to build on the substance of legislation as enshrined in the articles of the CRD (more precisely in article 57(a)). For legal certainty reasons, it is imperative that banks and supervisory authorities can rely on the substance of prudential norms as laid down in EU legislation. Hence, it is important that recitals or similar explanatory or contextual notes do not alter such substance. Therefore, the only reference that can be legitimately taken into account when constructing a common supervisory approach is the content of article 57(a). Recital 4 of the CRD could not possibly restrict the scope of the original definition of own funds contained in Article 57(a).

Therefore we invite CEBS to base its proposals only on article 57(a). The explicit reference to recital 4 under Point A should be deleted. Any explanatory references to recital 4 are acceptable only insofar as the latter is perceived as a supportive element adding to the factual background of the law. However, under no circumstances can the recital establish derogations from the substance of article 57(a).

Different classes of shares

Corporate law has always permitted and supported the existence of different classes of shares. Different rights and privileges counterbalance certain specific features of particular shares (e.g. the privileged payment of dividends compensates for the lack of voting rights). Such rights and privileges do not interfere with the substance of the criteria for the definition of capital laid down in article 57(a), and especially they do not impinge on the loss absorbency capacity of the instrument. Therefore, ESBG invites CEBS to delete paragraph 38, which unacceptably overvalues voting rights.

Criterion 1

The first criterion uses the concept of "legal owner", which is further detailed into brackets as "shareholders and other proprietors". ESBG regards critically the use of the concept of "legal owner", and argues for it to be abandoned in the CEBS guidelines. Instead the more common language of "shareholder and other proprietors" should be used, which is also the wording appearing in article 22 of Directive 86/635/EEC – the reference point indicated in article 57(a). "Legal owner" appears to be more restrictive than "shareholder and other proprietors" and could be misinterpreted and thereby unduly limit the interpretation of the criteria for determining core Tier 1 capital.

Furthermore, the first criterion requires that the instrument be recognised as equity under relevant accounting standards. ESBG supports an ever closer dialogue between banking regulators and accounting standard setters, however ESBG considers that the determination of capital elements for supervisory purposes cannot be made substantially dependent on external accounting standard setters. Therefore, we invite CEBS to use a more cautious wording when referring to the relationship between prudential capital requirements and accounting standards.

Criterion 2

Some clarification would be needed as regards the applicable treatment for the acquisition of pledging of own capital instruments. For instance it should be clear that shares that were pledged in the frame of a simple consumer credit are not deducted from capital. Also, it should be certain that in case of loans guaranteed with own shares, the shares concerned would not be deducted from capital, as long as the loans are granted under customary conditions.

In ESBG's view the second sentence under paragraph 44 should be deleted. The purchase of existing shares that were already paid up does in no way contribute to an increase of the capital base. A separate reporting of such positions for prudential reasons would put a disproportionate burden on the institutions.

Criterion 3

ESBG opposes the explicit indication of "ordinary shares" as the benchmark.

Also, ESBG disagrees with the proposed overall ban of indirect issuances through the use of Special Purpose Vehicles (SPVs). This prohibition goes beyond the current substantial provisions in the CRD. Thereby CEBS exceeds its mandate. Furthermore, in our understanding, the purpose of a requirement requesting that instruments are directly issued is to ensure that capital is made available effectively. Such objective would be already met through the fulfilment of criterion 2, which imposes that capital instruments are fully paid and renders the distribution channel irrelevant.

B. Permanence

Overall the guidelines as regards the permanence criterion appear to be clear. However there are some concerns that would need to be further addressed by CEBS.

Deduction from own funds

According to paragraph 48, the estimated amounts to be redeemed or bought back shall be deducted from original own funds once the prior approval of the supervisory authorities has been obtained. ESBG takes the view that such deduction would be inappropriate as long as the capital is still effectively available to the bank. According to the same logic, the approval of the issuance of new capital by the general assembly would be sufficient to have the new issues be fully considered as own funds from the day of the public announcement of their issuance, although they were not yet transferred to the institute. Such an approach is not reasonable and ESBG argues in favour of deleting such provision on deduction. Instead, the reference point for deduction from own funds/consideration as own funds should be the moment when capital flows out of /into the bank, which can be objectively determined and would confer the necessary legal certainty.

Requirement to demonstrate that an institution can re-access the market if necessary

The requirements in paragraphs 57 and 62 that an institution should demonstrate that it can re-access the market if necessary raise serious reservations. They do not seem to be feasible in practice. We therefore would invite CEBS to delete such requirement. Should CEBS not opt for a deletion, it is imperative that it elaborates and exemplifies on how an institution could demonstrate its ability to "re-access the market" in case of redemptions and buy-backs.

Specific situation of non-joint stock companies

The permanence criteria designed by CEBS appear particularly problematic to be applied in the case of non joint stock banks.

For instance, non joint banks that are part of a group with variable capital ("group à capital variable") would have problems observing the permanence guidelines as currently drafted. The groups with variable capital rely precisely on the interplay between requests for subscription of capital and redemption of subscribed capital. The shareholders (i.e. the holders of partnership shares) are allowed to redeem their shares without the need of being replaced by other shareholders. Such redemption is - according to law - subject to approval from the board of directors and redemption cannot bring down the amount of overall capital to a level inferior to ¾ of the highest amount of capital reached by the institution since its establishment. Furthermore, such variability of capital is counterbalanced by strict requirements to attribute profits to the legal reserve and by the principle of unavailability of reserves. Such banks with variable capital could not possibly observe the proposed permanence criteria.

ESBG invites CEBS to redraft its permanence guidelines in view of taking into consideration the above situations. Therefore, we suggest that the permanence criteria be considered fulfilled also when there are sufficient safeguards that redemption and buy-backs would not materially impinge on the availability of a bank's core capital (e.g. when there is approval by the supervisor, when there are counterbalancing measures such as in the case of the banks with variable capital).

Criterion 4

The information requirements under paragraph 56 are in ESBG's view too far-reaching given the information already available to the supervisors especially under Pillar 2 (ICAAP). To avoid any duplication, it should be clear that the approved results under the ICAAP should be taken into account and that any additional information required in the process of transmitting an application once the decision to redeem capital was made should be limited to information that is not yet available to the supervisors.

Paragraph 56 also requires that the issuer shall schedule the submission of its application "well in advance of the redemption date". This wording is in our view too vague and would need to be rendered more precise in order to be reliable. This is important especially in view of the fact that an eventual redemption will substantially depend on the market conditions at the time of the redemption. In this sense, it might appear useful to foresee for instance a maximum assessment period for the supervisor – which should be a clear reference point for the institution when submitting the necessary documentation in view of enabling redemption at the scheduled date.

Furthermore according to paragraph 56 the application for redemption should take into account the materiality of the amount to be redeemed. The materiality requirement should be formulated more precisely. A specific *de minimis* clause should be established – that would assure that below a certain threshold of the amount to be redeemed there is no obligation to transmit an application.

Criterion 5

The guidelines on buy-backs go beyond the provisions of the CRD. The general requirement of prior supervisory approval for buy-back programmes appears unnecessary, especially in the cases when the bought-back amounts were already replaced through equivalent capital.

C. Flexibility of payments

The guidelines are generally sufficiently clear; however ESBG invites CEBS to reconsider some aspects.

Also, CEBS explicitly indicates ordinary shares as the benchmark (paragraph 63), which – as discussed before – is inadequate and should be therefore deleted.

Criterion 6

The content of proposed criterion 6 goes even beyond what would characterise ordinary shares. The underlying assumption seems to be that in the case of common stock, management has full discretion to decide - on an "as needed" basis - whether or not to pay dividends and coupons. However, even in the case of joint stock companies, such full discretion does not pertain to the management, but the decision over the distribution of profits is left to be taken by the shareholders. It is subject to requirements of corporate law and also to possible interventions by the supervisors, who may suspend payments under certain circumstances.

Against this background ESBG suggests that paragraph 65 be changed and be based on a profit test that would determine the benchmark for qualifying instruments as Core Tier 1. Compulsory distributions should be possible if the following conditions are fulfilled cumulatively:

> a. the annual profit of the most recent fiscal year for which audited financial statements are available is equal or larger than the amount of the envisaged distribution and other distributions;
>
> b. the solvency ratio of the bank is well above the minimum requirements (i.e. the institution is "well capitalised") and
>
> c. there is no measure taken by the regulator that suspends payment.

The "well capitalised" threshold can be determined in the supervisory review process under Pillar 2. We also note that the U.S. has defined "well capitalised" for purposes of expanded powers of banks to mean a minimum core capital ratio of 6% and a minimum overall capital ratio of 10%.

Criterion 7

According to the guidelines proposed by CEBS, the level of distribution should not in any way be tied or linked to the amount paid in at issuance. This would exclude instruments with fixed coupon from being recognised as Core Tier 1 capital. In our view, such prohibition restricts the provisions in the CRD (the wording of which is inclusive of instruments with a fixed return). CEBS thereby goes beyond its mandate. Furthermore, such a requirement is not necessary to ensure the flexibility of payments, which is in our view sufficiently warranted through criterion 6.

D. Loss absorbency

Criterion 8 (Loss absorbency in a going concern)

According to paragraph 73 second sentence and paragraph 74 letter a), the capital instrument "should take the first share of any losses as they occur" and "absorb losses as and when they occur before all other capital instruments". Such requirements go beyond the provisions in article 57(a) of the CRD and are not in line with current contractual practices. There are no instruments attributable to core capital that would absorb losses as they occur, like ordinary shares. Therefore, ESBG suggests that these passages be deleted.

Criterion 9 (Loss absorbency in liquidation)

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 overhaul the wording of article 57(a). Our conclusion is hence that the directive defines core capital as including <u>all</u> equity instruments that are recognised as equity capital under national law, as long as they fully absorb losses on a going concern basis and represent the most subordinated claim during liquidation. ESBG therefore finds that CEBS' interpretation is in violation of the wording in article 57(a) and invites CEBS to accordingly adjust it.

There are also factual arguments explaining why CEBS 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 under Core Tier 1 Capital. It is irrelevant if different classes of equity capital have different ranking in the event of liquidation. What matters is that the equity holders 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 upon differences between the different types of equity (on the occasion of shareholders' general meeting). Any such agreement amongst the shareholders does not affect their joint relationship with the other claim holders, 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 new shares which rank prior to existing shares in a 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 of achieving financial stability.
- In the event a financial institution is in need of capital in a crisis situation and there is no other source of funding than the government, it would be contrary to the interests of the government (and of the taxpayers) to be forced to accept a rights issue of ordinary shares. This would increase the risk that taxpayers' money is used to bail out the original share holders 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 giving the government 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 realise a residual claim on the institution.

To conclude, ESBG takes the view 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 the one hand, and the equity holders collectively, on the other hand. This distinction is inherent in the type of claim each of these categories represents and is the only relevant distinction in a liquidation situation.

ESBG therefore suggests the following wording:

> "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~~.

Paragraph 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.

Paragraph 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."

About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 6061 billion (1 January 2008). It represents the interest of its Members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG Members are typically savings and retail banks or associations thereof. They are often organized in decentralized networks and offer their services throughout their region. ESBG Member banks have reinvested responsibly in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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