

EBA/OP/2017/07

23 May 2017

Opinion of the European Banking Authority on own funds in the context of the CRR review

Introduction and legal basis

On 23 November 2016, the European Commission published a proposal to amend Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)¹ and Directive 2013/36/EU (Capital Requirements Directive – CRD)². Some of these proposals concern Part Two of the CRR, related to own funds, and Chapter 4 of Title VII of the CRD, related to capital buffers and in particular restrictions on distributions.

According to Article 80 of the CRR on the continuing review of the quality of own funds, the ‘EBA shall monitor the quality of own funds instruments issued by institutions across the Union and shall notify the Commission immediately where there is significant evidence of those instruments not meeting the criteria set out in Article 28, or where applicable, in Article 29.’ Pursuant to this article, the EBA has continuously been monitoring the quality of the Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1) issuances in the EU since 2013. Based on this monitoring and on the occasion of the publication of the European Commission proposals for revision of the CRR and the consultation on the operation of the European Supervisory Authorities (ESAs)³, this opinion includes in particular the EBA’s views on a possible reinforcement of the EBA’s role in terms of CET1 instruments and a desirable clarification of the evaluation/permission provided by competent authorities under Article 26(3) of the CRR. This opinion also elaborates on restrictions on distributions with regard to the Maximum Distributable Amount (MDA) and its definition, as well as on reduction, redemption and repurchase of capital instruments, the introduction of an anti-circumvention principle and the introduction of a point of non-viability criterion.

This opinion is addressed to the European Commission, the European Parliament and the Council of the EU.

¹ <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2016:0850:FIN>

² <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2014%3A213%3AFIN>

³ https://ec.europa.eu/info/sites/info/files/2017-esas-operations-consultation-document_en.pdf

The EBA's competence to deliver an opinion is based on Article 34(1) of Regulation (EU) No 1093/2010⁴.

In accordance with Article 14(5) of the Rules of Procedure of the Board of Supervisors⁵, the Board of Supervisors has adopted this opinion.

Comments/proposals

1. By way of introduction, it is to be noted that this Opinion does not cover the changes made in relation to provisions relating to the Bank Recovery and Resolution Directive (BRRD), total loss-absorbing capacity (TLAC) or minimum requirement for own funds and eligible liabilities (MREL) and the corresponding changes brought to the own funds provisions with regard to eligibility criteria applicable to 'eligible liabilities'. More generally, the views expressed in this Opinion are not meant to be exhaustive but focus on the areas deemed to be the most significant ones. The EBA is using in parallel other vehicles or fora to convey comments of a more technical nature or to suggest a follow-up to previous contributions delivered by the EBA. It should in particular communicate separately to EU co-legislators about the follow-up of the technical advice on prudential filters/treatment of unrealised gains⁶ or the response to the Call for Advice from the European Commission on Q&As, flagging some fundamental Q&As in the area of own funds⁷.

a. Role of the EBA in terms of CET1 instruments (Article 26 of the CRR)

CET1 list

2. Pursuant to Article 80 of the CRR, the EBA has been monitoring the quality of CET1 issuances in the EU since 2013. In accordance with Article 26(3) of the CRR, it has regularly maintained and published a list of all forms of capital instruments in each Member State that qualify as CET1 (CET1 list).
3. As regards the CET1 list, the EBA focused its work primarily on collecting the list of existing forms of CET1 instruments, issued prior to the entry into force of the CRR (pre 28 June 2013). These instruments were included in the first CET1 list published by the EBA on 28 May 2014, which was based exclusively on the information received from competent authorities. Since then, new forms of CET1 instruments have been issued by institutions in the Union. The EBA has assessed the terms and conditions of all these new forms of CET1 instruments against the regulatory provisions (as defined in Article 28 or 29 of the CRR, where applicable, complemented by the applicable Regulatory Technical Standards (RTS) on own funds) in order

⁴ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

⁵ Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 27 November 2014 (EBA/DC/2011/01 Rev4).

⁶ <http://www.eba.europa.eu/-/eba-publishes-technical-advice-on-possible-treatments-of-unrealised-gains>

⁷ <http://www.eba.europa.eu/about-us/missions-and-tasks/calls-for-advice>

to identify provisions governing the instruments that the EBA would see as contradicting the eligibility criteria and with a view to updating the CET1 list.

4. The EBA requested some amendments to the terms and conditions of the instruments in several cases. The amendments related in particular to the aspects of permanence and loss absorption, but related most frequently to the aspect of flexibility of payments.
5. After almost 4 years, the monitoring of the CET1 instruments performed by the EBA in the context of the CET1 list has been beneficial in terms of implementation of the CRR and RTS provisions and has also allowed strengthening the quality of capital of EU institutions for newly issued instruments.
6. That said, according to current CRR provisions, the responsibility of evaluating whether issuances of CET1 instruments meet the criteria set out in Articles 28 or 29 of the CRR as applicable lies with competent authorities. This may lead to situations where, while the instrument has already been issued, the EBA may disagree with the evaluation of the competent authority; however, the final say would still be in the hands of the latter.
7. In this context, a reinforcement of the role of the EBA with regard to CET1 instruments should be further considered. This would guarantee the enforceability of the CRR and RTS provisions for CET1 instruments for all institutions in the EU and would ensure a harmonised and consistent application of the eligibility criteria. It is in particular recommended that the EBA is consulted on an *ex ante* basis for new forms of instruments that are not in the CET1 list. In addition, it is recommended to make explicit that the EBA could refrain from including new forms of instruments (which is currently implied in the text) and that it can also remove existing forms of instruments from the list, and is obliged to make an announcement, with an appropriate transitional period applying to both cases. Finally, although already also implied in the legislation (in Article 35 of the EBA founding Regulation), it is suggested, for added clarity, that the EBA can request information from competent authorities on all instruments, including those issued before entry into force of the CRR (which have been included in the CET1 list with no assessment by the EBA).
8. Drafting suggestions are proposed for this part in the Annex to this Opinion.

Evaluation/permission by competent authorities under Article 26(3) of the CRR

9. Another aspect that merits consideration is related to the implications of the inclusion of a type of instrument in the list, and its relationship vis-à-vis the permissions granted, or not, by the competent authority. More precisely, the question is whether the inclusion of a type of instrument in the list is sufficient for an institution to be able to classify subsequent issuances of the same type of instruments as CET1 pursuant to the first paragraph of Article 26(3) of the CRR, or whether a new permission by the competent authority is required for each new issuance.

10. The EBA considers that different readings of the regulation text are possible in this respect, which are also potentially backed by different supervisory approaches. This has led to different supervisory practices across the Union, each of which has different advantages and disadvantages. As a result, the EBA would welcome clarification from EU institutions of the corresponding provisions in the Level 1 text in the context of the CRR review.

b. **Restrictions on distributions and definition of the MDA (Article 141 of the CRD)**

Restrictions on distributions

11. The Commission has introduced into the CRD review a proposal for amending Article 141 on restrictions on distributions in the context of capital conservation measures. In particular, an institution that fails to meet or exceed the combined buffer requirement, after having calculated the MDA, shall not make a distribution in connection with CET1 capital or pay variable remuneration or discretionary pension benefits before having made payments due on AT1 instruments.

12. The following observations can be made with regard to the Commission's proposal:

- The proposal is introducing a 'pecking order', specifying that AT1 coupons should be the last distribution to be restricted (and the first one to take place). This is a change from the existing provisions of the CRD, where there is no order to be respected in the restrictions of distributions if not all payments on AT1 instruments, bonuses and dividends can be made and where full flexibility is left to institutions in the operation of these restrictions.
- It is important to recall first that dividend stoppers are not allowed in the EU, contrary to Basel rules. Article 52 (1)(l)(v) of the CRR stipulates that the cancellation of distributions imposes no restrictions on the institution. In addition, Article 53(b) of the CRR stipulates, in particular, that the provisions governing AT1 instruments shall not include a requirement for the payment of distributions on CET1, AT1 or Tier 2 (T2) to be cancelled if distributions are not made on those AT1 instruments.
- An enforcement of a specific pecking order, which would privilege AT1 holders, may be seen as the reintroduction of dividend stoppers in the EU and it is difficult to understand how this proposal would then not contradict the current CRR text if no change is made in parallel. At the same time, it is the EBA's view that the prohibition of dividend stoppers in the EU, which has not hindered the issuance of AT1 instruments by institutions in the last few years, needs to remain.
- There is currently no full automaticity with regard to the cancellation of AT1 coupons in case of a buffer breach, since the institution can decide to cancel dividends or bonuses first (where the amount of the MDA allows for any payment). How the order would be chosen would depend on the specificities of the institution (group structure, content of the issuances, contracts with the staff on bonuses, etc.). From this perspective, a predetermined enforced pecking order, while it would not bring any clear added value from the perspective of the

institution, would only provide more certainty on payments from the perspective of AT1 holders.

- Any change to the current features for AT1 instruments in terms of MDA would need to be carefully articulated with what is included in Commission Delegated Regulation (EU) No 241/2014, as amended by subsequent regulations (RTS on own funds), which requires that all distributions on AT1, either coupons or write-ups, shall be limited at all times by the MDA.
13. It is important to recall that the eligibility criteria for AT1 instruments were reinforced after the crisis in order to increase the certainty that they are able to absorb losses when needed. Everything that could be perceived as trying to reduce the loss absorbency or the full flexibility of payments should be considered with the utmost care, as, if it indeed resulted in such a perception, this would be an undesirable move back towards the pre-crisis situation.
14. In the EBA's view, the eligibility criteria for AT1 instruments should not be weakened. The costs of changing some of these criteria would probably outweigh the benefits that they could bring, in terms of both reputation and loss of confidence in their loss-absorbing capacity. The full flexibility of payments on AT1 instruments is, in this respect, a key feature, and altering it could create the expectation that coupons will always be paid. The existing CRR provisions should remain unchanged with respect to the absence of order in the restrictions on distributions.

Definition of the MDA

15. The EBA discussed some aspects of the definition of the MDA and a potential misalignment between the CRD definition of profits on the one hand and the Basel III definition of profits on the other hand, as input to that definition.
16. Article 141(5) of the CRD states that the MDA shall be calculated based on interim and year-end profits not included in CET1 capital that have been generated since the most recent decision on distribution or since the last payment of dividends, AT1 coupons, variable remuneration or discretionary pension benefits. This definition appears more restrictive than that of the Basel III framework.
17. The focus on the most recent distribution or last payment could further constrain profits that may be used for calculating the MDA. In practice, institutions often have multiple decision dates on paying out coupons, dividends and bonuses. As a result, profits could be limited to a period as short as one month or less, resulting in small amounts available for distribution under MDA restrictions (although to be complete, the amount available for distribution has to be compared with the amount that would need to be distributed, especially in the case of quarterly coupons). In addition, it is unclear to which specific date the decision date refers. Basel III does not explicitly constrain so strictly the period of profits used in the MDA calculation.

18. Institutions, especially larger ones, typically verify undistributed profits on a quarterly basis in order to include them in CET1 capital⁸. By contrast, Basel III does not exclude profits already in CET1 from the MDA calculation.
19. Consequently, under the CRD provisions, the more frequently an institution includes its profits in CET1 capital and makes decisions or payments on distributions, the shorter the period of profits eligible to be used in the MDA calculation and the smaller the amount available for distribution. although this is also due to the fact that institutions have an interest in regularly including their interim profits in own funds in order to improve their regulatory ratios, even if they are not obliged to do so. As a consequence, by design, zero eligible profits means that an institution will be subject to a total restriction on distributions even when it is in the top quartile of its combined buffer, whereas an institution with eligible profits and in the second quartile will be subject to a lower restriction.
20. This may be contrary to the intention of Article 141(6) of the CRD, which expects restrictions on distributions to be more severe for institutions entering into the lower quartiles of their combined buffer.
21. Against this background, the EBA considered several possible options on the basis of several numerical simulations, with the view to refining the definition of profits to achieve greater clarity and consistency across institutions when calculating their MDA, including the option of keeping the status quo. It is to be noted, however, that many scenarios are possible and not all assumptions and considerations can be factored in because of complexity issues. Furthermore, the difficulties are exacerbated by the fact that there are not enough real cases to analyse in more detail.
22. In the EBA's view, it should be reaffirmed that institutions are not able to use profits already included in CET1 capital for distribution purposes and that i) under the existing RTS on own funds not all profits are usually included in CET1 (given the deduction of foreseeable dividends and charges in particular) and ii) institutions can choose not to include interim profits in CET1 capital. Any possible change in the MDA definition should not give the impression that the EBA would support a more favourable treatment of AT1 holders and that coupons should be paid, as explained in the previous part on the restriction on distributions.
23. With this in mind, the EBA suggests a limited change in the definition of profits, so that the MDA is calculated based only on 'interim and year-end profits not included in CET1 capital', deleting the reference to profits generated since the most recent decision on distribution or since the last payment of dividends, AT1 coupons, variable remuneration or discretionary pension benefits.

⁸ Article 26(2) of the CRR stipulates that institutions may include interim or year-end profits in CET1 capital with prior permission of the competent authority. Such permission shall be granted where profits have been verified by independent persons and any foreseeable charge or dividend has been deducted.

c. Reduction, redemption, repurchase of capital instruments (Article 78 of the CRR)

24. The Commission has introduced some changes to Article 78 of the CRR relating to supervisory permission for reducing own funds.

25. The following observations can be made with regard to the Commission's proposal:

- The amendments made to bring the text in line with the fundamental issue raised in EBA Q&A 2013_290 are welcome. That said, the proposed text is not fully in line with the Q&A, which referred to an exchange of 'fully eligible instruments against fully eligible instruments of a *higher quality*' only, and not of 'equal or higher quality' (recalling that higher quality did not refer to a higher 'layer' of capital). It would be desirable to keep the more restrictive wording as is used in the Q&A, as it is not obvious why a fully eligible instrument could be exchanged before the minimum period of 5 years if it is to be replaced by an instrument of an equal quality.
- There is uncertainty about the reference to market-making purposes and its interaction with the limits set out in Article 29(3) of Commission Delegated Regulation (EU) No 241/2014 as amended by subsequent regulations (RTS on own funds), where competent authorities may permit institutions to repurchase AT1 or T2 instruments for market-making purposes from the date of issuance in accordance with the conditions stipulated by the RTS on own funds and EBA Q&A 2014_1352. As a reminder, the answer to EBA Q&A 2013_290 excludes market-making activities from the scope of the provisions on reduction, redemption and repurchase of capital instruments before 5 years after the date of issuance (as confirmed in the follow-up EBA Q&A 2015_1791).
- More generally, it is not always clear what applies to own funds only, or what applies to eligible liabilities only, or what applies to both. As mentioned in the introduction, this Opinion does not cover eligible liabilities. That said, a valid general remark regarding the set of responsibilities of competent authorities and resolution authorities, with regard to own funds and eligible liabilities, respectively, is that it is probably too complex and unclear. If this is left as it currently stands, it could lead to an inefficient and lengthy process. Further clarification and simplification is probably needed.
- On a separate note, it is suggested that the CRR text be amended to clarify that institutions shall obtain prior permission from competent authorities, not only in the case of a reduction, redemption, call or repurchase of an instrument (together with the related share premium), but also in the case of a reduction, redemption or distribution of a share premium without a simultaneous reduction, redemption, call or repurchase of the instrument to which the share premium relates (see EBA Q&A 2016_2808).

26. In conclusion, relevant issues arise with reference to the conditions for reducing/redeeming/repurchasing own funds instruments with regard to exchange of instruments before 5 years, market-making provisions and the responsibilities of respectively

competent authorities and resolution authorities with regard to own funds on the one hand and eligible liabilities on the other hand.

d. Anti-circumvention principle (new Article 79(a))

27. In the context of the monitoring of capital instruments performed by the EBA, it appeared that in some cases an instrument may formally meet the eligibility criteria of the CRR, but that its substance is altered by some covenants, arrangements or side agreements outside the instrument, which render it ineligible as a CET1 instrument when assessed globally and when assessing the economic effects of the overall arrangement and not just the instrument in isolation.
28. More generally, the EBA considers that covenants/side agreements or contracts have to be carefully assessed in conjunction with the main terms and conditions of the issuance, so that the overall substance of the instrument/transaction is captured. This way, it can be assessed whether the economic results of the overall arrangements are compatible with the objective of the act. The eligibility of the instrument should be assessed not in isolation but as part of the wider transaction(s). A similar recommendation had already been made in the AT1 monitoring report.
29. There is a long line of European Court of Justice jurisprudence that provides that EU law is to be interpreted not based only on a literal reading of the relevant acts but also by taking into account the wider context and the objectives to be achieved by those acts (teleological interpretation). Nevertheless, the EBA considers it desirable to add an explicit 'anti-circumvention' provision in the CRR, particularly for own funds purposes, for added clarity and legal certainty to the market at large. Drafting suggestions are proposed for this part in the Annex to this Opinion.

e. Point of non-viability (Articles 52 and 63 of the CRR)

30. The inclusion of the point of non-viability in the eligibility criteria in the Commission's proposals is in line with the Basel rules text and requires that, to be eligible as AT1 and Tier 2 capital, bonds governed by non-EU law should be subject to either contractual or statutory provisions in order to ensure that write-down and conversion are effective.
31. The absence of any grandfathering clause relating to the introduction of the point of non-viability may raise questions about the eligibility of existing capital issuances. Hence, it is suggested that such a grandfathering clause be introduced.
32. More generally, the EBA would recommend considering such grandfathering clauses in all cases where the existing CRR eligibility criteria for own funds instruments are expected to be amended in the context of the current negotiations on the text.

This opinion will be published on the EBA's website.

Done at London, 23 May 2017

[signed]

Andrea Enria

Chairperson

For the Board of Supervisors

Annex – draft changes

Article 26 of the CRR

(No change from current CRR)

3. Competent authorities shall evaluate whether issuances of Common Equity Tier 1 instruments meet the criteria set out in Article 28 or, where applicable, Article 29. With respect to issuances after 28 June 2013, institutions shall classify capital instruments as Common Equity Tier 1 instruments only after permission is granted by the competent authorities, which may consult EBA.

For capital instruments, with the exception of State aid, that are approved as eligible for classification as Common Equity Tier 1 instruments by the competent authority but where, in the opinion of EBA, compliance with the criteria in Article 28 or, where applicable, Article 29, is materially complex to ascertain, the competent authorities shall explain their reasoning to EBA.

On the basis of information from each competent authority, EBA shall establish, maintain and publish a list of all the forms of capital instruments in each Member State that qualify as Common Equity Tier 1 instruments. EBA shall establish that list and publish it for the first time by 28 July 2013.

EBA may, after the review process set out in Article 80 and, where there is significant evidence of those instruments not meeting the criteria set out in Article 28 or, where applicable, Article 29, decide to remove non-State aid capital instruments issued after 28 June 2013 from the list and may make an announcement to that effect.

Original article

Draft changes

3. Competent authorities shall evaluate whether issuances of Common Equity Tier 1 instruments meet the criteria set out in Article 28 or, where applicable, Article 29. Institutions shall classify capital instruments as Common Equity Tier 1 instruments only after permission is granted by the competent authorities, ~~which may consult EBA.~~

Competent authorities shall consult the EBA before granting permission with respect to issuances that involve a form of capital instrument which is not in the list referred to in the second subparagraph and which is a non-State aid capital instrument. Competent authorities shall take utmost account of the EBA's advice and explain their reasoning with regard to any significant deviation therefrom to the EBA, in writing, within three months

	<p><u>from receiving the EBA’s advice.</u></p> <p>For capital instruments, with the exception of State aid, that are approved as eligible for classification as Common Equity Tier 1 instruments by the competent authority but where, in the opinion of EBA, compliance with the criteria in Article 28 or, where applicable, Article 29, is materially complex to ascertain, the competent authorities shall explain their reasoning to EBA.</p> <p>On the basis of information from each competent authority, the EBA shall establish, maintain and publish a list of all the forms of capital instruments in each Member State that qualify as Common Equity Tier 1 instruments. EBA shall establish that list and publish it for the first time by 28 July 2013. <u>In the context of the maintenance of the list, the EBA may, in accordance with Article 35 of Regulation (EU) No 1093/2010, require competent authorities to provide the EBA with any information with regard to the compliance of any Common Equity Tier 1 instruments with the criteria in Article 28 or, where applicable, Article 29, with a view to providing its advice to competent authorities. Competent authorities shall explain their reasoning to the EBA with regard to any significant deviation from the EBA’s advice, in writing, within three months from receiving the EBA’s advice.</u></p> <p>The EBA may, after the review process set out in Article 80, and where there is significant evidence of instruments not meeting the criteria set out in Article 28 or, where applicable, Article 29, decide <u>not to remove-include</u> non-State aid capital instruments issued after 28 June 2013 from-in <u>the list or to remove them from the list. The EBA may shall</u> make an announcement to that effect <u>and agree an appropriate transitional period with the relevant competent authority.</u></p>
<p>Comments</p>	<p><i>A reinforcement of the role of the EBA with regard to CET1 instruments may be further considered. This would guarantee the enforceability of the CRR and RTS provisions for CET1 instruments for all institutions in the EU and ensure a harmonised and consistent application of the eligibility criteria. It is in particular recommended that the EBA be consulted on an ex ante basis for new forms of instruments that are not in the CET1 list. In addition, it is recommended to make fully explicit that the EBA could either not include or remove all forms of instruments from the list and that it shall make an announcement to that effect. Finally, it is suggested that the EBA can explicitly request information from competent authorities on instruments issued before the entry into force of the CRR (which have been originally included in the CET1 list with no assessment by the EBA).</i></p>

New Article 79(a) of the CRR

Original article	New proposal
Draft changes	<p><u>Article 79(a)</u></p> <p><u>Assessment of compliance with the conditions for capital instruments</u></p> <p><u>The assessment of compliance of capital instruments with the requirements of this Regulation and the delegated acts supplementing it shall take a ‘substance over form’ approach: it shall take into account all arrangements related to the instruments, even where those are not explicitly contained in the terms and conditions of the instruments themselves, with the view to confirming that the combined economic effects of such arrangements are compliant with the objective of Articles 28, 29, 52 or 63, as applicable, of this Regulation and the delegated acts supplementing it.</u></p>
Comments	<p><i>The EBA considers it desirable to add ‘anti-circumvention’ principles in the CRR for own funds purposes. In the context of the monitoring of capital instruments performed by the EBA, it appeared that in some cases an instrument may formally meet the eligibility criteria of the CRR, but that its substance is altered by some covenants, arrangements or side agreements outside the instrument, which render it ineligible as a CET1 instrument when assessed globally and not in isolation.</i></p> <p><i>More generally, the EBA considers that covenants/side agreements or contracts have to be carefully assessed in conjunction with the main terms and conditions of the issuance, so that the overall substance of the instrument/transaction is captured. The eligibility of the instrument should be assessed not in isolation but as part of the wider transaction(s). A similar recommendation had already been made in the AT1 monitoring report.</i></p>