

Implementation  
Guidelines on  
instruments referred to in  
Article 57(a) of the CRD  
- CP 33

Public hearing

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**CEBS**

Committee of European  
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# Overview

- Background
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- Definition of capital in the sense of Article 57(a) and Recital 4
- Permanence
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- Next steps

# Background

- CRD II introduces explicit rules for the treatment of **instruments eligible as capital** and requirements for their inclusion in institutions' original own funds without limits
- CRD II amendments to be transposed into Member States' national law by 31 October 2010 and be applied from 31 December 2010
- CP33 responds to the request in Art. 63a (6) of CRD II for CEBS to elaborate **guidelines for the convergence of supervisory practices with regard to instruments referred to in point (a) of Article 57.**

## Objectives of the draft guidelines

- achieve **common understanding** among competent authorities across the EU on the implementation and application of the new CRD provisions
- foster their **convergent transposition**
- create more **transparency for market participants**

## Definition of capital in the sense of Article 57(a) and Recital 4 (1/5)

### Article 57(a)

*“(a) capital within the meaning of Article 22 of Directive 86/635/EEC, in so far as it has been paid up, plus the related share premium accounts, it fully absorbs losses in going concern situations, and in the event of bankruptcy or liquidation ranks after all other claims;” .*

### Recital 4

*“(4) It is therefore important to lay down criteria for those capital instruments to be eligible for original own funds of credit institutions and to align the provisions in Directive 2006/48/EC to that agreement. The amendments to Annex XII to Directive 2006/48/EC result directly from the establishment of those criteria. Original own funds referred to in Article 57(a) of Directive 2006/48/EC should include all instruments that are regarded under national law as equity capital, rank pari passu with ordinary shares during liquidation and fully absorb losses on a going-concern basis pari passu with ordinary shares. It should be possible for those instruments to include instruments providing preferential rights for dividend payment on a non-cumulative basis, provided that they are included in Article 22 of Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, rank pari passu with ordinary shares during liquidation and fully absorb losses on a going-concern basis pari passu with ordinary shares. Original own funds referred to in Article 57(a) of Directive 2006/48/EC should also include any other instrument under a credit institution's statutory terms taking into account the specific constitution of mutuals, co-operative societies and similar institutions and which are deemed equivalent to ordinary shares in terms of their capital qualities in particular as regards loss absorption. Instruments that do not rank pari passu with ordinary shares during liquidation or which do not absorb losses on a going-concern basis pari passu with ordinary shares should be included in the category of hybrids referred to in Article 57(ca) of Directive 2006/48/EC.” .*

## Definition of capital in the sense of Article 57(a) and Recital 4 (2/5)

- Article 57(a) : general features of instruments that may be included in original own funds without limits
- Other instruments than ordinary shares may be included but must absorb losses pari passu with ordinary shares. Only difference = a preferential right for dividend payment (Recital 4)
- Mutual/cooperative banks : instruments issued by NJS companies deemed equivalent to ordinary shares should be included (Recital 4)

## Definition of capital in the sense of Article 57(a) and Recital 4 (3/5)

- On the basis of Art 57(a) and Recital 4, **10 criteria** have been developed for the assessment of capital instruments that may be included in original own funds without limits
  - **in line with the Basel proposal**
  - **Specificities of non-joint stock companies** have been taken into account
  - ordinary shares should be the benchmark
  - Art 57(a) instruments to be **simple, clear to understand** and **able to fully absorb losses** in going concern without any doubt and immediately. Art 57(a) instruments must also be of higher quality than hybrid capital instruments

## Definition of capital in the sense of Article 57(a) and Recital 4 (4/5)

- **Criterion 1: The instrument should be equity capital contributed by the legal owners under national law. It must also be recognized as equity under relevant accounting standards and insolvency law**
  - Holder not to be in a position to petition for the insolvency of the issuer
  - Possibility for mutuals/cooperatives to refuse the redemption of shares not considered as an event of default when activated
  - Definition of shareholders/other proprietors determined by the national legal structure of the institution



## Definition of capital in the sense of Article 57(a) and Recital 4 (5/5)

- **Criterion 2: Capital instruments must be fully paid. When the issuer provides financing to the shareholder or other proprietor to facilitate the subscription of capital, either directly or indirectly, the instrument cannot be considered as capital for regulatory purposes. The instrument shall ensure an effective permanent supply of capital.**
  - applies not only to the issuance of capital, but also to any later purchases of shares.
  - Circumstances where an institution returns capital to its shareholders/proprietors to be closely monitored
- **Criterion 3: The instrument shall be directly issued.**
  - No use of Special Purpose Vehicles.

## Permanence (1/3)

- Redemptions and buy-backs, deemed to undermine the permanence of the capital instrument = subject to a prior supervisory approval.
- Redemptions and buy-backs not to be announced to holders before the institution has obtained the prior approval of the competent authorities.
- When sufficient certainty + prior approval of the competent authorities, corresponding estimated amounts to be redeemed or bought back to be deducted from original own funds while waiting the effective redemption or buy-back to occur
- Sufficient certainty = the institution has publicly announced its intention to redeem/buy-back.

## Permanence (2/3)

- **Criterion 4: The capital instrument is perpetual and no terms shall enable redemption by the issuer outside liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under national law). The holder shall not be in a position to require redemption.**
  - Instruments to be undated + not redeemable outside of liquidation + freely available at all times.
  - no call at any time
  - no right of repayment of capital except as a claim for the residual assets in liquidation (except for mutuals/cooperatives)
  - no put option for the holder towards the issuer

## Permanence (3/3)

- cooperatives/mutuals: option to reject the holder's request for redemption
- possibility for competent authorities to refuse the redemption/limit the amount to be redeemed
- application to be transmitted to competent authorities with all necessary information and well in advance
- **Criterion 5: Neither the contract nor marketing conditions shall provide any expectation that the capital instrument will be bought-back. Buy-backs are subject to prior approval by the competent authorities.**
  - possibility for competent authorities to refuse the buy-back/limit the amount to be bought-back
  - application to be transmitted to competent authorities with all necessary information and well in advance

## Flexibility of payments (1/3)

- Benchmark for defining flexibility of payments in the context of Recital 4 = ordinary shares.
- Only difference foreseen by the Recital = instruments with preferential rights to dividends.
- Flexibility of payments can be defined as the right that issuers have to decide (i) if and (ii) how much they wish to pay dividends, in particular in order to preserve the financial and solvency position of the institution.

## Flexibility of payments (2/3)

- **Criterion 6: There is no right for the holders of capital instruments to claim distribution.**

On an on-going basis, a capital instrument shall:

- ensure full discretion of payments
- permit an institution to preserve cash by not paying out dividends; non-payment is not an event of default
- not have ACSM features
- not have dividend pushers nor dividend stoppers (all Art 57(a) instruments to be pari passu with themselves)

## Flexibility of payments (3/3)

- **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.**
  - dividends on instruments other than ordinary shares to be approved by the General Assembly (or relevant body) simultaneously with distribution of ordinary dividends
  - no dividends to be distributed if insufficient distributable items
  - no fixed amounts
  - no caps (exception for non-joint stock companies if no privileges)

## Loss absorbency (1/3)

### **Loss absorbency in a going concern**

- **Criterion 8**: The instrument takes the first and proportional share of any losses as they occur pari passu with other instruments included under Article 57 (a)
  - Art 57(a) instruments to fully absorb losses to help the institution continue as a going concern
  - Principal amount of an Art 57(a) instrument to be fully and immediately available to absorb losses. Losses to be absorbed proportionately and pari passu with other Art 57(a) instruments.
  - Must own the reserves pari passu with any other owners of the reserves or have a mechanism of loss absorbency to share losses pari passu
  - Cooperative/mutual banks: limited access to the reserves not to imply the inclusion of a specific mechanism of loss absorbency to be considered as fully loss-absorbent if limitations applicable pari-passu to all Art 57(a) instruments (no privileges).



## Loss absorbency (2/3)

### Loss absorbency in liquidation

- **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.**
  - rank after all claims and rank pari passu with ordinary shares during liquidation
  - no priority in liquidation and no fixed claim on the nominal amount of their holding but claim on any residual amount after all claims are satisfied reflecting the share in the credit institution

## Loss absorbency (3/3)


- cooperative/mutual banks: cap relating to the amount paid in liquidation acceptable if applicable to all instruments eligible under Article 57(a) (no privileges)
- **Criterion 10 : capital instruments must not be provided with guarantees, pledges or other credit enhancements that legally or economically enhance their seniority.**
  - no guarantees, pledges or other credit enhancements, vis-à-vis the shareholder or other proprietor

## Next steps

- **Next steps**

Finalisation of Guidelines on Art 57(a) Instruments based on the feedback received on CP 33

- Responses are still welcome at [cp33@c-eps.org](mailto:cp33@c-eps.org)
- Consultation closes on 31 March 2010
- Possible evolutions in the global regulatory framework with regard to the definition of capital instruments to be taken into account in the final guidelines as far as necessary
- CEBS endorsement and subsequent publication envisaged in June 2010



Thank you very much  
for your attention.

Questions?

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