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## **Response to the Committee of European Banking Supervisors**

### **CEBS consultation paper on Implementing Guidelines regarding Instruments referred to in Article 57 (a) of Directive 2006/48/EC recast (CP 33)**

The British Bankers' Association ("BBA"), the Association for Financial Markets in Europe ("AFME"), and the International Swaps and Derivatives Association ("ISDA"), hereinafter referred to as the Joint Associations, representing the UK, global, and European firms that constitute the financial services industry within the UK, are pleased to respond to the consultation on CP 33 Guidelines regarding Instruments referred to in Article 57 (a).

The BBA is the leading association for the UK banking and financial services sector, speaking for over 200 banking members from 60 countries on the full range of UK or international banking issues and engaging with 35 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1st November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association.

ISDA represents participants in the privately negotiated derivatives industry, and has over 810 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

The response, including recommendations, is provided in three sections. Section 1 outlines the key concerns of the industry regarding the guideline proposals as laid out in CP 33. Section 2 highlights the key points of clarification/ amendments to the criteria outlined in the guidelines and section 3 provides answers to the specific questions raised by CEBS.

The Joint Associations look forward to working with you as we progress the guidelines and will be happy to discuss any aspects with you as required.

## 1 Key Messages

We fully understand and recognise that CEBS has produced CP33 in order to respond to the requirement under CRD 2 (article 63a (6)) to expand on the criteria for assessment of capital instruments that may be included in original own funds without limits, in order to deliver the key objectives of a common supervisory interpretation, understanding and transparency. However, the industry has some key concerns as to the timing and content of the paper.

**International Alignment:** Whilst appreciating CEBS engagement with the industry upon the consultation, given the publication of BCBS's consultation paper *Strengthening the Resilience in the Banking Sector* (CP 164) along with the supporting CRD 4 package, both of which aim to further define capital instruments, we question whether it is the appropriate time to proceed with these guidelines when further changes are likely to occur. Alignment with the international regulatory community on capital definitions will be imperative if the European Financial Services industry is to continue to be competitive. We therefore urge CEBS to ensure alignment of these guidelines with international standards and allow fixed coupon features.

**The Benchmark:** The industry fully appreciates the intention to ensure that original own funds capital instruments are fully loss absorbing, however we do not agree with the fact that ordinary shares are the sole benchmark for Core Tier 1. Rather, we agree with Recital 4, that the instruments included in Core Tier 1 should act *pari passu* with ordinary shares in liquidation and in loss absorbency during going concern. We stress that this should be the fundamental benchmark not simply that ordinary shares are the benchmark. Therefore as supported by Recital 4 we do not agree that the instruments have to act like ordinary shares in every aspect (for instance regarding preferential rights for distributions/ payments). The industry is concerned that if the benchmark is limited to ordinary shares, the investor base for Core Tier 1 instruments will be limited at a time when a broad investor base will be critical to responding to the capital issuance needs of the industry. The fixed income investor is essential, and Core Tier 1 instruments should be allowed to have critical features to ensure fixed income investors' participation (e.g. fixed distribution rate / defined liquidation amount).

We see this being achieved through Instruments that behave as ordinary shares but which have a fixed coupon rate payable only if certain performance conditions are met; which would be clearly stated at the issuance stage. This aligns to CRD 2 principles and Basel intentions. We urge CEBS to ensure the criteria align to these standards and not as currently stated.

**Grandfathering:** As recognised by CEBS not all firms will have instruments within Core Tier 1 that fully match the new guidelines. Suitable grandfathering arrangements will be needed to preserve Core Tier 1 treatment of such instruments (rather than grandfather as hybrids) and the industry supports CEBS' view that these include the ability to grandfather instruments issued up to end 2010 as a minimum to enable the market to effectively operate in 2010. However, it is not clear that the CRD 2 proposals on grandfathering will be aligned with those internationally agreed. Whilst the Basel committee is considering grandfathering it has yet to issue concrete proposals. We support the CRD 2 view on grandfathering arrangements, and we therefore request CEBS seek to align Basel to the grandfathering stance as laid out in CRD 2 so that market dynamics can resume. The industry welcomes CEBS feedback in this regard.

**Accounting standards:** Given accounting standards differ across jurisdictions, as well as change over time, the industry does not think that instruments have to be recognised as equity under relevant accounting standards. This would disrupt the permanence feature and is a criterion the industry urges CEBS to remove.

## 2 Specific comments on the criteria:

### Criterion 1:

The industry does not agree with the view that the instruments have to be recognised as equity under national law as well as relevant accounting standards. In jurisdictions where corporate law allows for structuring of an instrument that has characteristics required for inclusion into Core Tier 1 yet may not be included in equity definition under national law, such instruments must be allowed and in fact they may help issuers to avoid administrative burden in relation to issuing ordinary shares. In addition, as stated above, tying qualification as a Core Tier 1 instrument to accounting standards is wrong. Accounting standards differ across jurisdictions and change over time, so the status of an instrument could change thereby affecting its permanence (permanence being one of the features central to CEBS guidance). We do not therefore support this element of the criterion and it should be reviewed.

### Criterion 2:

The industry acknowledges the relevance of this criterion but seeks changes to paragraphs 43 and 44. As currently drafted, paragraph 43 does not allow the use of employee share schemes or share save options, and paragraph 44 does not recognise that banks will never fully know how customer loans are used. So we suggest the following changes:

- i) 43: As currently written does not allow for employee share save schemes or share option schemes. This needs to be amended to allow for such mechanisms.
- ii) 44: In many instances it will not be possible for banks to monitor all credit facilities that its customers are granted to the extent of knowing exactly how the facilities is used, for example, a bank will not be able to monitor a revolving credit facility, or personal overdraft to determine if such facilities have been used to invest in the bank's shares. We suggest that guideline 44 be modified to include the word 'knowingly'. It may also be helpful to apply a materiality level.

### Criterion 3:

As previously stated the industry does not agree with the benchmark solely being ordinary shares. We support the Recital 4 definition whereby the instruments relevant to Core Tier 1 should act *pari passu* with ordinary shares in liquidation and in loss absorbency during going concern. We would stress that this should be the fundamental benchmark not simply ordinary shares. In keeping with Recital 4, we do not agree with the suggestion that the instruments have to act like ordinary shares in every aspect (for instance regarding preferential rights for distributions/ payments).

In addition, we believe that SPV structures should be allowed in certain circumstances where for example i) the SPV is an operating vehicle owned by the firm; ii) where to not issue via a SPV would cause constraint to the investor base; iii) where national 'corporation'

law allows issuance via SPVs. Examples where such flexibility will be needed are the UK and Spain.

**Criterion 4:**

The industry understands the basis of criterion 4 although we are concerned by the process outlined in paragraph 56. Members are concerned about facing delays in authority/ regulator approvals when it is important for the firm (issuer) to act quickly as regards its intended redemption. We recommend that the following statement be added to the current text to ensure that 'such approval is to be provided in a timely manner to allow the firm to act as soon as possible.'

In regard to paragraph 58, we suggest deletion of 'usually once a year'. Interim and in some cases quarterly results are posted.

**Criterion 5:**

We recognise the rationale for this criterion but we highlight a concern in relation to the process outlined in paragraph 61. This process must not in any way delay the firm (issuer) from its ability to manage its capital base in the most optimal and efficient manner to take advantage of prevailing market conditions. Therefore the guidance should include text recommending that the regulator/ authority provide approval 'in a timely manner to allow the firm to act as soon as possible.'

Consideration also needs to be given to the 'buy-back' process as regards state aided banks. This needs addressing in the paper.

We also suggest that requirements outlined in paragraph 62 are amply covered in paragraph 61; so paragraph 62 can be deleted.

As regards paragraph 63, as previously stated the industry does not agree with the benchmark solely being ordinary shares. Recital 4 allows for the instruments relevant to Core Tier 1 to act *pari passu* with ordinary shares in liquidation and in loss absorbency during going concern but not that the instruments have to act like ordinary shares in every aspect (for instance regarding distributions/ payment). Upholding Recital 4 is essential. This will be crucial if the broadest investor base is able to be continued to be accessed for capital raising purposes. The development of these criteria should not lead to the exclusion of fixed income investors who are an essential source of capital.

**Criterion 6/ 7:**

We question whether CEBS has thought through the economic consequences of this criterion for fixed income investors.

The industry is concerned that if the benchmark is restricted to ordinary shares, the investor base for core tier 1 instruments will be limited just when a broad investor base will be necessary to respond to the capital issuance needs of the industry. The fixed income investor is essential and Core Tier 1 instruments must be allowed to cater for their needs. We therefore do not support paragraph 65 part c) or paragraph 70.

As regards 65 c) the over riding criterion should be that the instrument is loss absorbing and ranks *pari passu* with ordinary shares, as such an ASCM feature should be supported. The current wording would also prohibit the use of scrip dividends and we do not support this. We recommend deleting point 65 c). This we believe aligns to CRD 2 intentions.

As regards guideline 70 if an instrument that has a pre-indication of amount to be paid it does not mean that it will be paid. Instruments with this feature can be and should be allowed, with the clear advice given to investors at the prospectus stage that payments will only ever be made provided the company has hit relevant financial targets and are therefore at the firm's discretion. The requirement as currently stated under 70 is super equivalent to the level 1 test and therefore the sentence 'There shall be no pre-indication of the amount that will be paid' should be deleted from it. These changes would also ensure consistency with guideline 72.

It should also be noted that when firms paid dividends during the crisis that, this was not a failing of the capital instrument, but of the firm governance and the supervisory process. The crisis did not arise because of fixed dividends. The issue of 'payment' should be addressed as part of the day to day regulatory management process, not in redefining instruments with fixed coupon characteristics.

### **Criterion 8/9/10:**

We note that it appears that loss absorption in liquidation goes further than *pari passu* ranking in liquidation, and enquire why CEBS consider this a necessary matter to address.

As regards Criterion 9 we suggest this is re-phrased to the below which more appropriately aligns to CRD 2 and the intentions of Recital 4: 'They are entitled to a claim on the residual assets that is proportional to their share of capital beyond the original principal amount'.

## **3 Response to the specific questions raised:**

### **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.**

The guidelines are clear however, we do not agree with the fact that ordinary shares are the sole benchmark. Rather we believe, as Recital 4 states, that the instruments relevant to Core Tier 1 should act *pari passu* with ordinary shares in liquidation and in loss absorbency during going concern. We believe this should be the fundamental benchmark not simply that ordinary shares are the benchmark. As supported by Recital 4, we do not agree that the instruments have to act like ordinary shares in every aspect (for instance regarding preferential rights for distributions/ payments). If you restrict the benchmark to ordinary shares the industry believes the consequence will be that you will limit the investor base at a time when a broad investor base will be critical to cater for the capital issuance needs of the industry. The fixed income investor base is essential and Core Tier 1 instruments should be allowed to have critical features to ensure fixed income investors' participation (e.g. fixed distribution rate / defined liquidation amount).

We see this being achieved through Instruments that behave as ordinary shares but do have a fixed coupon rate payable only if certain performance conditions are met. This condition should be part of the issuance process with the prospectus clearly defining that the issuance of dividends will only occur if firms' performance meets defined criteria. This aligns to CRD principles and Basel intentions.

In addition, we find that the criterion as currently worded would prohibit the use of share option schemes and or share save schemes, as well as the recognition that it is not possible in all circumstances for banks to be able to fully know what customer loans are used for.

We therefore recommend the following text changes to the main policy statements and criteria.

- To the main policy statement:

Point 17: Instruments which are ordinary shares *or act pari passu with ordinary shares in liquidation and in loss absorbency during going concern*, 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).

Point 34: CEBS considers, therefore, that ordinary shares *or instruments that act pari passu with ordinary shares in liquidation and in loss absorbency during going concern* 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).

- To criterion 2 :

43. The aim of Article 57(a) is to recognise only paid up items that ensure an effective supply of permanently available and fully loss-absorbing capital to the institution as eligible own funds items referred to in Article 57(a). *Employee share schemes such as option schemes or 'share save schemes' are the exception to this rule.*

44. To ensure an effective supply of capital, capital instruments are not eligible when the credit institution provides any financing to the shareholder or other proprietor to *knowingly* facilitate the subscription of capital, either directly or indirectly (e.g. through group members or other related parties). This shall not only apply to the issuance of capital, but also to any later purchases of shares by new shareholders/proprietors from existing shareholders/proprietors. Equally, all circumstances under which an institution returns capital to its shareholders/proprietors shall be closely monitored in order to prevent any improper distribution of capital.

## **1.2. Are there any circumstances under which indirect issuances would be justified? Please provide evidence.**

Issuances under non direct means should be allowed where:

i) the SPV is an operating vehicle owned by the firm; ii) where to not issue via a SPV would cause constraint to the investor base; iii) where national 'corporation' law allows issuance via SPVs. Examples of countries where this will be relevant are the UK and Spain.

Point 45 of Criterion 3 should therefore be changed to:

45. As the benchmark is ordinary shares, *or instruments that act pari passu with ordinary shares in liquidation and in loss absorbency during going concern*, the instrument shall be directly issued by the institution without using a Special Purpose Vehicle to fulfill Criterion 1; *unless the following circumstances prevail: the SPV is an operating vehicle owned by the firm; ii) where direct issuance would cause constraint to the investor base; iii) where national 'corporation' law allows issuance via SPVs.*

**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 amend**

Whilst the guidelines are generally clear, the industry has concerns over the prescription of buy-back procedures and recommends changes as detailed in our comments upon criteria 3, 4 and 5 above and response to questions 2.2 and 2.3 below.

**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.**

The industry has concerns over the prescription for redemptions and buy-backs and the manner by which the process will operate.

Specifically it will not be appropriate for delays to occur whilst awaiting authority/ regulator approvals when it will be important for the firm (issuer) to act quickly as regards its intended redemption.

This being so the following words should be added to the current guideline text: *'such approval is to be provided in a timely manner to allow the firm to act as soon as possible.'*

In addition under point 58 it may in-fact not be 'usually once a year' given the manner in which interim and in some cases quarterly results are posted. We believe this text in brackets should therefore be deleted.

Given the requirements outlined in point 61 we believe point 62 can be deleted as these are amply covered within 61.

**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.**

Yes, there may well be a lead and lag effect to any buy-back where e.g. the buy back process may occur over a period of time. This being so the deduction from own funds should be allowed to be staggered to accommodate this staggered 'buy-back' process.

Consideration also needs to be given to state aided banks/ government investment process; this needs addressing in the paper.

**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.**

As regards guideline 63, as previously stated the industry does not agree with the benchmark solely being ordinary shares. Recital 4 calls for the instruments relevant to Core Tier 1 to act pari passu with ordinary shares in liquidation and in loss absorbency during going concern but not that the instruments have to act like ordinary shares in every aspect (for instance regarding distributions/ payment). Upholding Recital 4 as the base line as

described and not just ordinary shares is therefore essential. This will be critical if we are to ensure the broadest possible investor base is able to be accessed to meet the demands for capital that will be required across the industry.

We therefore do not support paragraph 65 part c) and paragraph 70.

As regards 65 c) the over-riding criterion should be that the instrument is loss absorbing and ranks *pari passu* with ordinary shares, as such an ASCM feature should be supported. The current wording would also prohibit the use of scrip dividends and we do not support this. We recommend point 65c) is deleted. This we believe aligns to CRD 2 intentions.

As for paragraph 70: if an instrument that has a pre-indication of amount to be paid it does not imply that it will be paid. Instruments with this feature can be and should be allowed, with the clear advice given to investors at the prospectus stage that payments will only ever be made providing the company has hit relevant financial targets and is therefore at the firm's discretion. The requirement as currently stated under 70 is super equivalent to the level 1 test and the sentence '*There shall be no pre-indication of the amount that will be paid*' should be deleted.

**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.**

Please refer to our comments in 3.1 above. In addition we reiterate the industry's overall view that we believe that features such as dividend pushers and stoppers should be allowed providing the instrument itself in liquidation ranks *pari passu* with ordinary shares and in the same manner as ordinary shares for loss absorbency; as intended by Recital 4. We therefore recommend the deletion of 65 d).

**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.**

The guidelines are clear however we reiterate the need to uphold recital 4 as the benchmark and not just ordinary shares is therefore essential. Instruments with a coupon feature can and should be allowed. This will be critical if we are to ensure the broadest possible investor base is able to be accessed to meet the demands for capital that will be required across the industry. Criterion 9 should be altered to read: '*They are entitled to a claim on the residual assets that is proportional to their share of capital beyond the original principal amount*'.

**4.2. Are there any particular issues CEBS should consider regarding Loss absorbency features, both in going concerns and in liquidation? Please provide evidence.**

Please see above responses to 3.1, 3.2 and 4.1.

#### 4 Conclusion

In summary, whilst in broad terms the industry is supportive of this CP we believe it critical to the future ability to raise and sustain capital levels that a broad investor base is able to be accessed and that CEBS aligns to overall international capital standards as defined by Basel. In this regard therefore it is critical that fixed coupon parameters as outlined in Recital 4 continue to be permissible under these guidelines, and the criteria be adjusted accordingly.

Clarification on the grandfathering protocols is also essential if the market is to operate effectively.

The industry looks forward to CEBS response to the points raised above, which we view as essential to address prior to finalisation of the guidelines. We look forward to hearing from you in this regard, and will be happy to meet with you further to progress matters. If you have any comments or questions regarding this response please contact Irene Graham ([irene.graham@bba.org.uk](mailto:irene.graham@bba.org.uk)), Anita Millar ([anita.millar@afme.eu](mailto:anita.millar@afme.eu)), and Antonio Corbi ([acorbi@isda.org](mailto:acorbi@isda.org)).

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