Z E N T R A L E R   K R E D I T A U S S C H U S S
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Zentraler Kreditausschuss position paper on

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

31 March 2010

<u>A. Definition of capital in the sense of Article 57(a) and recital 4 of the CRD</u>

I. Concerning Criteria 1 to 3

Question 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.

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

Concerning 1.1
A change of paradigm was accomplished through the amendment of the Banking Directive (CRD) in the field of prudential capital. Instruments belong to capital if they comply with certain principles. We explicitly welcome this principles-based approach, which also found favour in the corresponding CEBS Guidelines on the definition of capital. This principles-based perception, which takes the form of a list of criteria for the eligibility of capital instruments as Tier 1 capital in the CRD, also corresponds to the intention of the author of the Directive. Against this backdrop, the instrument of the ordinary share should not, as assumed by CEBS (and also the Basel Committee on Banking Supervision), be assigned the function of the benchmark (see **points 17 and 34**). Rather an instrument should be eligible as Tier 1 capital if it already satisfies the criteria laid down in the CRD (Art. 57(a) and recital 4 of the CRD). Recital 4 does not maintain (as stated in point 32) that instruments under Article 57(a) must be configured exactly like ordinary shares and may only differ with regard to preferential rights for dividend payment.

Rather, all instruments must

- be capital in accordance with national law,
- rank pari passu with ordinary shares during liquidation,
- absorb losses on a going-concern basis pari passu with ordinary shares.

No more far-reaching requirements are laid down. Rather, it is merely clarified that instruments which provide preferential rights for dividend payment on a non-cumulative basis are also covered by these requirements.

Moreover, the Guidelines show that the course taken results in practice, in all key regulatory areas, in special legislation having to be drawn up for cooperative banks, public credit institutions and other comparable institutions. This demonstrates that the reference to the ordinary share only reputedly leads to the possibility of creating a uniform control system.

Criterion 1 (**points 39 to 42**) requires the instrument to be valued as capital under the respective accounting standards. In principle, we view the link between accounting and prudential treatment critically. The definition of capital elements usable for prudential purposes is thereby increasingly placed in the hands of external standard-setters. This cannot be in accordance with banking supervision. Excessively strong dependencies should therefore be viewed critically.

In the comments on **Criteria 1 to 3 (points 19 - 21 and 39 - 45)**, the concept of "legal owner" is introduced and interpreted in brackets as "shareholder" or "other proprietor". With regard to the definition of capital, the CRD – as too the present consultation paper (see point 40) – refers to Article 22 of Directive 86/635/EC (Accounts Directive), according to which the lender is likewise termed as "shareholder" or "other proprietor". The concept of "legal owner" is in our opinion too narrowly couched and does not correspond to the provisions of the Directive mentioned. Such a choice of concept could be misunderstood to mean that possible investors should be confined to the existing holders of the subscribed capital. Such an interpretation would however make the provisions of the Directive too narrow and would disproportionately restrict the intended possibility to issue instruments which satisfy the requirements defined for core Tier 1. As we understand it, it should make no difference whether the instrument originates from the legal owner of the institution or a third party, so long as the qualitative requirements concerning the permanence, flexibility of payments and loss absorbency are satisfied. To avoid misunderstandings and interpretation problems, we advocate not introducing the relevant concept and instead keeping to the proven terminology of Article 22 of Directive 86/635/EC – shareholder or other proprietor.

In view of the comments in **point 44**, possibly further supplementary information on the question of the treatment of acceptance as security of own capital instruments would be helpful. For instance, it should be clarified that own shares accepted as security under a simple consumer loan are not to be deducted from capital. Rather it should be shown for differentiation purposes that where loans are secured by own shares, the shares are not to be deducted from capital where the loans were issued on the usual market terms.

Furthermore, it is necessary, by analogy with the CEBS Guidelines on hybrid capital instruments (CP 27), to introduce market-making or market-smoothing clauses.

Regarding **points 38 and 63**, we point out that different classes of capital (especially of shares) are explicitly desired by the legislator and therefore laid down in the respective company law. These classes always confer different rights and privileges. For instance, as a rule, holders of shares without voting rights generally speaking receive a preferential dividend payment in compensation for the lack of the privilege of the voting right. One privilege therefore compensates for the other (likewise for holders of shares with voting rights). The various privileges do not however have any effect on the above-mentioned criteria (see points 32 and 34, inter alia) for the definition of capital under Article 57(a) and especially not on the loss absorbency function. We therefore request the deletion of point 38, which entails an unacceptable overvaluation of voting rights.

In this connection, it is also necessary to adapt **point 63**, which inadmissibly states that ordinary shares form a benchmark (see our comments above) and that recital 4 of the CRD maintains that the only difference that there may be between the instruments is that certain instruments confer preferential rights to dividends. Recital 4 merely states that it should be possible to recognise instruments providing preferential rights for dividend payment. This does not however constitute a definitive list of instruments, but merely provides an example.

Concerning 1.2

According to **Criterion 3** and **point 45**, the instrument must be issued directly by the institution, i.e. without using an SPV. Accordingly, Tier 1 bonds issued by special purpose vehicles would generally speaking not be eligible. Here too, CEBS exceeds its mandate, since this requirement too is not based on the provisions of the CRD. As we understand it, the need for the instrument to be issued directly focuses on capital being effectively made available. Since however, already according to Criterion 2, in any case only fully paid instruments are eligible, the way they are issued is unimportant. What is more, allowing SPV issuances will ensure a level playing field among banks from different jurisdictions with different tax and company law regimes as they will be able to make issuances in foreign countries. In this respect, we explicitly reject prohibition of the use of an SPV.

<u>B. Permanence</u>

II. Concerning Criteria 4 and 5

Question 2.1:
Are the guidelines in relation to Permanence sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals as to how the text could be amended.

Question 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.

Question 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.

Concerning 2.1
The Guidelines are sufficiently clear in relation to “Permanence”.

However, the requirement contained in **points 57 and 62** that institutions may be asked by the supervisors to demonstrate that they (still) have access to the capital market gives rise to strong objections. In our view, there are problems in implementing such a requirement validly in practice. In this respect, we advocate deletion of **points 57 and 62**. Furthermore we request examples for clarification of the conditions on which it could be assumed that investors expect repayment or buy-back of the instrument (point 59).

The minimum information to be provided by the institutions under the approval process according to **point 56** is in our opinion too comprehensive and also, in view of some of the documents already available to the supervisors, unjustified. The data to be provided by the institutions should therefore be confined to the information which is not yet available to the supervisor. This applies in particular with regard to the information already available to the supervisor under pillar 2 (ICAAP).The results of the ICAAP are liable not to be sufficiently considered, as a result of which there is not least a duplication of the institutions’ duty to provide information.

Rather, the (audited) results of the ICAAP should be recognised as correct and sufficient. The beginnings of this are already set out in point 56.

Point 56 provides that institutions are obliged to make the necessary documents available to the supervisor “well in advance of the redemption date”. Any repayment or redemption depends however on the market conditions on the actual appointed date. This vague wording should therefore be made more concrete to ensure sufficient dependability for the institutions. This could be achieved, for example, by establishing a maximum time for examination for the supervisor. In this case, there would be a clear indication for the institution wishing to make a repayment of the final deadline for submission of the necessary documents to be able to effect a repayment on the planned date. In addition, keeping the preliminaries for a repayment as short as possible clearly restricts the possibilities for insider dealing, which always exist with long preliminaries.

In respect of the disclosure obligations provided for in **points 56 to 58** for corresponding redemptions, provision should be made for a de minimis clause or bagatelle clause formulated in concrete terms. Below threshold amounts established in this way, it should be possible for the disclosure obligation in principle to be waived in the interests of reducing bureaucracy.

Concerning 2.2

CEBS clarifies in the comments on permanence and **Criteria 4 and 5** respectively that both redemptions and buy-backs are subject to prior supervisory approval (**points 46 ff.**). The regulations concerning buy-backs extend beyond the provisions of the CRD. We consider the general requirement for supervisory approval for buy-back programmes to be superfluous. When considering this position, we ask the Committee to take into account the fact that cancellation of shares is only one of a variety of possible uses of bought-back shares. Even more often they are not cancelled but are used to compensate employees or to make acquisitions. They might even be sold again. In all these cases, the shares are returned to sharholders very quickly and qualify as core Tier 1 capital. At least, however, no supervisory approval should be necessary if the amounts bought back are replaced by equivalent capital.

In principle, consideration should be given to establishing regulations according to which the approval of the authorities may be assumed to be given if certain minimum capital thresholds are complied with. In the abstract, it can be stated here too that the capital situation of the institution must be adequate, for example within the meaning of “well capitalised”. In the interests of simple handling in practice, corresponding benchmarks should then be established.

It should also be clarified which time horizon is observed by the supervisors in their examination, since point 55 provides that both the current and the expected level of capital are to be assessed.

Concerning 2.3

CEBS requires (see **points 48 ff.**) that once the prior approval of the supervisor has been obtained and the intention to redeem or buy back has been publicly announced, the corresponding amount of Tier 1 capital redeemed or bought back is to be deducted. We consider the deduction from Tier 1 capital at the proposed time to be unjustified, as the capital is still in fact at the disposal of the institution and will remain so until the shares are ultimately bought back. The execution of buy back programmes is always subject to current market conditions. For instance, from the beginning of the crisis in mid-2007, many banks reduced significantly their share buy-back programmes which had been approved before the beginning of the crisis. In fact the proposed requirement would result in announcements with very short time horizons in order to be able to react to market developments at short notice. This would contradict the goal of market transparency and the prevention of market manipulation as article 4 (2) of council regulation (EC) no. 22273/2003 asks for when requiring announcements of share buy-backs. Following the same logic, the approval of the authorised capital by the general meeting of shareholders of a joint stock company should already be considered in full as capital at the time of the official announcement of the issue of new shares, even if the capital has still not reached the institution. Rather, the decisive factor should be the circumstance of the inflow into or outflow of capital from the undertaking. These points in time can be determined objectively and consequently also lead to application of the standards with greater legal certainty. A corresponding provision should accordingly be renounced and para 48 and 49 deleted.

Such a regulation also cannot be implemented as the announcement of buy-backs of shares as a rule is indeterminate. Depending on national company law, only an upper limit of shares which may be bought back is determined (in Germany, for example, 10% of the shares in issue on the day of the general meeting of shareholders). Such flexibility for the management is necessary to be able to react rapidly to changes in the capital market environment.

In particular, it should be borne in mind that the public disclosure of a share buy-back programme complies with the requirements of Article 4(2) of Council Regulation (EC) No 2273/2003. It serves to improve market transparency and to prevent market manipulation but not to boost investor expectations.

C. Flexibility of payments

III. Concerning Criteria 6 and 7

Question 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.

Question 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.

Concerning 3.1
In principle, the guidelines in relation to the flexibility of payments are sufficiently clear. However, there are various aspects which require comment. In this respect, we refer to the comments in the reply to question 3.2.

Concerning 3.2
The explanation regarding **Criterion 6** providing for full discretion of management in respect of dividends or coupons (**point 65**) is an unrealistic concept which even ordinary shares do not offer. The underlying assumption seems to be that this is a feature of ordinary shares and that therefore any other instrument of the core Tier 1 category has to have this very same feature. However, it is incorrect to assume that it is an inherent feature of ordinary shares that a bank management is able to decide on an "as needed" basis whether or not to pay the coupon. The management is responsible only for the preparation of the financial statements. The decision on the distribution of the profit is referred to the proprietors or shareholders. If the proprietors or shareholders resolve to distribute the profit, the corporation becomes obliged to make this distribution. If the requirements of company law for distributions are met, only regulators can intervene to suspend the payment with their enforcement powers. Against this background, even ordinary shares in Europe do not meet the requirements for core Tier 1 proposed.

Acknowledging that even dividends on ordinary shares are not at the full discretion of management, Criterion 6 (and **point 65**) have to be changed. In our view a profit test would be sufficient for instruments to qualify as core Tier 1: “Distributions may only be obligatory if

a. the annual profit of the most recent tax year for which audited financial statements are available is equal to or exceeds the amount of the envisaged distribution and other distributions and
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 order of the regulator that suspends the payment.

The “well capitalised” threshold can be determined in the supervisory review process under Pillar 2.

Criterion 7 provides that the level of distribution may not depend on the amount paid in and in this respect instruments with a fixed coupon cannot be recognised as core Tier 1 capital. The prohibition of fixed coupon payments represents a tightening up of the provisions of the Directive, which allow fixed yields; this is not covered by the CEBS mandate. In addition, this restriction in our view is unnecessary to ensure the flexibility of payments. We consider this requirement to be adequately ensured by Criterion 6, according to which the instrument must be configured so that the issuers have freedom of decision whether and to what amount payments are made.

CEBS also clarifies in **point 67** that payments on any core Tier 1 capital instrument are to be handled in the same way as the distribution of dividends on share capital, i.e. also require approval by the general assembly or general meeting of shareholders. An objectively imperative reason for the approval obligation beyond the provisions of the CRD is not obvious to us. Rather in interaction with Criterion 6 (no right to claim distribution), this would even be a disadvantage for the lender if, for example, the majority of the ordinary share capital were to decide to pay a distribution on the ordinary share capital, but not on capital instruments of a third party.

Regarding **point 69**, we would call on CEBS to clarify that preferential payments other than multiple ones are also covered by recital 4 (‘preferential rights’). For example, premium amounts that are totally discretionary and not pre-indicated in any way (unless no decision had been taken at the general assembly) should also be regarded as acceptable capital instruments under Art. 57(a) of the CRD (recast). This would imply that dividend payments in terms of fixed premiums on preferential instruments might be possible even when ordinary shareholders receive no payment at all.

Point 71 states that a cap may not be imposed on payments. For non-joint stock companies, however, an exception is to apply if a cap is permissible under national law for all instruments eligible under Article 57(a) of the CRD. CEBS justifies its prohibition of caps by it being potentially interpreted by market participants as a kind of obligation for the issuer to pay. We cannot understand the fear expressed by CEBS. In so far as a distribution is at the sole discretion of the issuer and therefore Criterion 6 is adequately satisfied, we consider a cap to be harmless. In this respect, we advocate allowing all institutions to establish a cap. Otherwise we request further explanations of which concrete issues lie behind providing for the exception in the second sentence of point 71 and especially which national law in which EU Member States provides for such regulations.