17 December 2009

Consultation Paper on Implementation Guidelines regarding

Instruments referred to in Article 57(a) of Directive 2006/48/EC recast

(CP 33)

Introduction

1. The latest amendments to the Capital Requirements Directive (CRD)[1] introduce explicit rules for the treatment of instruments eligible as capital and, in particular, requirements for their inclusion in institutions'[2] original own funds without limits. The amendments will have to be transposed into Member States' national law by 31 October 2010 and will be first applied from 31 December 2010.

2. Article 57(a) sets out which instruments – apart from reserves and retained earnings - are eligible for inclusion in an institution's original own funds as capital. The revised text after the CRD II review reads as follows:

   "(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;".

3. Furthermore, Recital 4 lays down criteria for those capital instruments to be eligible for original own funds of credit institutions. In particular, original own funds referred to in Article 57(a) of Directive 2006/48/EC should include all

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[1] Capital Requirements Directive (CRD) is a technical expression which comprises Directive 2006/48/EC and Directive 2006/49/EC. Please note that, in general, references to "Directive 2006/48/EC" and "Directive 2006/49/EC" or "CRD" refer to the amended versions of the Directives and references to a particular article of the CRD refer to the former. The amending Directive (Directive 2009/111/EC) has been published on 17 November 2009 and can be found under: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF.

[2] The term "institutions" encompasses all institutions subject to the CRD (i.e. credit institutions and investment firms). In some parts of this document "institutions" may also be referred to as "issuers".

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.

4. This consultation paper responds to the request in Article 63a (6) that CEBS shall elaborate guidelines for the convergence of supervisory practices with regard to instruments referred to in point (a) of Article 57[3].

Objectives and methodology

5. The objectives of the consultation paper are to:

   a) achieve a common understanding among competent authorities across the EU on the implementation and application of the new provisions;

   b) foster their convergent transposition; and

   c) create more transparency for market participants.

6. The guidelines presented in the consultation paper do not aim to be a comprehensive set of rules, but rather to complement the new CRD provisions, in particular, Article 57(a) and Recital 4, where additional guidance appears necessary or appropriate.

Impact assessment

7. In line with the 3L3 Guidelines, CEBS has conducted a high-level qualitative impact assessment, focussing, in particular, on those parts of the consultation paper that will potentially have the largest impact.

8. For joint-stock companies, in many countries, the only instruments currently eligible under Article 57(a) are ordinary voting shares with voting rights. Even if some other instruments, such as non-cumulative perpetual preferred shares, are currently eligible without limit in original own funds in some countries, the amount issued is rather limited in practice. As a consequence, the cost of the guidelines should be limited for joint-stock companies.

[3] The guidelines regarding hybrid instruments referred to in Article 63(a) have been the subject of a separate document "Implementation Guidelines for Hybrid Capital Instruments" published on 10 December 2009..

9. For non joint-stock companies like cooperatives and mutuals, CEBS has taken into account some of their specificities, notably with regard to the right of redemption. CEBS has, nevertheless, imposed some restrictions on the possibility of redeeming cooperative shares. These restrictions are necessary to preserve the permanence of the instruments eligible under Article 57(a) and to ensure a minimum harmonization within the EU. In some jurisdictions or institutions, these restrictions are already applicable, but, in others, they will have a cost if there is a need to adapt the legislation or the articles of association in order to take them into account.

10. CEBS's guidelines also propose deducting from the original own funds instruments referred to in Article 57(a) (i) the amount the institution provides knowingly to its shareholders to finance the subscription or to buy any of those instruments; and (ii) the amount of those instruments that it wants to redeem or buy-back when the redemption or buy-back becomes sufficiently certain.

11. These new proposals should have a minimal cost for the sector because CEBS believes that it is not common practice to finance subscription of own capital instruments; the deduction of instruments when the redemption or buy-back becomes sufficiently certain is simply an anticipation of the impact of the effect of these transactions on regulatory own funds. Introduction of these rules in the guidelines will ensure the availability of instruments referred to in Article 57(a) and promote a harmonized approach within the EU.

Public consultation

12. With regard to the highly practical relevance the guidelines set out in this consultation paper will have for the industry, CEBS is keen to continue useful dialogue with the industry. In accordance with CEBS's consultation guidelines (CP 01 rev) this consultation paper is, therefore, published on CEBS's website for a three month public consultation until 31 March 2010. Comments received will be published on CEBS's website unless respondents request otherwise. Please send your comments to the following e-mail address: cp33@c-ebs.org. CEBS is interested in stakeholders' views on the entire consultation paper. However, where specific input is requested, questions have been inserted.

13. In addition to the written consultation, a public hearing will be organized on 23 February 2010.

Implementation date:

14. CEBS expects its Members to transpose the guidelines into their national legal framework and apply them by 31 December 2010 at the latest.

Executive summary

15. The guidelines are structured in **four main parts**, covering the topics of (i) Definition of capital in the sense of Article 57(a) and Recital 4 (ii) Permanence (iii) Flexibility of payments and (iv) Loss absorbency.

16. CEBS has defined **10 criteria** covering each of the main features of capital instruments that may be included in original own funds without limits. The **general principles** are the following:

17. Ordinary shares 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).

18. To be eligible, capital instruments should be simple, easy to understand and be able to immediately and without any doubt fully absorb losses in going concerns.

19. 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. The definition of shareholders or other proprietors is determined by the national legal structure of the institution. (Criterion 1)

20. 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. (Criterion 2)

21. To be eligible, capital instruments shall be directly issued. (Criterion 3)

22. 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. (Criterion 4)

23. When there is a right under the law for the holders of shares to return their shares to the issuing institutions (in particular as regards cooperative and mutual banks or similar institutions), this right is not considered as a put option under these guidelines. This is under the condition that such redemption is

subject to an approval process which provides the institution with the option to reject the holders' request, specifically with attention to the prudential situation of the institution.

24. Neither the contract nor marketing conditions shall provide any expectation that the capital instrument will be bought-back or redeemed. Buy-backs or redemptions are subject to prior approval by the competent authorities. (Criterion 5)

25. There is no right for the holders of capital instruments to claim distribution. Non-payment must not trigger the insolvency of the institution. (Criterion 6)

26. 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. (Criterion 7)

27. A cap related to the payment on the instruments is not acceptable since it can be viewed by the market as an obligation to pay this capped amount. There is an exception for non-joint stock companies if, resulting from a provision under national law, the cap is applicable to all instruments eligible under Article 57(a), so that it does not create privileges.

28. Capital instruments take the first and proportional shares of any losses pari passu with other capital instruments referred to in Article 57(a). Concerning cooperative and mutual banks or similar institutions, depending on the national law, the shareholder may have a limited access to the reserves since, in the case of redemption or liquidation, he receives only the amount paid for shares. In other words, the shareholder gives up (some of) his rights to the reserves. The fact that the shareholder has limited access to the reserves does not necessarily mean that he does not share the first losses. This is under the condition that the reserves are not owned by some shareholders and not all, and that the limitations relating to the access to reserves are applicable pari passu to all instruments eligible under Article 57(a), so that it does not create privileges. (Criterion 8)

29. 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. Concerning cooperative and mutual banks or similar institutions, a cap on the amount paid is acceptable if it is applicable to all instruments eligible under Article 57(a), so that it does not create privileges. (Criterion 9)

30. Capital instruments must not be provided with guarantees, pledges or other credit enhancements that legally or economically enhance their seniority. (Criterion 10)

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

> 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."

31. Article 57(a) defines the general features of instruments that may be included in original own funds without limits.

32. The Recital 4 states that, for all institutions, other instruments than ordinary shares may be included under Article 57(a) but they must absorb losses pari passu with ordinary shares. The only difference with ordinary shares may be a preferential right for dividend payment.

33.For mutual, cooperative societies and other similar institutions, Recital 4 states that instruments issued by non joint stock companies that are deemed equivalent to ordinary shares, in terms of capital qualities, in particular, as regards loss absorption, should be included.

34.CEBS considers, therefore, that ordinary shares 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).

35.CEBS elaborates hereinafter the criteria that will be used to assess wether an instrument fulfils the requirements of Article 57(a), taking into account Recital 4.

36.In developing these criteria, CEBS takes into account that instruments under Article 57(a) are the basis of the regulatory own funds of an institution. To be eligible, these instruments, as ordinary shares, should be simple, clear to understand and be able to fully absorb losses in going concern without any doubt and immediately when they arise. Eligible instruments under Article 57(a) must also be of higher quality than a hybrid capital instrument referred to in Article 57 (ca).

37.While voting rights certainly provide an important source of market discipline vis-à-vis the credit institution, the CRD does not require voting rights attached to the instruments to be eligible under Article 57 (a).

38. Particular supervisory scrutiny should apply when capital is divided into classes of shares with different rights, such as voting, attached to them. In particular, it should be considered whether such a division creates a privilege for one of the classes or affects the general loss absorbency capacity. It is only under the condition that they do not create such a privilege that voting rights are irrelevant for the analysis of the eligibility of the capital instrument.

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

39.Article 57(a) refers to “capital within the meaning of Article 22 of Directive 86/635/EEC”. Article 22 of Directive 86/635/EEC states “this item includes all amounts, regardless of their actual designations, which, in accordance with the legal structure of the institution concerned, are regarded under national law as equity capital subscribed by the shareholders[4] or other proprietors”.

40.According to Article 22 of Directive 86/635/EEC only equity capital can be regarded as subscribed capital; it must not, therefore, be accounted

[4] The term “shareholders” referred to in this paper encompasses not only shareholders of joint stock companies, but holders in general (holders of cooperative shares for example).

as a liability under national accounting standards (or IFRS if a Member State uses IFRS as the relevant accounting standard). Furthermore, the capital must be contributed by the legal owners of the credit institution (shareholders or other proprietors) – as opposed to other investors contributing additional equity capital who are neither shareholders nor other proprietors.

41. Additionally, the amount paid in should be recognised as equity capital (i.e. not a liability) for the purposes of determining insolvency where relevant under national legislation. The holder of the instrument must not be in a position to petition for the insolvency of the issuer. The possibility for mutuals, cooperative societies and similar institutions to refuse the redemption of shares is not considered as an event of default when activated.

42. The definition of shareholders or other proprietors is determined by the national legal structure of the institution concerned (Article 22 of Directive 86/635/EEC). There is no differentiation to be made between common shares issued by an institution that is organised as a public limited company and other types of subscribed capital issued to proprietors of differently organised institutions (for example, instruments issued by cooperative/mutual societies or similar institutions). Under these guidelines, no specific distinction has thus to be made between joint and non-joint stock companies.

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.

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).

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 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.

<u>Criterion 3</u>: The instrument shall be directly issued.

45. As the benchmark is ordinary shares, the instrument shall be directly issued by the institution (i.e. without using a Special Purpose Vehicle) to fulfil Criterion 1.

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

B. Permanence

> <u>Article 57(a)</u>
>
> *"(a) capital within the meaning of Article 22 of Directive 86/635/EEC, in so far as it has been paid up (...)"*
>
> <u>Recital 4</u>
>
> *"(4) (...) 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 (...)"*

46. Redemptions and buy-backs are deemed to undermine the permanence of the capital instrument. In prudential terms, buy-backs are equivalent to a call or redemption. Both redemptions and buy-backs are subject to a prior supervisory approval.

47. Redemptions and buy-backs shall not be announced to holders before the institution has obtained the prior approval of the competent authorities.

48. When redemptions and buy-backs are deemed to take place with a sufficient certainty, and once the prior approval of the competent authorities has been obtained, the corresponding estimated amounts to be redeemed or bought back shall be deducted from original own funds referred to in Article 57(a) while waiting the effective redemption or buy-back to occur.

49. A sufficient certainty is deemed to exist when the institution has publicly announced its intention to buy-back.

<u>Criterion 4</u>: 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.

50. Instruments referred to in Article 57(a) shall be undated and are not redeemable outside of liquidation. They must be freely available within an institution and remain so at all times.

51. The issuer must not have the option to redeem (no call), at any time, any such instrument (setting aside discretionary repurchases or other means of effectively reducing the capital in a discretionary manner that is allowable under national law).

52. The holders of instruments referred to in Article 57(a) should also have no right of repayment of their capital except as a claim for the residual assets in liquidation in proportion to their share of issued capital. This claim may be set aside for cooperative and mutual banks or similar institutions as stated in paragraph 77.

53. Accordingly, the holder of such instruments shall not have a put option towards the issuer.

54. When there is a right under the law for the holders of shares to return their shares to the issuing institutions (in particular cooperative and mutual banks or similar institutions), this right is not considered as a put option under these guidelines. This is under the condition that this redemption is subject to an approval process which provides the institution with the option to reject the holders' request with regard in particular to the prudential situation of the institution.

55. In any case, competent authorities shall have the possibility to refuse the redemption or limit the amount to be redeemed, notably when they have determined that the level of capital of the institution (both current and expected) is not adequate to its risks.

56. The issuer is required to transmit an application as soon as it has made its decision to redeem capital instruments. Competent authorities may define a process for the transmission of the application taking into account the materiality of the amount to be redeemed and/or the information already provided notably as part of the evaluation of the ICAAP of the institution. This application shall be accompanied by all required/necessary information allowing the competent authority to conduct its assessment on the potential impact of the redemption on the financial and solvency positions of the issuer. The application shall at a minimum include all the information required for the redemption of hybrid instruments[5]. The issuer shall schedule the submission of its application well in advance of the redemption date.

[5] As detailed in the Implementation Guidelines for Hybrid Capital Instruments dated 10 December 2009.

57. Competent authorities may also ask the institution to demonstrate that it can re-access the market if necessary.

58. With regard to some specificities of cooperative and mutual banks or similar institutions, the application for the redemption of capital instruments may be submitted to competent supervisory authorities on the same frequency as the one used by the competent body of the institution to examine redemptions (usually once a year).

<u>Criterion 5</u>: 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.

59. As for ordinary shares, the issuer may buy back the instrument but neither the contract nor marketing conditions shall provide an(y) expectation that the instrument will be redeemed or bought back.

60. The competent authorities shall have the possibility to refuse the buy-back or limit the amount to be bought-back notably when they have determined that the level of capital of the institution (both current and expected) is not adequate to its risks.

61. An issuer that intends to buy back capital instruments shall submit an application to the competent authorities as soon as it has made its decision to buy-back some instruments. Competent authorities may define a process for the transmission of the application, taking into account the materiality of the amount to be redeemed and/or the information already provided, notably as part of the evaluation of the ICAAP of the institution. The application shall contain a detailed updated capital plan allowing the competent authority to conduct its assessment on the potential impact of the buy-back on the financial and solvency positions of the issuer. The application shall, at a minimum, include all the information required for the buy-back of hybrid instruments[6]. The issuer shall schedule the submission of its application well in advance of the buy-back date.

62. Competent authorities may also ask the institution to demonstrate that it can re-access the market if necessary.

Question 2:

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.

[6] As detailed in the Implementation Guidelines for Hybrid Capital Instruments dated 10 December 2009.

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.

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.

C. Flexibility of payments[7]

Recital 4

"(...)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 (...)."

63. As mentioned above, the benchmark for defining flexibility of payments in the context of Recital 4 is ordinary shares. The only difference foreseen by the Recital is that there may be instruments with preferential rights to dividends.

64. 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.

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

65. On an on-going basis, like any ordinary share, for which the payment of dividend is fully discretionary, any capital instrument shall:

a) ensure full discretion: the institution must have discretion to decide whether or not it will pay a dividend on the instrument, and how much;

b) permit an institution to preserve cash by not paying out dividends, without triggering an event of default. Non payment is, therefore, not an event of default;

[7] Payments referred to in this paper relate with no differentiation both to dividends or similar distributions.

c) not have ACSM features[8] (if the dividend is not paid in cash, then the holder is not entitled to receive payment in kind, as a 'fall-back payment' may create an expectation that the dividend will be paid);

d) not have dividend pushers[9] nor dividend stoppers (i.e. if the institution issues different instruments, to be eligible under Article 57(a), they shall be pari passu with themselves).

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

66. When instruments other than ordinary shares are also eligible, the dividends on these instruments should replicate the behaviour of dividends on ordinary shares.

67. The distribution of dividends on these other instruments must be approved by the General Assembly (or the relevant body depending on the legal structure of the institution concerned under company law or other relevant governing law) simultaneously with the distribution of ordinary dividends.

68. The amount of the dividends on these instruments must first depend on the amount of the distributable items as defined under national law: as long as there are insufficient distributable items, no dividend must be paid.

69. If the institution has issued different instruments that are eligible under Article 57(a), the potential preference (preferential rights mentioned in Recital 4) that some of them may have shall be limited to a multiple of the dividend on the instrument that does not have a preferential right.

70. The amount of payments shall be fully discretionary. There shall be no pre-indication on the amount that will be paid. A fixed amount (= percentage of the nominal amount) is not acceptable.

71. A cap related to the payment on the instruments is not acceptable since it can be viewed by the market as an obligation to pay this capped amount. There is an exception for non-joint stock companies if, resulting from a provision under national law, the cap is applicable to all instruments eligible under Article 57a, so that it does not create privileges.

[8] Alternative Coupon Satisfaction Mechanisms (ACSM) or similar mechanisms oblige the issuer to substitute the payment of coupon or dividend by a payment in the form of an instrument referred to in Article 57(a).

[9] Under normal circumstances, a dividend pusher requires the issuer to pay its coupons/dividends on hybrids if it has paid coupons/dividends on a more junior instrument, for example, its ordinary shares.

72. This does not prevent institutions from disclosing a dividend policy if it only reflects the current intention of the Board and does not undermine the discretionary feature of payments.

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.

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.

D. Loss absorbency

Article 57(a)

"(a) capital (...) in so far as it (...) it *fully absorbs losses in going concern situations, and in the event of bankruptcy or liquidation ranks after all other claims*;"

Recital 4

"(...) *Original own funds referred to in Article 57(a) of Directive 2006/48/EC should include all instruments that (...) rank pari passu with ordinary shares during liquidation and fully absorb losses on a going-concern basis pari passu with ordinary shares.(...). 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.*"

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)

73. On an ongoing basis, instruments referred to in Article 57(a) must fully absorb losses to help the institution continue as a going concern. In particular, in order to comply with Article 57(a), the instrument should take the first share of any losses as they occur.

74. Instruments referred to in Article 57(a) should demonstrably absorb losses that may arise to enable an undertaking to continue as a going concern. In the context of capital instruments, the own fund item that unequivocally meets this test is ordinary share capital or the equivalent capital of non-joint stock companies. This is because these items:

    a) absorb losses as and when they occur before all other capital instruments; and

    b) rank below all other capital instruments in a liquidation.

75. The principal amount of an original own funds item referred to in Article 57(a) should, as with ordinary share capital, be fully and immediately available to absorb losses when they arise. The losses should be absorbed proportionately and pari passu with the other original own funds under that Article. A key feature of these items is that they should automatically absorb losses when they arise on a non-discretionary basis.

76. Losses may, of course, first be absorbed by the reserves owned by the ordinary shareholders, but the item must own the reserves pari passu with any other owners of the reserves. These reserves provide an initial buffer that allows an institution to absorb losses and to continue as a going concern. If reserves are exhausted, items of original own funds referred to in Article 57(a) may absorb losses by supporting negative reserves. For joint stock companies, other original own funds instruments under Article 57(a) that do not own the reserves may also share in losses on a pari passu basis (instruments with a write-down mechanism that absorbs losses pari passu with ordinary shareholders).

77. Concerning cooperative and mutual banks or similar institutions, depending on the national law, the shareholder may have limited access to the reserves since, in case of redemption or liquidation, he receives only the amount paid for the shares. In case of liquidation, any remaining net assets are distributed to another cooperative/mutual organization, a charitable organization, a sponsoring organization (like a municipality or church), or to a guarantee fund. In other words, the shareholder gives up (some of) his rights to the reserves. The fact that the shareholder has limited access to the reserves does not necessarily mean that he does not share the first losses and, consequently, that such an original own funds instrument should include a specific mechanism of loss absorbency as mentioned above (see paragraph 74) to be considered as fully loss-absorbent. This is under the condition that the reserves are not owned by some shareholders and not all, and that the limitations relating to the access to reserves are applicable pari passu to all instruments eligible under Article 57(a), so that it does not create privileges.

Loss absorbency in liquidation

<u>Criterion 9</u>: 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.

78. Any instrument, other than ordinary shares, eligible for inclusion in original own funds referred to in Article 57(a), shall rank after all claims and rank pari passu with ordinary shares during liquidation, thus absorbing losses on a pro rata basis with ordinary shareholders.

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 after all claims are satisfied reflecting their share in the credit institution. This would mean in practice that in case the institution has more than one category of capital instruments (i.e. ordinary shares and other capital instruments), 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.

80. Concerning cooperative and mutual banks or similar institutions, distribution of net assets in case of liquidation may be different among national jurisdictions. In some jurisdictions, the net assets are distributed, and in other jurisdictions the holder receives only the nominal amount paid for the share as a maximum refund. Such a cap relating to the amount paid in liquidation is acceptable if it is applicable to all instruments eligible under Article 57(a), so that it does not create privileges (see also paragraph 77).

Criterion 10: Capital instruments must not be provided with guarantees, pledges or other credit enhancements that legally or economically enhance their seniority.

81. Capital instruments are not eligible under article 57(a) when the credit institution provides guarantees, pledges of its assets or other credit enhancements, vis-à-vis the shareholder or other proprietor, that legally or economically increase the seniority of the instruments.

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.

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