Österreichischer Raiffeisenverband

Committee of European
Banking Supervisors

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cp33@c-ebs.org

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

Dear Sir/Madam,

The Austrian Raiffeisen Federation welcomes the opportunity to comment on the consultation paper regarding Instruments referred to in Article 57 (a) of Directive 2006/48/EC.

Please find our remarks on the following pages. Do not hesitate to contact us should you have any questions.

Yours sincerely,

Markus Dellinger
Head of Legal Department

Friedrich-Wilhelm-Raiffeisen-Platz 1
A-1020 Wien
Tel. ++43 1 211 36-2564 Fax ++43 1 211 36 2559
E-Mail: markus.dellinger@oerv.raiffeisen.at

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Concerning CP 33 we may comment as follows:

I. General remarks

We appreciate that CP 33 takes into account on many occasions some special features of cooperatives. So the draft Guidelines will be helpful in the future. For the time being still there is a problem, because CP 33 exceeds its task.

CP 33 is based on Art. 63a, para 6 of RL 2006/48/EC as amended in RL 2009/111/EC and reads as follows:

(6) “The Committee of European Banking Supervisors shall elaborate guidelines for the convergence of supervisory practices with regard to the instruments referred to in paragraph 1 of this Article and in Article 57(a) and shall monitor their application. By 31 December 2011, the Commission shall review the application of this Article and shall report to the European Parliament and the Council together with any appropriate proposals to ensure the quality of own funds.”

According to this provision CEBS was supposed to concentrate on the scope of interpretation granted to banking supervision in RL 2009/111/EG, in order to ensure an as consistent supervisory practice as possible. Instead CEBS established a system of rules, which in many respects does not (only) address to national supervisory authorities and their supervisory practice, but to legislative bodies of the member states. This has partly been done by an extensive interpretation of the wording of the directive and especially of its recital 4. This already exceeds the task assigned to CEBS in Art 63a, para 6, concerning the elaboration of guidelines for the convergence of supervisory practices. The supervision of a consistent legislative interpretation of directives and of a correct implementation of directives, is exclusively covered by the authority of the commission and the European Court of Justice (see Art 258 TFEU).

Even more critical is, that CEBS has not contented itself with such an extensive interpretation, but also comprises recent regulatory concerns, which are part of the Basel consultation paper, dated December 17, 2009 into guidelines concerning directive 2009/111/EC. CP 33 tries for example to reduce the 14 criteria for core tier 1 capital, which have been temporarily agreed on in Basel, to 10 criteria and to make these 10 criteria part of an interpretation of directive 2009/111/EC which was finally agreed on on September 16, 2009. But these (10) criteria (see point 16 – 30 of CP 33) are not part of the directive.

Although the guidelines presented in CP 33 do not have fully binding effect this approach of CEBS causes serious problems. The implementation of Basel III falls within the competence of the council and the European Parliament and must not be anticipated on administrative level by way of extensive interpretation of existing provisions. Guidelines concerning the convergence of supervisory practice can not be addressed to the legislator. If the directive (2009/111/EC) intended otherwise the principle of "comply or explain" according to Art 42b para 1 lit b of RL 2006/48/EC as amended RL 2009/111/EG would also have to address legislative bodies and not only competent authorities.

In addition this is not only an essential question of CEBS' competence within the scope of Art 63a, para 6 of RL 2006/48/EG as mended by directive 2009/111/EG, but also a practical problem of implementation deadlines. By (indirectly) applying the principles agreed on in Basel III through interpretation of directive 2009/111/EC starting Dec. 31, 2010 instead of Dec. 31, 2012 or 2013 (as expected), the implementation deadline would be shortened dramatically. The outcome of all this would be exactly what has been warned against, namely the implementation of more severe provisions concerning own funds at a time when banks - in view of the general crisis - are already under pressure. Therefore all pull-forward effects are to be eliminated from the Guidelines.

Our central demand is therefore: Elimination of all pull-forward effects from the Guidelines (CP 33). This implements a radical revision and abbreviation of the draft.

Despite these general concerns we shall also concentrate in detail on particular aspects of CP 33.

II. Handling of cooperative shares

1. Initial point: Recital 4 – Equivalence at loss absorbency

In Recital 4 of CRD 2 – as well as in the FSB-report - it is expressly stressed out that the specific constitution of cooperatives shall be taken into account. Concerning the equivalence of cooperative capital to ordinary shares Recital 4 is especially adjusted to loss absorbency. In this respect there arise no problems with member shares in the Austrian jurisdiction. The loss and risk absorbency of member shares – both according to the going and gone concern principle – can be proven by the characteristics given below:

- Payments of dividends (upon member shares) are only paid out of distributable items.
- In case of resignation, according to Austrian law and the statutes members of a cooperative maximally receive the nominal value of their capital shares (§ 79 para 2 GenG). Therefore there are barely any inducements for members of cooperatives to resign.
- Furthermore redemption (payment) is reduced, if a deficit is not covered by retained earnings.
- In case of voluntary liquidation of cooperatives, the title for compensation of members is subordinate, which means members are satisfied after all other creditors.
- Furthermore members of cooperatives do not get any compensation in case of bankruptcy, instead they have to provide for additional capital contributions (see below).

2. CP 33 calls for more

a) Presentation of equity capital (also) according to IFRS – point 40

Point 40 sentence 1 of CP 33 says:

"According to Article 22 of Directive 86/635/EEC only equity capital can be regarded as subscribed capital; it must not, therefore, be accounted as a liability under national accounting standards (or IFRS if a Member State uses IFRS as the relevant accounting standard)."

The bracket term according to which subscribed capital shall be presented as equity in the balance sheet according to international accounting standards is new and problematic. If we understood things correctly, this may only apply, if a member state uses IFRS as relevant accounting standard (assuming that "relevant" is meant as relevant for the calculation of own funds; such relevance is not already given by the obligation to prepare an annual consolidated financial statement based on IFRS, but only if an institute considers IFRS as basis for the assessment of its own funds). Nevertheless this is to be rejected.

So far it has been clear that the possible[1]) classification of share capital of cooperatives as liability according to IAS 32 is irrelevant for supervisory authorities. Therefore cooperative shares were classified as own funds, even if own funds were deduced from book values according to IFRS (cl. § 29a para 3 sentence 1 BWG). This is based on the ability of share capital of cooperatives to absorb losses, which is (also) seen as essential for the consideration of equivalence by recital 4 of directive 2009/111/EC; besides it is based on the fact, that IAS 32 for the distinction between equity and liabilities refers to any theoretical option to terminate the membership and does not take the actual probability of termination into account. This is inconsistent with the nature of cooperatives. Furthermore the following characteristics of (share) capital of cooperatives – typical for equity – shall be considered.

- The right to vote within the general assembly
- Right to participate in the general assembly
- Petition right
- Right to ask questions
- The right to be elected as a member of statutory bodies of the cooperative
- Minority right to convene a general assembly and to add items to the agenda;
- Right to do business with the cooperative,
- Right to participate in the liquidation proceeds

Under theses circumstances it is inapprehensible why CEBS believes, that it shall follow the evaluation of IASB concerning the presentation of cooperative share capital.

b) Permanence

This criterion established in CP 33 demands that the holder of a financial instrument shall have no right of repayment of their (share) capital, in order to qualify the financial instrument as own funds (see point 22, 23 and especially 50 ff).

The criterion of permanence is a consequence of CP 33 declaring ordinary shares as well as a fixed nominal capital as benchmark (point 17).

aa) moveable company share capital

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[1]) Also the IASB has recognized that the economic reality is too complex for a strictly principal based approach in the distinction between equity and liabilities. Thus there are not only the IFRIC 2 exceptions but in 2008 IAS 32 was amended. Now IAS 32 point 16A clearly states, that also a puttable instrument can be qualified as equity under certain circumstances, especially if it is the most subordinated form of capital, if it represents a residual interest and if there is no other equity instrument.

Cooperatives banks have an alternative model of business and membership. Those who need credit join the cooperative. After the credit is paid back they can resign again. This is – besides the mortality of natural persons – the reason why cooperatives will always have a fluctuation of members and no fixed nominal capital. Instead they have a flexible net sum of member shares. Figuratively the total nominal amount of member shares can be compared with a lake with a flow-in and -out. The water of the lake is changing constantly, while the lake itself is permanent.

To a certain extent point 54 considers the specificities of cooperatives, by not qualifying the redemption of cooperative capital shares as (problematic) put option in terms of supervisory practice. But this consideration is immediately constricted by implementing the condition that a redemption of the member shares is subject to an approval process, which provides the cooperative with the option to reject the holders' request with regard in particular to the prudential situation of the cooperative.

Austrian cooperatives normally do not have such a formal right to refuse redemption. Instead there are other cooperative instruments, which lead to a similar capital quality in terms of prudential practice (see bb below).

The subsequent implementation of the formal right to reject the holders' request – as claimed in point 54 – (especially in view of the general financial crisis), would expose cooperative banks to the risk of loosing reputation. It is not unlikely that members of cooperatives would even worry about their savings if they were informed that their bank must not pay back member shares. We think this risk to be not adequate taking into account, that cooperative banks have proven to be very stable in times of a crises, which in addition was caused by others. The possible consequences can not be within the interest of any supervisory authority. The cost of implementing CP 33 for cooperative banks may thus turn out to be much higher than expected by the authors of CP 33 (cf. point 9 of CP 33).

bb) *Cooperative hedging of share capital in Austria:*

Practical experience has shown that share capital of cooperatives has proven to be stable not at least within the actual crisis. In the extent members resign, others join, so that own funds remain almost the same or even increase. This empirically verifiably permanence is adequately legally assured by the following typically cooperative legal instruments:

- Notice period and termination date: resignation is only possible by giving at least a four weeks notice to the end of the business year (sometimes more according to statutes, cf.§ 77 para 2 GenG).
- Retention period: redemption of the terminated capital share may not take place before the lapse of one year since effectiveness of resignation (§ 79 para 1 GenG).

- Nominal value principle: Generally speaking there is no incentive to resign because of the limitation of any compensation to the nominal amount. Quite the contrary: Those who resign do not only lose their entitlement to promotion but also any possible further entitlement for participation in liquidation proceeds (§ 79 para 2 GenG).
- Also in times of a crisis there is no incentive for resignation according to Austrian Cooperative Law:
  - In the case a member wanted to resign from the credit cooperative in a crisis, he/she would have to share a possible accumulated loss. He would get his/her capital shares only insofar as they have not been absorbed by losses (§ 5 Z 6 GenG; § 3 para 1 GenKonkVO; § 7 para 2 and § 13 para 1 GenVerschmG; see also art. 16 para 1 of the statutes of the European Cooperative).
  - In case of winding-up of the cooperative within the retention period (§ 79 para 1 GenG), the resigned as well as all other members of the cooperative obtain the business assets only after all creditors have been fully satisfied in the liquidation procedure (§ 81 para 2 GenG).
  - In case the assets do not suffice for the satisfaction of creditors' claims, bankruptcy would be the result. Within bankruptcy of a cooperative neither actual nor within the last three years resigned members, can declare a claim provable in bankruptcy for their member shares (§ 1 para 2 GenKonkVO).
  - Quite the contrary: In Austria resigned members who have already got their member shares repaid, are obliged to pay it in again if the cooperative goes bankrupt within a period of three years after his/her resignation (§ 3 para 1 of GenKonkVO). Additionally members or within the last three years resigned members of cooperatives are obliged to make an additional capital contribution in this case according to § 76 GenG, which can be implemented simply and efficiently within a special procedure according to the Cooperative's Bankruptcy Act.

cc) Hedge of share capital of cooperatives in Austria in terms of banking supervisory practice

Also in view of banking supervisory practice there is a possible brake concerning the repayment of any company shares: According to § 70 para 2 Z 1 of Austrian Banking Law (BWG) the Austrian Financial Market Authority is entitled to partly or wholly prohibit "redemption of capital and profits" in case of "danger concerning the settlement of debts" of banks. In case of endangerment of a cooperative bank an only theoretically possible mass layoff thus can be stopped at any time.

dd) Intermediary result

Recapturing all measures mentioned under bb) and cc) there exists only a very theoretic residual risk for own funds based on cooperative share capital. Theoretically members may resign despite the inappropriateness and implausibility as explained under bb) and therefore weaken the capital (basis) hold by a credit cooperative to an extent that § 70 para 1 Z 1 Banking Law does not yet restrict (because then there is no “danger concerning the settlement of debts”), but the situation of own funds might already get alarming.

This theoretic residual risk can be neglected in practice. As already mentioned the share capital of cooperatives has proven to be stable also in the actual crisis.

Thereby it may have played a certain part that the nominal capital share is typically very low in Austria. As a rule the single company share amounts to € 7,26. For single member purposes only insignificant amounts are concerned. That may be one reason why even in times of a crisis nobody cares how to get his shares repaid.

ee) Possible future banking supervisory hedge of share capital by means of capital buffers according to Basel 3

In some places the Basel consultation paper addresses to capital buffers (see in detail point 247 et seq.). Thereupon only a certain quota of the yearly profit may be used for the receipt of dividends, buy-backs and voluntary bonus payments as long as the capital buffer does not reach a certain (still to clarify) extent (see in particular point 258).

In case these measures are effectively put into practice, the possible theoretical residual risk as described above would also be abandoned. The banking supervision law would then define a threshold for own funds independent of the legal form, beyond that a repayment of (company) shares or a buy-back would be illegal. In case this measure will be put into practice the condition as claimed in FN 19 of the Basel Paper for the acceptance of share capital as Core Tier 1 Capital would be achieved without any further action in Austria.

This shows again that the attem pt to shortened implement the 14 criteria for Core Tier 1 Capital from the Basel Paper in the course of CP 33 to 10 points is inappropriate and dangerous. There will be overall QIS-studies for the Basel Paper, in order to assess the single measures in their concurrence. An anticipation concerning certain aspects would disregard these interactions and therefore a malfunction would be the result.

ff) resulting demand

Although an approval process which provides the institution with the option to reject the holder's request with regard in particular to the prudential situation of the institution (paragraph 54) is a proper way to make sure, that the condition of the institution is not weakened as a going concern during periods of market stress, this cannot be the only way. As in many jurisdictions there are special cooperative solutions avoiding any weakening of the condition of cooperative banks in periods of market stress because of redemption, it must be left to the national supervisory authorities to check the appropriateness of these regulations and to report upon it.

c) Regulatory action for repayment point 56-58

For capital decrease and share buy-back CP 33 asks for the possibility of competent authorities to refuse the redemption. For cooperatives it would not be practicable to transmit an application for normal fluctuation of members. Point 58 considers the specificities of cooperatives insofar as it allows for a yearly approval. This however still overshoots the mark, in particular if the number of joining exceeds the number of resigning members and a net rise of the cooperative share capital would be the result. Even if the share capital of cooperatives decreased on balance, the transmission of an application and the whole process would be overreaching in cases in which only insignificant amounts are concerned.

An implementation of materiality limits is already declared acceptable in sentence 2 of point 56 ("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 problem is, that this seems to be withdrawn in sentence 4 by saying: "The application shall at a minimum include all the information required for the redemption of hybrid instruments."
This sentence 4 shall be attenuated in order to provide for an appropriate solution.

e) Criteria 6 and 7 – amount of dividends (point 65 – 72)

According to point 65 lit a) the bank shall have full discretion when fixing the amount of dividends. The same applies for points 70 and 71, according to which there must not be a pre-indication on the amount of the dividend and no limitation of the dividend[2]). At least point 71 contains an exemption

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[2]) The ban of a cap and the claimed discretion are in no way to be gathered from CRD 2. Criterion 6 and 7 are a clear example of pre-implementation of Basel III.

for non-joint-stock companies, if resulting from a provision under national law of a member state and if the cap is applicable to all instruments eligible in the same way.

This thematic complex is still to be discussed intensely within the scope of Basel III, because without advance notice of a certain amount of dividend participation papers (and non voting preference shares) would be much more difficult to be placed on the market. This foreseeable placement difficulties should make a legislator, who claims the increase of own funds, rethink things.
Furthermore the exception contained in point 71 is to narrow. Caps are to be found not only in “national law”, but also in the statutes. A deletion from the statutes would be counterproductive in terms of banking supervisory.
It has to be considered that with cooperative banks the decision about the adoption of annual accounts lies within the competence of the general assembly. The general assembly may therefore decide about the liquidation of revenue reserves and thus about the amount of distributable profits. General assemblies are sometimes hardly attended (less than 10% of the members). In case such a hardly attended general assembly decides on the adoption of annual accounts by an unexpected majority, it could – without statutory limitation of the amount to be distributed – distribute the accumulated profits. Then not a dividend of maybe 5-10% would be the topic, but possibly of several hundred percent. To avoid this, model articles of association provide for cooperative banks, that the amount of possible distribution of profits is limited by value (e.g. with the interest rate of the last emitted federal bond). It would be incomprehensible if already this measure of precaution led to repudiation as tier 1 capital.