

Own Funds Regulatory technical standards

The purpose of this note is to provide the European Banking Authority (EBA) with input from the Banking Stakeholder Group (BSG) to help it devise draft Regulatory Technical Standards (RTS) to complement CRR I on topics related to own funds as required by art 24, 25, 26, 27, 29, 33, 38, 46, 49, 71, 73, 74, 75 and 78 and 79 of the revised CRR version.

The goals pursued by the BSG are the following:

- European harmonization and limitation of regulatory distortion or arbitrage ;
- guaranteed financial stability to preserve taxpayers' money;
- preservation of European banks' ability to finance the economy and encourage economic growth in Europe.

To ensure the absence of competitive distortion, main BSG recommendations are the following:

- harmonizing the signification of "foreseeable dividend" by maintaining the most **prudent** method currently used by European supervisors, i.e. to regard foreseeable dividend as being generated simultaneously to quarterly results and corresponding to the official payout policy unless the institution can demonstrate to the supervisors it has been amended (e.g. through management committees proceedings);
- preserving the important place of mutual banks and the likes but ensuring their common equity Tier 1 instruments (CET1) are as non-derogatory as allowed under their statuses;
- avoiding regulatory arbitrage: in particular, the economic substance must prevail over the form when considering externally issued instruments (i.e. those instruments must be disregarded when they are only hedges and funded by the group) and instruments to be deducted (i.e. all instruments which are economically equivalent to a type of banking regulatory capital). Furthermore, no institution issuing or being legally able to issue on individual basis common or preference shares that would qualify as CET1 under Article 26 could be included in the definition of mutual banks;
- without prejudice to single rule book which the BSG fully supports, some flexibility should be allowed so that national specificities regarding the CET1 legal or fiscal regime can be taken into account appropriately, e.g. relating to share premium accounts or pre-defined trigger of write-ups.

To preserve stability, the BSG encourages a consistent application of the capital criteria set out in the CRR. The BSG supports as well a prudent (but not penalizing) calculation of regulatory own funds, including a definition of prudential valuation adjustments and of a conservative method to compute exposures through indices.

To avoid penalizing European credit institutions in a manner that brings no enhanced stability, the BSG considers that economic substance should be taken into account when specifying the RTS on deductions. For instance, excess assets located in pension funds which the institution would be able to recover should not be deducted. The same holds for deferred tax assets the value of which is certain to be realized at a defined time horizon.

Finally, to alleviate EBA's heavy workload, the BSG recommends certain RTS can be leveraged on the significant work done by Danish presidency which has made the level 1 text clear enough for an RTS not to be necessary anymore, as long as these amendments are accepted. This observation concerns for instance for the RTS on article 46 or the deduction of current year losses. To avoid mobilizing public money, the BSG also suggest leaving national supervisors a broad enough room for manoeuvre when devising prudential incentives to rescue distressed financial institutions.

Detailed BSG recommendations are described in the attached Annex.

Annex: detailed recommendations

- Deduction of foreseeable charge or dividend from retained earnings for CET1.
 - Art. 24
 - **Suggested approach:** if the institution has referred in its financial communication or in statements from the management or directors to a consistent dividend payout policy, define the “foreseeable dividend” as the one consistent with such policy unless if it is amended by the institution’s management. This amendment to the payout policy would have to be reported to the competent supervisory authority (who shall be entitled to require evidence, such as proceedings from the institution’s management), but not necessarily disclosed publicly as it is privileged information.
If the institution does not refer to a dividend payout policy, the foreseeable distribution rate should be equal to an average of the distribution rate actually paid over the last two or three years. Again, an amendment of this by the institution’s management demonstrated to supervisory authorities would be translated into a change in the foreseeable dividend.¹The expected dividends amount would be reduced, if the application of the dividend payout policy or of the distribution rate actually paid over the last two to three years would lead the CET1 ratio, calculated on a legal entity basis or on a consolidated basis, to fall in the range of the applicable conservation buffer, extended by countercyclical and systemic buffer requirements, as appropriate.
- Determine undertakings recognised as mutual, cooperative societies, savings institutions or similar, as well as the nature and extent of the features and the market stress for those institutions.
 - Art. 25
 - **Suggested approach:** define “undertakings recognised as mutuals, cooperative societies, saving institutions or similar” according to relevant national law, it being understood that no undertaking issuing or being legally able to issue common or preference shares that would qualify as CET1 under Article 26 could be included in such definition. This definition applies on an individual basis only, since a banking group may consist of both mutual and non-mutual legal entities.
 - Features that could cause the condition of an institution to be weakened include any features that would lead (i) the institution to buy back its CET1 instruments, including if this corresponds to a market expectation and not a legal obligation; (ii) the issuance of new instruments to be delayed in market stress (either because the institution does not have the power to issue them legally or because their financial conditions would make them unattractive).
 - Market stress should be defined as a situation with a dry-up of inter-bank liquidity and a brutal fall of capital markets.
- Forms and nature of indirect funding of capital instruments, and the meaning of distributable items for determining the amount available to distribute.
 - Art. 26
 - **Suggested approach:** a funding of capital instruments may be considered as indirect if it is made to artificially inflate the own funds of the institution, as in the following cases .:
 - A purchase of own shares by a controlled subsidiary (NB: this is only applicable in the case of individual supervision); It would be worth mentioning whether it’s a control under the accounting or prudential standards or one of them at least ;

¹Moreover, in the member States where a dividend bonus to employees is compulsory by law, the corresponding expected amount should be included in the calculation of the foreseeable dividend, unless it is already taken into account in the P&L (e.g. “prime de partage du profit” in France)

- A direct or indirect loan to a third party that is used by this third party to purchase the capital instruments issued by the lender or by an entity controlled by the lender ;
 - A loan to a shareholder that is not performed at arm's length and does not cover the shareholder's business or personal needs that are not related to its holding in the institution;
 - A purchase of shares by a "sister" company, if both the following conditions are met (i) the institution has funded the "sister" company via one of the above examples; (ii) the institution and the "sister" company are not included in the same consolidated supervision.

- Limitations on redemption necessary for mutuals, cooperatives societies, saving institutions and similar institutions.
 - Art. 27
Suggested approach: the limitations should be as stringent as allowed under the applicable national law. It may include an automatic lock-up of the cash to be delivered in exchange for redemption, etc. In this prospect, the competent supervisory authority should be entitled to impose such a lock-up if deemed necessary.

- Application of deductions from CET1 for losses, DTA, pension fund assets and taxes.
 - Art. 33
 - **Suggested approach:**
For losses: the BSG feels that the text is quite clear; if any precision is to be made, it is to stress that losses correspond to applicable accounting standards and do not include other comprehensive income items. Also it should include losses for interim periods as determined under conservative estimates.
 - *For DTA that rely on future profitability:* DTA that arise from accounting specificities such as portfolio-based provisions or purchase price accounting should not be considered as relying on future profits as they will be absorbed under all circumstances.
 - For pension fund assets: see below Article 38.

- Specifying the types of instruments of financial institutions and insurance undertakings that shall be deducted from own funds.
 - Art. 33
 - **Suggested approach:**
 - For third country insurance and reinsurance undertakings / banking institutions / any other supervised financial entity, only capital instruments which are recognized as prudential own funds and may be deemed equivalent to a tier or category defined by CRR should be subject to deduction.
 - The overall approach should be consistent with Financial Conglomerate Directive.

- Specifying the criteria for permitting reduction of the amount of assets in the defined benefit pension fund.
 - Art. 38
 - **Suggested approach:** The "restricted ability to use" shall characterize only situations in which the institution is not able to recover the excess of the fund's assets over defined benefit obligations through refund or reductions in future contributions, including indirectly via a transfer of such excess assets to another plan in deficit (as liabilities linked to that other plan are already fully deducted from Common Equity Tier 1 via the accounting treatment). The BSG calls on the EBA to take into account if necessary the different accounting treatment in IFRS between (i) plans funded through an entity which

is legally separate from the institution and (ii) plans funded within the institution or through a related party (case in which all the plan's assets are accounted for in the institution's consolidated balance sheet and therefore are not netted against the corresponding defined benefit liability, and only excess assets should be deducted, provided they cannot be recovered). It should be noted that under IFRS, it is already required to limit the amount of any net pension asset accounted for in the balance sheet to the amount that is recoverable, either through a refund or a reduction in future contributions (asset ceiling).

- Specifying the conditions of application to not deduct holdings in specified institutions from CET 1
 - Art. 46 [amended by Danish compromise]
 - **Suggested approach:** the scope of this RTS in the EC proposal was to detail the conditions to be filled for the supervisory authorities to allow the alternative to deduction in the banking ratio. As the Danish compromise is very explicit on what conditions are to be filled (conditions (a) to (e) of paragraph 1 of the Article) and on the impacts on the banking ratio, the BSG considers that this RTS is no longer necessary, insofar the proposal set out in the Danish compromise is finally adopted.

- Specifying details for additional tier 1 instruments
 - Art. 49 [amended by Danish compromise]
 - **Suggested approach:** confirm that the write-down may be temporary only; ensure that the write-up is defined so as to respect the seniority of the existing Additional Tier 1 holders with respect to existing shareholders, and in accordance with the requirements imposed by capital buffers (i.e. coupon payments should be restricted when the buffers are not met, but not if dividend payments to existing shareholders are allowed).
 - In particular, the write-up mechanism must pre-determined² but must also fully preserve the rights of new shareholders, for instance by defining a formula so that some (but not too much) of the new CET1 generated is automatically attributed via the write-up to the written-down securities.

- Specifying the extent of conservatism required in estimates to calculate exposures to indirect holdings arising from index holdings and the meaning of operationally burdensome for monitoring these holdings.
 - Art. 71
 - **Suggested approach:** define a conservative estimate of the share of the index which is invested in relevant entities and define the portion to be deducted as this share times the overall value of the index holding. The BSG suggests that EBA should clarify in which cases this approach would be acceptable (e.g. the share of relevant entities in the reference index is < x% or total exposure of index holdings is < y% of total own funds).

- Specifying the meaning of sustainable for the income capacity of the institution, the appropriate bases of limitation of redemption and the process and data requirements for an application.
 - Art. 73
 - **Suggested approach:**

² The tax regime for additional Tier 1 instruments differs among jurisdictions in Europe. In a number of jurisdictions write-down is considered as a cancellation of debt in absence of return to good fortune provision and generates taxable profit. The existence of a pre-determined write up clause entails that in case of return to "normal", the write up should take place automatically in accordance to certain conditions to be defined and upon approval of the competent authority. This write up automatism makes possible not considering the write down event as a cancellation of debt, and therefore makes the taxation of write down less likely.

- *sustainable* for the income capacity of the institution would mean that if the expected payments on an instrument do not risk to impact the institution's profitability in a material manner, as defined by the competent authorities ;
 - the appropriate basis of limitation of redemption ;
 - *process and data requirements*: the institution must apply for the reduction, the repurchase or the call for redeem as soon as possible and at least two months before the latest date at which the reduction, the repurchase or the call for redeem will be performed.
- Specifying the concept of temporary for temporary waivers from deduction of own funds.
 - Art. 74
 - **Suggested approach**: it must be stressed that the competent authorities should be allowed to grant the waiver even if the institution has not applied for the waiver prior to the actual acquisition (as such rescuing operations are usually done in urgency and there may not be enough time to apply for the waiver and obtain a response), and should do so in a manner that gives incentives for all institutions to participate in rescuing financial distressed firms, which saves taxpayers' money. Within the 6 months following such an operation, the Supervisory Authority should inform the relevant institution whether the waiver should continue to apply and to which extent, based on the restructuring plan provided by the institution.
- Specifying the concepts of minimal and insignificant for AT1 and Tier 2 issued by SPE.
 - Art. 78
 - **Suggested approach**: the BSG suggests defining a quantitative threshold, e.g. 1% of the instruments issued by the SPE.