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Commissioner Michel Barnier
Internal Market and Services
European Commission
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5 November 2012

EBA/Op/2012/03

Dear Commissioner Barnier

The EBA has been contacted by various stakeholders on some of the latest amendments introduced within the Trilogue on the Capital Requirements Regulation (CRR). On this basis, I would like to bring to your attention serious concerns with respect to some of the proposals under consideration in the definition of own funds.

Going back to the rationale for developing a new regulatory framework for more resilient banks at the international and European levels, it appears fundamental that the revised European rules ensure a genuine enhancement of the quality of regulatory capital. The definition of capital has been a major loophole in the run-up to the crisis. The lack of a uniform regulatory definition across the Single Market triggered a very damaging competitive pressure on national supervisors, which ended up watering down the regulatory requirements up to a point that innovative instruments accepted as capital were not in a position to absorb losses when the crisis came, and continued in several cases to pay coupons to investors while taxpayers money was injected to avoid the default of the banks. This is the area where the commitment to the Single Rulebook is of the utmost importance: we should achieve the same rules, to be jointly maintained through coordinated mechanisms in front of financial innovation.

It is desirable to ensure an identical quality of capital instruments for key global competitors and a better alignment with competitors in other non-EU jurisdictions. With this in mind, the EBA would suggest to the co-legislators to strengthen the provisions currently included in Recital 53 of the CRR in order to ensure that only common equity instruments are included in the capital of the highest quality for joint-stock companies, in particular in cases where they have significant international activities.

Moreover, some of the proposals recently being discussed do not seem to sustain the overarching principle of strengthening the quality of capital and may even in some cases lead to lower standards than the ones currently applicable. A few of these recent proposals are detailed in the annex attached to this letter.

As a general message, while the EBA is fully supportive of the necessity to take into account the specificities of non-joint stock companies which form a very significant part of the European banking sector and whose business models have proved to be resilient during the crisis, we also believe that these banks should not be treated more favorably than joint-stock companies, where this is not fully justified by their specificities. In the same vein, there should not be any differential regulatory treatment depending on the structure chosen by non-joint stock companies. Finally, it is of crucial importance that there is a clear separating line between the legal structures and business models of joint-stock companies on the one hand and of non-joint stock companies on the other hand, so that the frontier between the two types of companies is not blurred and there is no misuse of the specific provisions foreseen for each type of company in the CRR.

Also having in mind the provisional conclusions of the Basel Level 2 assessment for the European Union, the EBA urges the European Commission and the co-legislators to be mindful of adding provisions in the Level 1 text which would reinforce the concerns expressed on the definition of capital for cooperative banks.

I stand ready to discuss further the points raised in this letter and the more technical observation contained in the Annex, if you consider this could help.

Yours sincerely

(signed)

Andrea Enria

Copy sent to:
Mr Othmar Karas, Member of the European Parliament
Mr Constantinos Trikoupis, Councellor, Financial Services, Cyprus Presidency
Mr Jonathan Faull, Director-General, DG Internal Market and Services, European Commission

Annex

1. First, several amendments concerning cooperative institutions which have been introduced in the draft text can be questioned (articles 25(1)(aa)(iv), 46).

The EBA does not see any good justification that would lead to require institutional protection schemes to meet only the capital requirements as set out by Article 87 of the CRR, while joint-stock companies and consolidated groups (including cooperative networks organised as a group) would have to meet the capital requirements as set out by Article 87 of the CRR plus the buffers requirements plus the Pillar 2 requirements. This creates a situation where there is an unjustified uneven playing field between joint-stock companies and non-joint stock companies on the one hand and among non-joint stock companies on the other hand.

The EBA does not see any good justification for having an aggregation method for some cooperative networks, while other cooperative networks organised as a group would be required to elaborate consolidated regulatory ratios. The aggregation method may lead to different results compared to a consolidation, which creates an uneven playing field. The consolidation will ensure that there is no appropriate creation of own funds between the members of the institutional protection scheme. When publishing its consultation paper on technical standards for own funds on 4 April 2012, the EBA took the view that, in order for cooperative institutions not to deduct holdings in other such institutions or in a central or regional institution, the capital requirements of the institutions gathered under a same institutional protection scheme shall be met on a consolidated basis only. The rationale was that the introduction of a gain of own funds linked to the possibility not to deduct holdings in institutions of the same network shall have a corresponding cost, this cost being the elaboration of consolidated accounts. Said otherwise, there is no clear rationale for permitting cooperative institutions participating to an institutional protection scheme not to deduct holdings in other such institutions or in their central or regional institution where only the aggregation method is used. Such derogation to the rules on deductions shall only be justified in the case of a group that is supervised on a consolidated basis, thus ensuring that no double gearing is introduced.

Introducing the possibility for some institutional protection schemes to rely only on aggregated accounts, notion for which there is no proper definition or common understanding, do not seem to provide sufficient certainty that there will not be inappropriate creation of own funds between the members of the institutional protection scheme. The use of the aggregation method, in some cases even qualified as an "extended" aggregation method, will be open for interpretation and will create an uneven playing field in Europe.

Under these circumstances, it is hard to see what would prevent cooperative groups organised as groups and elaborating consolidated accounts that are also institutional protection schemes to turn to most favorable regimes like the one foreseen for institutional protection schemes. Rather, we should encourage upgrading the practices and providing for an appropriate phasing-in period for institutional protection schemes to report under consolidated accounts.

More generally, the EBA does not think it is appropriate to introduce references to many different cooperative structures in the Level 1 text (like credit institutions permanently affiliated to a central body, cooperative networks organised as a group, institutional protection schemes, cross guarantee schemes, cross guarantee arrangements, cooperative networks affiliated to a central body which are not organised as a group). This adds complexity and confusion to a text which is already very complex, makes the EU cooperative banking sector even less transparent for external stakeholders and does not enable a transparent and harmonised treatment in Europe.

The EBA is also concerned by the introduction of Article 25(1)(aa)(iv) of the CRR on joint-stock companies fully owned by a non-joint stock company. This provision opens the door for regulatory arbitrage and creation of structures/banking groups which would try to use the specific exemptions for cooperative-shares-like instruments whereas they are not truly cooperative institutions or alike. More generally, this provision blurs the line between joint-stock companies and non-joint stock companies.
With this in mind, it is EBA view that there shall be no deletions of EBA mandates on cooperative institutions and alike. In particular, the mandate included in article 25(2)(a) aiming at specifying the conditions according to which competent authorities may determine that a type of undertaking qualifies as a mutual, cooperative society, savings institution or similar institutions should not be narrowed down to a specific category of institutions in particular. Doing otherwise would reinforce the feeling of external stakeholders that the European cooperative sector is not transparent at all and that there is a wish from European co-legislators that it stays this way.

2. Second, the EBA is very uncomfortable with the introduction of multiple dividends for some type of capital instruments (articles 26(1)(h)(i) and 27(5a)).

In case multiple dividends are to be recognised, they shall be limited to some of the instruments issued by non-joint stock companies. This may be justified to some extent by reduced or inexistent possibilities to raise capital on capital markets in a short period of time, the need to gain some attractiveness while the remuneration of cooperative-shares like instruments is capped at a low level, as well as the need to frame the influence between affiliated institutions and the central body in cooperative structures. Even in this case, the use of instruments with a higher remuneration associated with a different access to reserves in liquidation shall be clearly framed and limited to a reasonable amount. It would not seem acceptable that this type of instruments represents an amount equal to the shares issued without a multiple dividend.

The use of multiple dividends shall nevertheless be prohibited for joint-stock companies. Doing otherwise would be a clear deviation from the Basel rules which would be very hard to justify. We would be close to see the shadow of preferred shares coming back in the Common Equity Tier 1 (CET1) capital of joint-stock companies. In general, institutions are keen to maintain a reasonable level of dividends on their classic shares in order to satisfy their shareholders, which mechanically increases the amount of dividends to be paid on the shares with multiple dividends. Also, there could be a temptation for the institution to increase the dividends on the classic shares in order to ensure a sufficiently good treatment for the holders of the multiple dividends shares through a maximisation of their dividends. Both situations would lead to a substantial drag of capital outside the institution.

The explicit recognition of different classes of shares for joint-stock companies would also be very confusing and would water down a little bit more the quality criteria for eligible CET1 capital instruments.

3. Third and finally, the EBA is very much concerned by a proposed amendment which would bring the quality of CET1 capital of EU institutions below its current quality (article 463 para 5a).

The potential introduction of an amendment which would allow instruments (other than State Aid instruments) that did not qualify as Core Tier 1 (CT1) capital and that were disqualified as hybrid instruments under the Capital Requirements Directive (CRD) to qualify as CET1 capital under the CRR is very much questionable.

This would undoubtedly undermine the general objective of enhancing the quality of the regulatory capital base in Europe and is in clear contradiction with the Basel rules text. It would not be acceptable that instruments which were qualifying only as hybrids under the current applicable rules could qualify as the highest form of capital under the new rules.