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Mr. Adam Farkas
Director General
European Banking Authority
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CP-2012-02@eba.europa.eu

Dear Mr. Farkas,

DB Response to EBA consultation paper on Draft Regulatory Technical Standards (RTS) on Own Funds – Part 1

DB welcomes the opportunity to comment on the first set of RTS on the Own Funds requirements in the Capital Requirements Regulation (CRR). We broadly agree with the proposals set out in the consultation paper.

Our detailed comments are in the attached Annex. We appreciate that it is difficult to achieve harmonisation in the EU while catering for different national legal frameworks. However, there are a number of areas of the RTS where we believe that the approach taken by the EBA is overly restrictive and would create distortions in the level playing field in Europe. It is also essential to ensure that the RTS do not have the unintended consequence of being contrary to the objectives of other regulatory initiatives. This is particularly the case with regard to the treatment of instruments issued via Special Purpose Entities.

We look forward to continuing our dialogue with you on these RTS and on the second tranche of Own Funds RTS once they are published.

Yours sincerely,

Andrew Procter
Global Head of Government and
Regulatory Affairs

Detailed comments on CP questions

Section 1

Article 2

Q1: Are the provisions on the meaning of foreseeable when determining whether any foreseeable charge of dividend has been deducted sufficiently clear? Are there issues which need to be elaborated further? What would be your definition of foreseeable?

We agree the definition of "foreseeable" is broadly reasonable. There, however, are a number of points which could be simplified without losing the prudential spirit of the guidance:

- The calculation of the dividend based on a three-year average, referred to in Article 2.4, would be overly burdensome and could lead to inappropriate dividend calculations. Dividends paid two or three years previously are no longer relevant in times of crisis. Additionally, the Basel Committee's proposed new capital disclosure framework includes publication of the "foreseeable dividend". If there is an expectation that the calculation of the dividend will be based on the previous years' numbers, it would create false expectations amongst investors that the bank will continue to pay high dividends irrespective of market conditions. We recommend simplifying the guidance to allow a choice between the dividend payout ratio based on the preceding year, or accruals based on a dividends policy.

- Article 2.7 requires the competent authorities to sign off in advance of the institution including interim or year-end profits in Common Equity Tier 1 capital. Given that the draft guidance is clear and relatively prescriptive, it should be possible to agree the general approach with the competent authority upon implementation of the RTS. It would be inefficient to require a consent process before the preparation of each quarterly COREP report.

Article 6

Q2: Are the provisions on the applicable forms of indirect funding of capital instruments sufficiently clear? Are there issues which need to be elaborated further?

In general, the provisions around indirect funding should be clearly aligned with those on direct funding. This is not always the case in the current draft.

Direct funding is defined as a loan, or other funding, which has the specific purpose of the purchase of the institution's capital instruments. Indirect funding should be defined in the same manner, i.e. it should only be treated as indirect funding where the institution is aware of the intent, or "specific purpose", concerning its capital instruments. For example, if a client that owns equity instruments receives funding for buying real estate, that loan should not be treated as indirect funding even where the client in fact uses the finds to purchase equities.

In that context, clarification is needed in Article 6.1.c that capital instruments should not have to be derecognised where the institution has granted a loan for general purposes and where the client already holds capital instruments of the institution. In the same vein, to ensure there is no penalty for situations where the institution or a consolidated entity may not know that funding has been passed on to an investor for the purchase of shares, the following language should be added in Article 6.1.c: *"Funding of a borrower that passes the funding on to the ultimate investor for the purchase of capital instruments, where the institutions is aware that the funding is passed on for the purpose of the purchase of the institutions capital instruments (...)".*

Furthermore, the potential scope of Article 6.1.b is wide: Not every “external entity that is protected by a guarantee or a credit derivative or is secured in some other way” should automatically qualify as an example of indirect funding. This is acknowledged in the reference to credit risk transfer. However, it is not entirely clear whose credit risk is transferred to the institution. To qualify as indirect funding, the guarantee or credit derivative should be provided by the institution, or a consolidated entity, for the express purpose of the purchase of the institution’s capital instruments (in line with Article 6.1 on direct funding). Additionally, the guarantee or credit derivative should be structured such that the credit risk of the external entity is completely, or at least materially, transferred to the guaranteeing or protection selling institution or consolidated entity. This should ideally be clarified by the wording of Article 6.1.b.

Q3: How do you assess the provisions on related parties in particular the requirement to assess that, on an ongoing basis, the related party has sufficient revenues?

The requirement to assess that the related party has sufficient revenues on an ongoing basis is vague and open to interpretation. A more practicable approach, likely to achieve more consistency, would be to require that the exposure be adequately secured in line with general banking practice.

Article 7

Regarding distributable items, we welcome the reference to the applicable national laws and the statutes of the institution.

Articles 11-14

Q7: Are the provisions on the deductions related to losses for the current financial year, deferred tax assets, defined pension fund assets and foreseeable tax charges sufficiently clear? Are there issues which need to be elaborated further?

We welcome the clarification provided by Article 14 that where an institution applies IFRS accounting standards (in accordance with Regulation 2002/1606/EC), foreseeable tax charges have already been taken into account (and that no additional deductions for foreseeable tax charges are required).

On an additional point arising from the CRR legislative process, both the European Parliament and the European Council have proposed that Article 35.b of the CRR be amended to read *“the deferred tax assets and the associated deferred tax liabilities relate to income taxes levied by the same taxation authority and on the same taxable entity.”* It is not clear to us what would qualify as *the same taxable entity* and we believe this should be clarified in the EBA’s RTS. We would propose that text along the following lines could be used as a definition: *“the same taxable entity includes any number of entities which are members of the same tax group, fiscal consolidation, fiscal unity or consolidated tax return under applicable national law.”*

It is also essential that the EBA clarify that deductions relating to pension funds should be recognised for the Risk Weighted Asset calculation on pension fund assets. Increasingly pension assets are being treated as off balance sheet exposures (this is required in Germany) and are risk-weighted as such although this is not required consistently across the EU. This creates level playing field concerns that are further exacerbated by pension fund deductions.

Articles 15-17

Q8: Are the provisions on the types of capital instruments of financial institutions, third country insurance and reinsurance undertakings, and undertakings excluded from the scope of Directive 2009/138/EC in accordance with Article 4 of that Directive that shall be deducted from the following elements of own funds sufficiently clear? Are there issues which need to be elaborated further?

Q9: How would you assess the impact of operating a deduction from Common Equity Tier 1 items?

The underlying principle of Articles 15-17 seems to be that capital instruments of financial institutions, third country insurance and reinsurance undertakings, and undertakings excluded from the scope of Directive 2009/138/EC have to be deducted from CET1, regardless of their qualification as CET 1, Additional Tier 1 or Tier 2 capital. The scope even includes capital instruments that do not qualify as regulatory capital. The corresponding deduction approach is limited to EU entities or entities subject to equivalent third-country prudential requirements.

This is gold-plating of Basel III and is, in our view, inappropriate. The general treatment should be reversed: the corresponding deduction approach should be the starting point as is the case in paragraph 85 of Basel III, i.e. "this means the deduction should be applied to the same tier of capital for which the capital would qualify if it was issued by the bank itself". Given that the stricter requirements included in the draft RTS are not justified by concerns of double gearing, it is not clear why the EBA has proposed these stricter requirements.

The reference in Article 16.4 and Article 17.3 that "items shall be treated as holding of undertakings included in the scope of Directive 2009/138/EC" is unclear: the CRR does not prescribe a specific treatment for such holdings. Clarification is needed that a treatment parallel to that outlined in Article 15.4, i.e. a corresponding deduction approach, should apply.

Section 2

Article 20-24

Q12: Are the provisions on the procedures and timing surrounding a trigger event and the nature of the write-down sufficiently clear? Are there issues which need to be elaborated further?

Q13: How would you assess the impact of the provisions to be applied to temporary write-downs and write-ups?

We broadly agree with the approach taken in this section. However, it should be clearly specified in Article 20.1.b that a temporary write-down, when evidenced as such, should not result in an increase in capital.

We have concerns with the interactions between the provisions on write-ups and inconsistencies in the application of IFRS in the EU. There is no harmonised view in the EU on the need for a write-up feature. We would therefore propose that Article 20.1.b should be revised as follows to avoid the application of IFRS, and resulting instrument features, jeopardising the regulatory objective: *"the write down shall lead to an increase in equity, under the relevant accounting standards, that is eligible as Common Equity Tier 1 capital pursuant to Article 24 of the CRR,* ***unless such increase in equity is prevented only by a write-up pursuant to subparagraph 3 of this Article 20 in which case the write down shall be deemed to be treated as equity for purposes of determining Common Equity Tier 1 capital pursuant to Article 24 of the CRR."***

Article 20.2 and 20.3 cover the conditions for Additional Tier 1 instruments with permanent versus temporary write down. It is essential that there is a symmetrical treatment between the two. In particular, it should be possible for an instrument that is temporarily written down to have a write up that is at least equivalent to a distribution on the reduced principle amount. This would be in line with the treatment of distributions for instruments permanently written down as per Article 20.2. This adjustment to the proposals would prevent a potential reversal of hierarchy whereby AT1 instruments, after a write down, do not pay out while lower ranking capital instruments (i.e. CET 1 instruments) pay a dividend. Any such reversal would have an impact on investor appetite for AT1 instruments. We understand that there is a regulatory concern that AT1 write-ups would disadvantage shareholders where CET1 shares have been issued prior to the write-up to meet buffer requirements. In that case, supervisory approval should be sought.

We believe that Article 24 is too restrictive to allow for differing national regimes. In our view, language allowing a broader interpretation of the requirements on Special Purpose entity issuance is essential in Article 24 to address a number of level playing field concerns in the EU. There are material differences between the requirements in EU Member States on corporate approval, civil code prerequisites, registration requirements and withholding tax, and those inconsistencies make the issuance of AT1 instruments in some Member States extremely onerous.

Article 49.1.p of the CRR requires that the proceeds of instruments not directly issued by the institution or its relevant entities, must be immediately available without limitation to them. Specifically, Article 49.1.p refers to a “form that satisfies the conditions laid down in this paragraph (...)”. Although we do not think it is the intention, it would be possible to interpret this language as limiting the regulated institution to issuing a single eligible instrument to the Special Purpose Vehicle for on-lending. In reality, institutions usually use a number of legal instruments between the entity and the SPV, the sum of which compose a single instrument that is issued by the SPV. It is, therefore, important to interpret “form” in a broader sense.

Similarly, Article 78.1.d of the CRR could suggest that AT1 on-lending is required for recognition under Article 49.1 of the CRR and Tier 2 on-lending for recognition under Article 60 of the CRR. This should be clarified to ensure that it is clear that AT1 or T2 can be used in either case.

To address these concerns we would suggest that Article 24 should only deal with the example outlined at the top of page 39 of the RTS. Thus the language would read as follows:

(a) Where the institution or any other entity listed in points (p)(ii), (p)(iii), (p)(iv) and (p)(v) of Article 49.1 of the CRR and in points (n)(ii), (n)(iii), (n)(iv), (n)(v) of Article 60 of the CRR issues a capital instrument that is subscribed by a special purpose entity, this capital instrument shall not, at the level of the institution or of the above-mentioned entities, receive recognition as capital of a higher quality ***than the form of the capital issued to third parties by the special purpose entity would receive recognition as capital if issued directly at the level of the institution or of the above-mentioned entities.*** Such requirement applies at all levels of application of requirements (consolidated, sub-consolidated, individual levels).

(b) The rights of the holders of the instruments issued by the special purpose entity shall be no more favourable than if the instrument was issued directly by the institution or any other entity listed in points (p)(ii), (p)(iii), (p)(iv) and (p)(v) of Article 49(1) of the CRR and in points (n)(ii), (n)(iii), n(iv), n(v) of Article 60; ***nor shall the sum of any claims of the special purpose entity under any instruments issued or rights granted by the institution or any other entity listed in points (p)(ii), (p)(iii), (p)(iv) and (p)(v) of Article 49(1) of the CRR and in points (n)(ii), (n)(iii), n(iv), n(v) of Article 60 be more favourable than the rights of the holders of the instruments issued by the special purpose entity unless the institution or any other entity listed in points (p)(ii), (p)(iii), (p)(iv) and (p)(v) of Article 49(1) of the CRR and in points (n)(ii), (n)(iii), n(iv), n(v) of Article 60 shall have at all times full and unrestricted access to any such excess in rights.***

Article 24 would thus ensure that the sum of rights granted under multiple instruments between the SPE and the bank would be equal to a directly issued instrument.

Articles 25-26

Q14: Are the provisions on indirect holdings arising from index holdings sufficiently clear? Are there issues which need to be elaborated further?

Q15: How would you assess the meaning of operationally burdensome and which circumstances would be considered as operationally burdensome?

Q16: How would you assess the cost of conducting look-through approaches vs structure-based approaches for the treatment of indirect holdings arising from index holdings?

As a general point, the fact that the alternative approach proposed in the CRR would still require an institution to look through indirect holdings, irrespective of the materiality, would impose impractical operational burdens. As immaterial positions do not raise any double-gearing concerns and are adequately risk-weighted, we would urge the EBA to introduce a de minimis threshold under which institutions are not required to look through individual investments. For example, 0.1% of regulatory capital per individual scheme with underlying assets would be a reasonable threshold.

Article 25.1 states that “For the purpose of this Article, an index includes, but is not be limited to, index funds and indices of credit derivatives”. We would suggest explicitly including equity indices or bond indices, as mentioned in Article 25.5, in this sentence as clarification. Moreover, we are of the opinion that the reference to “indices of credit derivatives” is unclear. A CDS relating to bonds issued by a financial sector entity would not necessarily lead to an indirect/synthetic holding unless the underlying bonds qualified as Common Equity Tier 1, Additional Tier 1 or Tier 2 instruments.

It is not clear why the application referenced in Article 25.5 depends on the nature of the index. One would assume that a corresponding deduction approach should apply irrespective of the index. We would, therefore, suggest deleting the first part of the sentence (“depending on the nature of the index (equity index or bond index).

More clarity would be helpful on the treatment of different financial sector entities. It is not clear what treatment would apply when the institution is unable to determine the maximum percentage for investments in a small number of relevant financial sector entities. It would be too conservative to deduct the full amount of the index investment relating to each of those entities. If, for example, there were 5 relevant financial sector entities for which it was impossible to determine the maximum amount, it would lead to a deduction of the overall index investment multiplied by five. In our view, an appropriate approach would be to cap the overall deduction amount with the index investment.

It would be helpful for Article 25 to include a clarification on the alternative to a direct look-through approach in cases where the underlying exposures are unknown. In fact, this would be more useful than for index securities, where the underlying investments are generally transparent, as opposed to investments in, for instance, more opaque (esp. non-UCITS) funds.

Articles 27-32

Q17: How would you assess the levels of the thresholds for market making purposes (identical to hybrid instruments to the ones provided by CEBS/EBA guidelines on hybrid instruments published in December 2009) for competent authorities to give a prior consent (Article 29)?

Q18: How would you assess the impact of the proposed timing of 3 months for the submission of the application (Article 31)?

Q19: How would you assess the levels of the thresholds for the non-materiality of the amounts to be redeemed for mutuals, cooperative societies or similar institutions (Article 32)?

We broadly agree with the proposals in this section. However, a public announcement of the intention to redeem an instrument would not provide sufficient certainty. As long as the institution still has the right to withdraw from a redemption, a deduction should not be required.

We are concerned that the proposal in Article 29.5 that own funds instruments purchased for the purposes of staff compensation may be subject to the thresholds for the period in which they are held by the bank. The requirement to deduct equity compensation instruments for a relatively short period, where the purpose of the share buy-back is clear, would have perverse incentives contrary to the FSB and European objective of increasing the equity element of remuneration to allow for claw-back. Employees are mandatory investors in the bank's equity and the capital position should not be impacted in this case. We therefore propose to replace “may also” in Article 29.5 with “shall not”. This provision is significantly stricter than the current requirements at national level.

Article 33

Q20: The EBA is considering setting a time limit the waiver shall not exceed. This time limit would be set up at a maximum of 5 years and a lower time limit could also be considered. Which time limit, within a maximum of 5 years, would you find appropriate?

The defined time limit seems unnecessary. Every financial assistance operation plan will look different and it should be left to the discretion of the competent authority to assess this limit over time.

Article 34

Aside from the specific questions asked on Article 34, it is not entirely clear what “related subsidiary” means in this context. Article 71.1.d CRR states that “the only asset of the special purpose entity is its investment in the own funds of that subsidiary”. We therefore suggest replacing “the related subsidiary” with “that subsidiary” – or to otherwise clarify that the SPE and the subsidiary refer to the same entity.