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Dear Delphine

BBA response to EBA consultation paper on Draft Regulatory Technical Standards (RTS) on Own Funds – Part One

The British Bankers' Association ("BBA") is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 220 banking members from 60 countries on the full range of the UK and international banking issues. All the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

The BBA is pleased to respond to the EBA's consultation on own funds – part one[1].

General Comments

Global alignment

In order to ensure a level playing field it is vital that the proposals are applied evenly and concurrently in all parts of the world and that EU regulations therefore stay closely aligned with the agreed Basel III rules. Due to the nature of these regulations, particularly in regards to the writing down of hybrid instruments, failure to do could severely penalise those institutions bound be these rules, inhibiting their ability to access capital and consequently exacerbating the challenges faced by the European economy in times of financial difficulty.

An example of the need for a global playing field would be the accounting standards applied to alternative tier 1 instruments. When the European Commission draft of CRD IV was released, there was a concern that there was no differentiation of Alternative Tier 1 instruments on an accounting basis between those that are equity and those that are liability, even though Art 49.1 made it clear they cannot be legal liabilities for the purposes of assessing insolvency.

[1] http://www.eba.europa.eu/cebs/media/Publications/Consultation%20Papers/2012/CP02/EBA-BS-2012-059--CP-2012-02v2.pdf

This was a concern because the original Basel III made a distinction between the requirements for principal loss absorption that would apply to (1) liability and (2) equity accounted Alternative Tier 1 instruments. If the USA applied Basel III it would allow US issuers to put out equity-accounted Alternative Tier 1 instruments (which would avoid the need for several of loss absorption features otherwise required in Basel III Alternative Tier 1 instruments), and thus issue these at a lower capital cost than their European peers could.

The recent Dodd-Frank rule-making has indeed maintained the original Basel III distinction in the USA, meaning as the proposed US regulations require alternative tier 1 to be classified as equity under GAAP so, as per Basel III, they don't need to have going concern principal loss absorption. This is just one example of the potential consequences of not having a level playing field, and the need for the rules on own funds to be applied on a global basis.

Future opportunities for consultation

It is important that the industry plays an integral part in the creation of regulations such as those for own funds, as they will play a key role in determining how effectively institutions will be able to manage their capital in the future. We would pleased if the EBA could give the industry prompt feedback on the comments received from industry feedback, and how it intends to incorporate the comments into the final regulations.

Write downs and write ups

The EBA will note from our answers below that the key issue for our members regarding this Draft Regulatory Technical Standards concerns the structure of Additional Tier 1 securities and in particular the following points:

- Prohibition in respect of dividend stoppers
- Triggered write down/conversion
- Write downs and write ups.

In summary, it is essential that hybrid instruments remain attractive to investors, and that institutions are able to retain sufficient discretionary decision making powers in order to react to their individual situations, market opportunities and ensure their own financial stability and that of the banking industry.

We hope these comments are useful and the BBA would be delighted to provide any future assistance we can.

Yours sincerely

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Annex

Q01. Are the provisions on the meaning of foreseeable when determining whether any foreseeable charge or dividend has been deducted sufficiently clear? Are there issues which need to be elaborated further? What would be your definition of foreseeable?

We are concerned that Article 2 para 2 which relates to the amount decided by management is to be deducted from the interim or year end profits under consideration may, depending on the timing of a firm's end of year reporting, create the possibility that regulators will have possession of potentially important financial information before the market. This may lead to issues such as data protection and confidentiality of information. In such instances we would need to be satisfied that under no circumstances would it be possible for the information to be "leaked".

The formula for deduction from interim or year end profits in Article 2 para 3 needs further refinement. For example, how would it work where a group structure requires subsidiaries to "upstream" their profits. Details need to be given on how the requirements would take into account a potential change of group structure (for example, one occurring four months into the financial year).

In regards to the dividend policy, tax changes could potentially have an impact on the level of dividends to be paid out. Other regulatory initiatives could also have an unforeseen impact on the level of dividends available for distribution, for example, under Basel III, where there are a number of potential scenarios that could restrict dividend distribution due to application for instance of the Capital Conservation Buffer.

Article 2 para 7 potentially gives the regulators the authority to override decisions and recommendations by chartered accountants and similarly qualified audit professionals. We are not convinced that any such decision would be advisable, and should any decision be taken there would needs to be a clear procedure in place detailing the (exceptional) circumstances under which this may operate.

A "foreseeable", event is something that could be reasonably anticipated. We would recommend in this instance anything that could be reasonable deemed to be included in a bank's stated dividend policy should be categorised as foreseeable. By exception "exceptional" would be anything that could be reasonable deemed to fall outside the scope of the bank's stated dividend policy.

The definition of "foreseeable" should also explain who it is foreseeable too, for example, would it be to a senior executive in the bank, an informed investor or just a reasonable lay person? We recommend that it should be foreseeable to a senior bank executive or regulatory official.

Article 4 para 4 implies that equity could not be used to recapitalise a mutual. However, it is not actually possible to recapitalise a mutual with equity, so this point should be deleted.

Under Article 5 the phrase "institution's viability" might be better replaced with "conditions that would lead the regulatory authority to the conclusion that the institution is likely to fail". This would provide a greater degree of certainty, and would be consistent with crisis management approaches.

Q02. Are the provisions on the applicable forms of indirect funding of capital instruments sufficiently clear? Are there issues which need to be elaborated further?

They are sufficiently clear.

Q03. How do you assess the provisions on related parties regarding the necessity to assess on an on-going basis that the related party has sufficient revenues?

The BBA has no comment.

Q04. Are the provisions on the limitations on redemption of own funds instruments sufficiently clear? Are there issues which need to be elaborated further?

They are sufficiently clear.

Q05. How would you assess the impact of documenting decisions on redemptions?

We are not against the principle of documenting decisions on redemptions, and we agree this is an important part of the regulatory process. However, we are keen to avoid multiple reporting. Where an institution already reports these details to its competent authority under the relevant reporting mechanism, this information ought to be available for passing on where necessary with no ongoing input from the bank in order to avoid duplicative reporting.

Q06. How would you assess the cost impact of including in the provisions of the instruments criteria as listed in paragraphs 2 and 3? *(please note that the CRR requires in point (b) of Article 27 (2) that where the refusal by the institution of the redemption of instruments is prohibited under applicable national law, the provisions governing the instruments shall give the institution the ability to limit their redemption).*

The BBA has no comment.

Q07. 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?

They are sufficiently clear.

Q08. 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?

In general, the provisions are clear, with one notable exception.

Article 15 of the draft technical standard aims to distinguish between the treatment of capital instruments issued by unregulated financial institutions and capital instruments issued by financial institutions which are regulated in accordance with EU-equivalent standards. Similarly, Article 16 distinguishes between the treatment of capital instruments issued by insurance companies which are regulated in accordance with EU-equivalent standards and those which are not. We believe that the intention is that "EU-equivalent" capital instruments should get a corresponding deduction approach, while "non-EU-equivalent" capital

instruments should be considered to be Common Equity Tier 1 items, and that in determining the "applicable amount" CRR Article 43 should then apply. However, Article 15(1) and 16(1) of the draft technical standard could be taken as meaning that the full amount of any "non-EU-equivalent" capital instrument should be deducted from Common Equity Tier 1 capital, even in cases where the aggregate of holdings in relevant entities is well below the 10% thresholds mentioned in CRR Article 43(1)(a).

If our understanding of the intention is correct, we suggest Article 15(1) and 16(1) should be extended by the addition of the clause "provided the overall threshold criteria set out in CRR Article 43(1) are met". Similar principles also apply to Article 17(1).

<u>Issues which could be elaborated further</u>

There are two further specific areas where there is not complete clarity, and one where the EBA has not been requested to develop technical standards, namely

(a) What constitutes an indirect holding and
(b) What short positions may be offset against long positions in respect of trading book holdings.

(a) Indirect holdings

In respect of indirect holdings, the specific example of index securities is raised in CRR Article 71, but the principles of the definition of an indirect holding in CRR Article 22(17) would also appear to extend to positions such as the following:

- Positions in derivative instruments which reference a relevant entity
- Incidental holdings by way of positions in mutual funds which happen to have an investment in a relevant entity
- Positions in derivative instruments which reference an index or a mutual fund which contains a relevant entity.

In the interest of consistent implementation of these standards across the EU, we believe it would be helpful for the EBA to clarify the extent to which the above indirect holdings should be included in the calculation of "applicable amount". Further, if incidental indirect holdings as a result of holdings in mutual funds are to be considered within the scope, it would be helpful if the EBA could address the question of whether the same "operationally burdensome" provisions apply as in the case of index securities.

(b) Short positions

In respect of short positions in the trading book held via options it would be helpful if the EBA could confirm whether, in quantifying the amount of holding to be offset against a long position, the delta equivalent amount should be used.

Q09. How would you assess the impact of operating a deduction from Common Equity Tier 1 items?

The market is aware of the current regulatory initiatives in regards to the strengthening of the definition of capital which has to a large extent already been factored in to the cost of raising capital. As a result operating a deduction from Common Equity Tier 1 items is unlikely to have a significant impact.

Q10. Are the provisions related to the requirements for cooperative networks sufficiently clear?

They are sufficiently clear.

Q11. Would you agree on the types of incentives to redeem as described in paragraph 2 of article 19? Should other types of situations be considered as incentives to redeem?

It needs to be clarified whether this is to be regarded as a comprehensive list, and that any potential features of instruments that fall outside this list would not be considered an incentive to redeem. If this is not the case, then a full description needs to be provided of how to define what is an incentive to redeem is.

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?

It remains unclear what regulatory purpose is satisfied by writing down to common equity a security (e.g. preference share) which is already recognized as equity (i.e. no obligation to repay).

The provisions and timing surrounding a trigger event are sufficiently clear.

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

When an instrument write down is considered temporary, payments are to be cancelled while the write down is in effect, until the nominal amount of the instrument has been fully reinstated. Conversely, where the instrument has been written down permanently, any distributions payable after the write down, whilst they will be reduced to on a pro-rata basis in line with the write down, may be resumed when the institution meets the minimum requirements to allow distributions.

We do not understand the logic of this decision. The withholding of distributions on temporary write downs while permitting them on write ups does not seem fair or just, and we do not understand the thinking behind this decision, and would appreciate an explanation of the rationale behind the requirement in this article.

Under Article 30(3)(a) all payments are to be cancelled while the write-down is still in effect, until the nominal amount of the instrument has been fully reinstated. However, there are still potential circumstances where the institution would have the discretion to pay ordinary dividends. This would essentially mean common equity holders would become senior to holders of additional tier 1 capital, which is contrary to the accepted capital hierarchy outlined in the draft Crisis Management Directive. If an institution is able to make discretionary payments to common equity holders, it should also be able to make them to holders of Additional Tier 1 securities.

Following on from this, if an institution is in a position to be able to use its discretion to write up Additional Tier 1 securities, then it should be allowed to use its judgment to make coupon payments where appropriate. While we understand the need for regulators to set certain boundaries in such circumstances, it is important for institutions to be able to retain enough

control of payments to be able to make individual decisions that could benefit the bank and its capital structure rather than to be constrained by pre-designed guidelines.

The conditions that need to be met in order for an instrument to be written up are too restrictive. We appreciate that action needs to be taken in order to preserve suitable capital ratios with a view to protecting the viability of the bank. However, leading on from this it also makes sense to provide conditions that will support and encourage recapitalisation. There is a balance that needs to be struck between not allowing write ups to take place prematurely, but also providing the right environment for firms to start writing up instruments and moving towards an organic increase in their capital ratios.

Furthermore, it is important to bear in mind at all times that investors will only invest in products that are deemed investable. Ultimately, if the restrictions placed on Additional Tier 1 securities are too onerous, this will reduce investor appetite. If an institution is unable to procure capital from traditional fixed income investors then it will need to increase its common equity base in order to achieve defined Basel 3/CRD IV capital ratios. Market dynamics suggest that this will be challenging for many EU banks which suggests greater pressure to de-lever.

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

They are sufficiently clear.

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

The BBA has no comment.

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?

The BBA has no comment.

Q17. How would you assess the levels of the thresholds for market making purposes (identical for 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)?

Article 29 para 4 suggests the prior consent given in para 3 (around Common Equity Tier 1, Additional Tier1 or Tier 2 instruments) could be lowered or removed at any time. The changing of this consent (particularly in the case of complete removal) would be a significant step and could be unreasonably detrimental to the institution. We would expect the competent authority to have a detailed procedure for managing this process, and the outcome should not be in any way a foregone conclusion.

Under Art 30 para 2(d), there is a suggestion that firms would need to conduct stress tests on main risks evidencing potential losses under certain scenarios. The stress tests bank undergo as part of Pillar 1 and 2 should be sufficient. The competent authorities should need to demonstrate why additional stress tests are required in each circumstance, and this should be done through a pre-designed series of steps which would include a justification of why the extra stress tests might be deemed necessary.

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

The BBA has no comment.

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)?

The BBA has no comment.

Q20: The EBA is considering setting a time limit that the temporary waiver from deduction from own funds 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 BBA has no comment.

Q21. Would you assess the limit on the amount of assets set at 0.5% of the average total assets of the special purpose entity over the last three years as appropriate?

The BBA has no comment.

Q22. How would you assess the impact of setting the limit at 0%, meaning keep only the possibility offered by paragraph (a)?

The BBA has no comment.