CP on draft RTS on Own funds part four

Outline

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EBA technical standards on own funds

- EBA's technical standards should avoid the significant divergences in national implementation of EU rules that have caused serious harm in the run up to the crisis:
- leading to legal uncertainty,
- opening the floor to regulatory competition to favour national champions and market places,
- enabling institutions to exploit regulatory loopholes, distorting competition, and making it burdensome for firms to operate across the Single Market.

- 5 sets of technical standards: parts one to part four of the draft RTS on own funds, as well as the ITS on the disclosure of own funds.
- Part 1: submitted to COM in July 2013
- Part 2: submitted to COM in July 2013
- Part 3: is being finalised, final draft RTS to be submitted to COM shortly
- Part 4: draft CP has been published, consultation ends on 24 January 2014

Own funds part four

This Consultation Paper puts forward draft RTS related to Article 28(5) of the CRR, which mandates the EBA to:

1- specify whether and when multiple distributions would constitute a disproportionate drag on own funds,

2- specify the meaning of preferential distributions.

Recital 72 of the CRR specifies:

"[…] This should not prevent institutions from paying, on shares that have differentiated or no voting rights, distributions that are a multiple of those paid on shares which have relatively higher levels of voting rights, provided that, irrespective of the level of voting rights, the strict criteria for Common Equity Tier 1 instruments are met, including those relating to the flexibility of payments, and provided that where a distribution is paid it is to be paid on all shares issued by the institution concerned. "

Own funds part four – preferential distributions

Preferential distributions:

- They are are deemed to exist when holders of CET1 instruments are at an advantage compared with other holders of CET1 instruments of the same institution, particularly regarding the timing and order of distribution payments. In addition, instruments where the distributions are in excess of the limits set with respect to multiple distributions are considered preferential.
- Regarding preferential distributions, the main objective of the draft RTS is to ensure that there is sufficient flexibility of payment for all CET1 instruments.
- The RTS clarify the cases where distributions can be considered preferential regarding their order. In addition, distributions not complying with the provisions laid down for multiple distributions will also be considered preferential.

Own funds part four – multiple distributions

The level 1 text :

- CRR uses the terms « multiple distributions », « dividend multiple » and « differentiated distributions ». While differentiated is deemed to simply mean different from other CET1 instruments, the notion of multiple may be understood as referring to an explicit rule.
- It is also unclear from Article 28 whether non joint stock companies (NJS) are in the scope on the RTS or not. The EBA has written to the EU Commission in order to receive clarification regarding the scope.
- At present, the CP contains provisions that would apply to NJS companies, if they were deemed to be covered by the scope of these RTS. The final draft RTS will take due account of the answer received from the EU Commission on the legal scope of the mandate.

Own funds part four – multiple distributions

Objectives:

- The draft RTS aim at proposing harmonised criteria for instruments with multiple distributions. Capital instruments may include provisions giving rise to distributions that are different from those paid on voting CET1 instruments (differentiated distributions) or that are a multiple of the distributions paid on voting CET1 instruments. However, only a subset of those instruments would be considered not to create a disproportionate drag on capital, and could therefore be included in CET1 themselves.
- Here the objective is to ensure that the ability to create internally (through retained earnings) own funds is not compromised by disproportionate distributions constituting a drag on own funds and that the multiplicity of instruments does not hinder the recapitalisation. This should be achieved in a way compatible with the different capital structures existing in Europe and especially for institutions from the cooperative sector.

Own funds part four – multiple distributions

Two approaches:

- In particular, joint stock companies may only issue, in addition to their instruments with full voting rights, instruments where the multiple is predetermined and non-revisable, as well as limited.
- Because of the specificities of the capital structure and of the voting CET1 instruments of NJS companies, there are circumstances where the treatment outlined above shall not apply to those institutions.
- As a consequence, two separate approaches have been developed, in order to distinguish between JS companies and NJS companies.
- The approach for NJS companies is not strictly based on the setting of hard quantitative limits, as for joint stock companies, but takes into account other factors, such as the fact that the non-voting shares shall be held by voting members, that voting shares are in some cases subject to a legal cap or that the level of distributions for NJS companies is in general limited.

Own funds part four – multiple distributions

For joint stock companies:

Joint stock (JS) companies would have to comply with two limits: the amount paid on an instruments with a dividend multiple shall not exceed 125% of the distribution on the voting CET1 instrument; furthermore the total of distributions on CET1 instruments shall not exceed 105% of the amount that would have been paid if non-voting instruments received the same distributions as voting instruments. The multiple should be set contractually or statutorily, and be the same for all non-voting shares. If those criteria are not met, the full amount of voting instruments would be disqualified (a specific question is included on this aspect in the CP).

Own funds part four – multiple distributions

For <u>non-joint stock companies</u>:

- In the event that the NJS companies were deemed to be covered by the mandate of the RTS, the approach suggested would take into account the following elements:
- In the case of NJS companies, the legal framework may be different, notably for cooperative societies.
- The cooperative shares (with voting rights) are generally issued at par, the return for the shareholders is generally limited to the dividend payment (no access to reserves in liquidation, redemption at par and no dilution effect when new shares are issued, no possibility to sell apart from redemption by the institution itself, as the institution generally constitutes the only market for its own capital instruments).
- The dividend payment on the voting shares may be subject to a cap and this may (notably when the cap on dividend is low) also reduce the ability of the cooperative society to raise capital through the issue of voting shares.

Own funds part four – multiple distributions

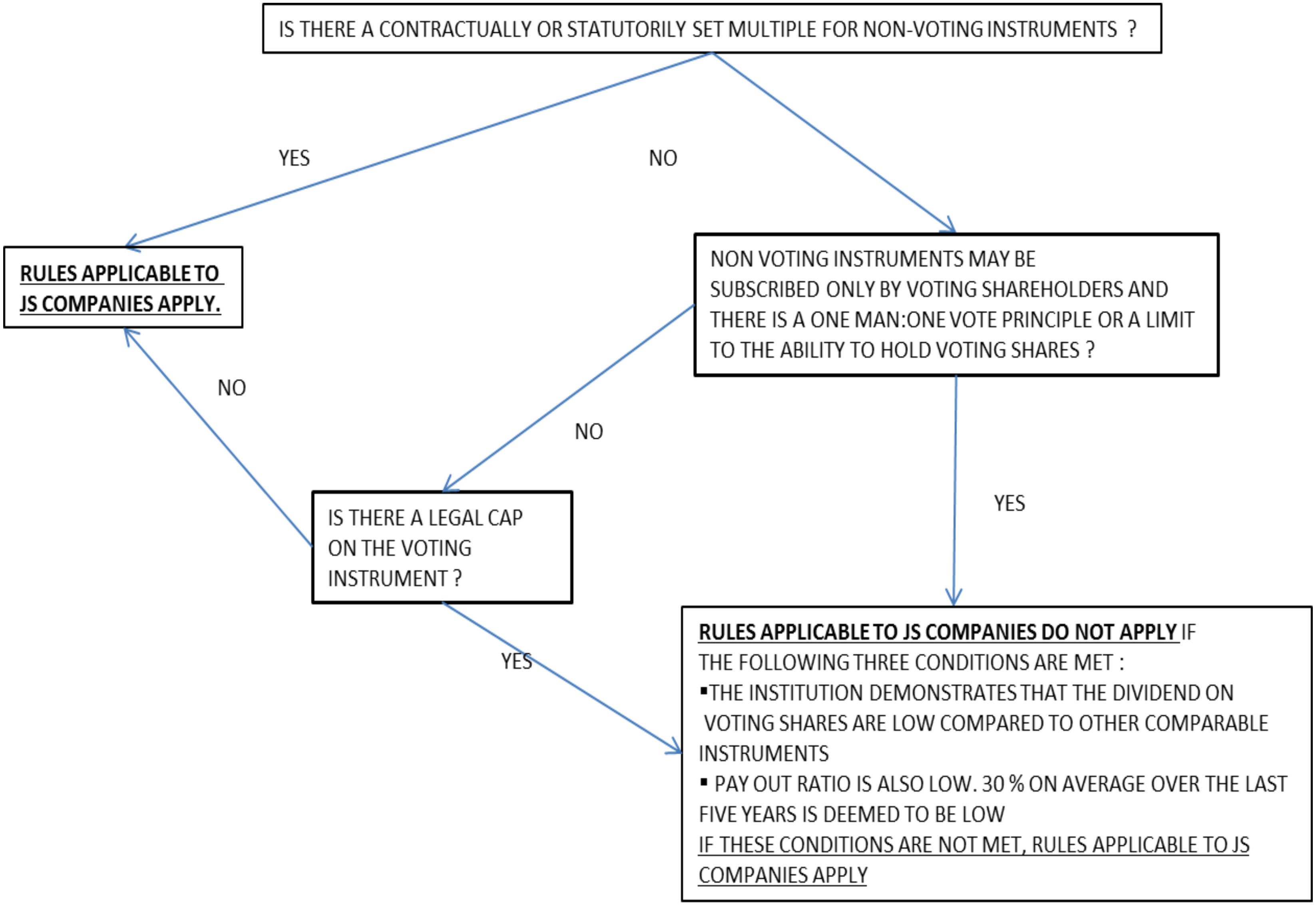
For <u>non-joint stock companies (cont.)</u>:

- Another issue is that most NJS companies apply the principle of 'one man, one vote'. When the non-voting shares may be subscribed only by holders of voting shares, issuing non-voting shares will not influence the level of voting rights. When shareholders have the flexibility to decide on the dividend to be paid on voting and non-voting shares, the situation of an institution where a shareholder subscribes one voting share and several non-voting shares will be the same as the situation of an institution where a shareholder subscribes several voting shares.

- The requirement that the dividend multiple shall be predetermined and fixed for joint stock companies is justified by the concern that the non-voting shares should behave like voting shares, mainly in case of recapitalisation, where the non-voting shares should also be subject to dilution. For cooperative societies, even for voting shares, there is no clear dilution effect in case of recapitalisation.

- **For non-joint stock companies, the application of the limits applying for joint stock companies to the non-voting instruments of non-joint stock companies would be decided on the basis of several tests and conditions as summarised in the decision tree (where conditions are not met, rules applicable to JS companies would apply)**

Own funds part four – multiple distributions



QUESTIONS

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