European Banking Authority
Via email: CP-2012-02@eba.europa.eu

4 July 2012

RE: Response to EBA/CP/2012/02

To whom it may concern,

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the EBA's first consultation paper on own funds regulatory technical standards (EBA/CP/2012/02). AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

AFME's specific comments relating to particular questions are contained in the annex to this letter.

AFME and its members would like to express concern about the short period available for implementation of the EBA's regulatory technical standards (RTSs). Firms are expected to implement these RTSs from 1 January 2013, though they will not be finalised until the EBA has made recommendations to the Commission and the Commission formally adopts them. This process will leave an extremely short period for firms to make the necessary systems changes and changes to capital structures and contracts to comply with the RTSs.

We note that this consultation covers only a subset of the RTSs to be released, meaning that for many other RTSs that are still to be published by EBA and consulted upon this lack of time will be even more acute. Furthermore, the CRD IV requirements on which the RTSs are based are still open to change as the CRD IV trilogues continue. The Council and Parliament compromise texts currently under discussion suggest a number of new RTSs to be written. For instance, the Parliament proposed a new RTS by 1 January 2013 in CRR Article 30 specifying the conditions for applying prudential filters to sovereign debt, while the Council proposed new RTSs by 1 January 2013 under CRR Article 33(2) to specify the deductions from CET1.

AFME believes that the short implementation period could undermine the EBA's RTSs and even the new regulatory framework. Firms across the industry may find it impossible to comply with all of the RTSs by 1 January 2013. The short period could lead to rushed and imprecise implementation and regulatory forbearance where firms are unable to comply. The short period could also eliminate the EBA's and firms' ability to fully consider all of the issues, both in policy formulation and implementation. We do not believe these outcomes are in anyone's interest.

AFME suggests that EBA considers whether the implementation date should be delayed. We believe that EBA should draw the attention of other policymakers to this issue as leaving it unaddressed could undermine the EBA's own credibility.

In terms of general approach, AFME recommends the following:

- Some of the concepts and definitions require further clarification in order to ensure a consistent application across member states on one hand and on the other to prevent regulatory arbitrage.
- However, RTSs should remain pragmatic and not unnecessarily specific or burdensome. For this purpose, we encourage EBA to carefully consider the economic substance of the subject and choose the appropriate level of detail for each RTS from the cost benefit perspective.
- Without prejudice to the single rule book principle, national specificities especially in terms of legal and fiscal regimes will need to be taken into account. Given the diversity of corporate laws and taxation practices across Europe, a one-size-fits-all approach might unwittingly create competitive distortion.
- Finally, some proposed provisions in the RTSs make the requirements more restrictive than the Regulation (e.g. the write-up and write-down clauses). We do not believe that RTSs should impose more restrictive rules that are super-equivalent to Basel III and might put European institutions at a competitive disadvantage at a global level.

We look forward to working with the EBA in achieving its work programme and the full implementation of CRD IV.

Yours sincerely,

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Annex

Reponses to each of the questions asked in the consultation are set out below. As well as responding to the questions asked we would like to make a general point about other areas where EBA expertise could usefully be applied. Specifically, we recommend that the EBA consider detailed standards that specify the treatment of particular issues such as, but not limited to, early termination clauses, valuation of derivatives to be treated as exposures, treatment of options, and recognition of short derivative positions driven by client activity as eligible where maturity is less than one year. These are areas in the current CRD IV drafts that give rise to uncertainty or problematic treatment.

We note that the consultation does not address questions around application of prudent valuation adjustments in the own funds calculations. The EBA will develop standards under CRR Article 31(2) as part of a later consultation, which we eagerly await.

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?

For operational purposes, we would welcome additional clarity on the degree of formality that is required for a management decision to determine the foreseeable dividend. In particular, such decision amending the payout policy would have to be reported to the competent 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.

Additionally, in the "average payout method" it should be clarified whether consolidated profits or statutory profits are to be taken into account (this should depend on the financial communication of the bank, which is generally consistent).

We also wish to make a remark on **Article 7** of the draft RTS (meaning of distributable items for the purposes of determining the amount available to be distributed to the holders of own funds instruments of an institution): we would like clarification that this is to be understood as an economic requirement and that the spirit is more important than the letter. In particular, for AT1 instruments that are legally debt (and for which coupons may not be paid "out of" distributable items as these are reserved for shareholders), we suggest including in these instruments a clause stating that if coupons are higher than statutory distributable items, then the institution will be prohibited from paying the amount of coupons exceeding the allowed amount of distributable items. We understand from the explanatory text that the EBA is aware of the issue.

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?

The scope of restriction could be extended to entities not included in prudential consolidation or in the supplementary supervision in accordance with Directive 2002/87/EC, but included in accounting consolidation. Moreover, any entity where the issuer institution directly or indirectly has control, but the entity for some reason nevertheless is not included in the consolidation, should be included also in the scope considered for indirect funding.

The RTS should also clarify that "normal" situations should not be penalised, as the provision in Article 26 is clearly directed at regulatory arbitrage attempts. For instance, if a 100% controlled subsidiary lends its excess cash to its parent company in the normal course of business and not as a consequence of capital transactions, this should not be interpreted as an indirect funding by the subsidiary of the purchase by its parent of its capital instruments. Likewise, if a bank lends money to a private customer as part of the normal course of business and the latter incidentally invests part of their wealth into capital instruments issued by the bank, this should be outside the scope of direct / indirect funding, except obviously if the loan is conditional on such investment (either at initiation or through a clause demanding repayment in case the customer sells their investment).

Q03. How do you assess the provisions on related parties in particular the requirement to assess that, on an on going basis, the related party has sufficient revenues?
The definition of "sufficient" revenues to repay interest on funding does not seem specific enough. In addition, it may be difficult to demonstrate for the purposes of this provision that a related party would have such "sufficient" revenues, and this may raise legal issues (as the institution may not have access to information on the related party's other sources of income, for confidentiality reasons). Requiring that the funding is made fully at arm's length should be sufficient to ensure there is no regulatory arbitrage.

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

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

Q06. How would you assess the cost impact of including in the provisions of the instruments criteria as listed in paragraphs 2 and 3?
N/A

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?
We welcome the fact that the netting between Deferred Tax Assets (DTA) and Deferred Tax liabilities (DTL) does not seem dependent on the accounting representation. In other words, in order for the netting between DTA and DTL to be applicable, it seems that there is no need for explicit netting in the balance sheet (i.e. "net" DTA); instead, DTA and DTL can remain represented as "gross" values and be netted for regulatory purposes (provided the other conditions set in Article 12 of RTS are met).

We also recommend further elaboration of the EBA stance on Deferred Tax Assets (DTA) and Deferred Tax liabilities (DTL) raised at the consolidated level, since the treatment of such DTA-DTL are not currently clear. In our view, DTAs and DTLs recognised only for consolidation purposes should not be taken into consideration for the Capital calculation. DTL amount recognised only for consolidation purposes is in general higher than the respective DTA amount, largely depending on Purchasing Price Allocation (PPA) under IFRS3 rules.

Regarding pension fund assets that are exempt from deduction, it should be clarified (i) that, consistent with IFRS standards, this extends to the assets where the surplus can be refunded, used instead of future contributions or used to cover the deficit of another plan; and (ii) that in the case of pension funds managed by a related party and as such being accounted for on a gross basis (showing separately assets and liabilities), only net assets should be deducted.

According to the provision a prior consent is to be granted only when the access to the assets is *immediate.* One interpretation of the provision might be that the assets shall be accessible at all times. Given that a board decision may be required to access assets in a pension fund some time is needed in between the prior consent of the competent authority and the access to the assets. To reflect this in the RTS a possible solution might be to be replaced *immediate* with *without delay*.

This condition should only apply when assets are to be refunded (not used to reduce future contributions or to cover the deficit of another plan, as in these cases a temporal condition makes no sense). In that respect, we draw attention to the clarification adopted by the US consultation paper on Basel III transposition, where the access to the assets is deemed to be unrestricted if the institution "is not required to request and receive specific approval from pension beneficiaries each time it would access excess funds in the plan".

Finally, we would like further clarification on the condition laid out in paragraph 1 of Article 14: IFRS-based accounts clearly fill that condition, but it is unclear which other GAAP will be deemed equivalent to IFRS in that respect.

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?

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

[Q08 & Q09] We feel that the wording of the standard suggests that all "capital" instruments (including dated subordinated instruments) are to be deducted from CET1, except if the issuing financial institution is supervised as under CRR, which will usually not be the case, even in the EU ("financial institutions" are not subject to CRR, whose scope is limited to "institution"). As a result, the standard would be **in explicit contradiction** with the level 1 text which clearly stipulates that the deduction approach is to be "corresponding". It will make it extremely costly for EU institutions to invest in subordinated debt from most financial sector entities, and as a result create a clear competitive disadvantage for them – it could even, paradoxically, incent EU institutions to invest in (riskier) equity than in (less risky, but less remunerative) debt, as the two will bear the same capital charge.

Furthermore, it is inconsistent to advocate demanding eligibility criteria for EU institutions (which we do not contest) but to consider that all instruments issued by non-EU institutions or by EU financial institutions which do not meet those criteria carry the same level of risk as CET1. We suggest reviewing the wording to make it consistent with the text, which in this respect is fully derived from the Basel recommendations.

We understand the EBA may legitimately be concerned that if CRR criteria are kept as a reference (which would be the logical position), almost all subordinated instruments issued by banks outside the EU and financial institutions would be out of the scope of deduction as banks outside the EU will not in general have to respect the strict criteria outlined in CRR and financial institutions are not subject to banking regulation. As a **pragmatic alternative** to the criteria listed by CRR, we therefore suggest that the corresponding deduction approach be based upon **subordination**, with equity being regarded as equivalent to Common Equity Tier 1, deeply subordinated debt to AT1 and subordinated debt to Tier 2. This alternative would apply to:
- non-EU institutions;
- non-EU insurance entities (including reinsurance, etc.);
- all other financial sector entities.

For EU institutions and EU insurance entities, the criteria listed in CRR and "Solvency II" would naturally apply.

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

Q11. Would you agree on the types of incentives to redeem as described in paragraph 2? Should other types of situations be considered as incentives to redeem?
The text seems comprehensive. It could be advisable to insert a revision clause to keep up with any new market developments. Furthermore, we recommend that a specific statement be added to clarify that any mandatory conversion does not constitute an incentive to redeem, and that any instrument containing such a provision would not thereby be deemed ineligible as AT1.

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?
We welcome the clarification that the write-down may be either permanent or only temporary. As in other parts of the text, it would be preferable to limit the recognition of AT1 to the "foreseeable" amount of Common Equity Tier 1 to be generated in the event of a write-down.

For operational purposes, the RTS should state that a conservative estimate of the amount of CET1 needed to restore the CET1 ratio to the trigger level should be computed, in order for the write-down to occur as quickly as possible. This could be done by identifying the main sources of decrease in the CET1 and increase in the RWA since the last regulatory reporting (for instance unrealised losses on securities, surge in risk and as a result risk-weighted assets in a particular sector, etc.), computing an estimate of the shortfall of CET1 when incorporating these effects to the last solvency ratios computed, and grossing-up the resulting amount by a small amount to cover for non-identified variations.

We are puzzled by the prohibition of distribution on AT1 while the amount is written down (Article 20(3)(a)), as distributions on shares or CET1 instruments may still be paid during this period. This clause, which made sense for "previous" instruments (incorporating dividend pushers and/or stoppers), now amounts to making AT1 holders worse off than those shareholders which were present in the institution before the fall of the ratio, with a risk of moral hazard. As a reminder, AT1 holders have no voting rights to protect their interests. While we recognise that dividend stoppers are prohibited by the Regulation, the prohibition of coupon payments is not required by it in any way (on the contrary, coupons are required to be subject to "full discretion").

We argue that if amounts are available for distribution, the ability to make (partial) T1 coupons should not be excluded. The amount should be subject to the constraints on T1 coupon (i.e. MDA restrictions), but the bank should be able to choose to pay T1 coupons rather than distributions to the shareholders.

The marketability and pricing for T1 with temporary write down features will likely be spectacularly impacted if the RTS is not amended, as traditional hybrid investors will not invest in instruments which, even in the best case scenario and assuming no confiscating behaviour from shareholders, would not pay anything for a very long time (i.e. until a complete write-up is fulfilled). Such instruments would not only be unduly costly, which would make EU institutions more fragile, but also the majority of them would simply find no investors. Indeed, those instruments would have equity-like features, and the equity investor base is much smaller than the fixed income investor base – much too small at any rate to absorb the supply of all EU institutions.

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

Write-up formulas

The RTS is too restrictive in requiring write-ups to be discretionary. This will not be consistent with the 27 company laws and debt security laws that coexist across the European Union and may lead to competitive distortions or to institutions being prohibited from issuing out of their head offices (which is clearly not a goal of the new regulatory framework). The tax regime for AT1 instruments differs among jurisdictions in Europe. In a number of jurisdictions write-down is considered as a cancellation of debt in absence of a 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 would take place automatically in accordance with certain conditions to be defined and upon the approval of the competent authority. This automatic write up means the write down event will not be considered a cancellation of debt, and therefore makes the taxation of a write down less likely. As another example, under some jurisdictions contracts that derive from the draft RTS may be deemed leonine and have no legal enforceability.

We feel that what matters is to preserve the institution's capacity to proceed to a capital increase once it is in a difficult situation, so that any contractual clause that makes "previous" AT1 holders worse off than "new" shareholders and does not hinder recapitalisation should not disqualify the instrument. In addition, any amount available for distributions and write-ups should meet the requirements imposed by capital buffers (i.e. coupon payments and write-ups should be restricted when the buffers are not met, but not if dividend payments to existing shareholders are allowed).

As an example, the simplest version of such a clause could specify that the right to an automatic write-up disappears when and if any capital increase is performed after a write-down. This would ensure that AT1 holders are not worse off than "former" shareholders, especially in cases where the bank is able to achieve recovery on its own via for instance disposals of its assets, but may not capture any funds injected by new shareholders where recovery requires external capital.

We understand the EBA may be concerned that the 5.125% trigger is fixed at such a level that, when breached, recovery cannot be achieved without external capital. In that case, we request that the RTS clarify that the restrictions imposed do not apply to AT1 instruments incorporating a trigger set at a higher level (for instance 6.375 % and higher).

Amounts available for write-ups
With respect to the amounts available for write-ups, these should include all surplus CET1 generation, without limitation to accounting profits (for instance a reversal of unrealized losses, or disposals that lead to a reduction of risk-weighted assets).

To elaborate on the example provided by EBA, profits (and other sources of surplus CET1 generation) of preceding years "attributable" to AT1 holders should also be available for write-ups. Indeed, in as much as distributions may be made out of earnings from previous years, in the example provided shareholders essentially keep all of the 100 profit made in year 1 as they are incorporated into retained earnings and will eventually be distributed to them, while AT1 holders will never have a claim on the 29 profit attributed to them (in other words, while AT1 coupons are non-cumulative, this is not the case of dividends). As a result, in year 2 the amount available for write-ups before MDA should be 54 (not 25).

Marketability issues
Finally, here again we wish to draw attention to the US notices of proposed rulemaking transposing Basel III currently open for public consultation. It requires *either* a contractual loss absorption clause *or* a legal loss absorption regime. The latter is deemed to exist in the US, making the contractual clause unnecessary. By requiring that all instruments issued by EU banks incorporate the clause, the Regulation is already super equivalent to Basel requirements – and the draft RTS make its requirements even harsher.

If the draft RTS are not amended, the gap between the different instruments will widen, with the result that non-EU banks will capture all the market for hybrid instruments, thus putting European institutions at a competitive disadvantage.

Q14. Are the provisions on indirect holdings arising from index holdings sufficiently clear? Are there issues which need to be elaborated further?
The text is clear. However, we would like more granularity about how options on indices interact with the definition of indirect index holdings (for example, how the in-the-money percentage of the options has to be considered (if at all) for the calculation of underlying exposure from options on indices). Also, we would like more clarity on how indirect index holdings are different from "synthetic" holdings that are added to the list of the deductions from CET1 in the current Council draft, as this is not clear.

Q15. How would you assess the meaning of operationally burdensome and which circumstances would be considered as operationally burdensome?
In general, EBA should further specify the meaning of the indefinite legal terms used such as "low materiality", "low" (net exposure), "short duration", and "strong liquidity".

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?
N/A.

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)?
The thresholds are acceptable and consistent with the current practice. Please note there is a typo in point 3 (a) of Article 29 ("3%" and "10%" are misplaced).

It would be worth clarifying the circumstances under which competent authorities may lower the limits indicated in points (a) and (b) of Art 29 (3) and Art 32 (2) of the draft RTS.

Q18. How would you assess the impact of the proposed timing of 3 months for the submission of the application (Article 31)?
The timing is appropriate and welcome as it creates a uniform European perspective and a level playing field.

We do not think necessary to systematically include the over-exhaustive information referred to in Article 30 in the applications (it will probably be time-consuming for all stakeholders and to no use), except obviously if required by the supervisor, who could for that purpose define a materiality threshold.

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 welcome the alignment between all types of institutions.

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 time limit of five years seems a minimum and thus there seems no reason to reduce it (if anything, an increase would be welcome).

In addition, the authorities that may approve the plan should be defined more broadly (they might include supervisory authorities, resolution authorities, the relevant ministry). Furthermore, this RTS should not be too restrictive *ex ante* (as is the case in the proposed draft), as during stressed times authorities may want to be able to use this exemption as broadly as possible to make rescue of distressed institutions more attractive and preserve taxpayers' funds.

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 limit seems appropriate. However, to accommodate smaller institutions which are likely to issue small amounts of instruments per SPE, the EBA could consider setting the limit as the maximum between 0.5% of assets and 0.5 M EUR.

We seize the opportunity to seek clarification on the fact that, consistent with the Basel text, where the conditions are met for instruments issued out of SPEs to be qualifying, they should be treated as if issued directly by the institution (i.e. not subject to the computation described in CRR Article 79).

Q22. How would you assess the impact of setting the limit at 0%, meaning keep only the possibility offered by paragraph (a)?
Setting the limit at 0% would change the meaning of Article 78, with the risk of excluding AT1 instruments issued by an SPV even in cases where it is clear that the only assets of the SPV are the investments in the subsidiary's own funds.

Again, we draw attention to the variety of corporate and tax laws across the EU to advise against taking radical positions.