European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

Mr. Nout Wellink
Governor
De Nederlandsche Bank
Westeinde 1,
1017 ZN Amsterdam

Brussels, 4 October 2010
HG/VH/B2/10-176

Co-operative Banks and the Basel proposal to ensure the loss absorbency of regulatory capital

Dear Governor,

The EACB[1] is closely following the work of the Basel Committee and thus has delivered its comments on the "Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability" as well[2].

We believe that the concept to enhance the loss-absorbency of Tier 1 hybrids and Tier 2 capital instruments raises a lot of problems, both from a regulatory and a company law perspective.Moreover, the particularities of co-operatives and their governance model have to be taken into consideration as well, when rules are designed.

In view of the proposal in question, the EACB considers that the proposed conversion regime for Tier 1 hybrid and Tier 2 capital instruments would lead to a serious disadvantage for co-operative banks. In fact, such conversion does not fit with the co-operative statutes applicable in the different jurisdictions, which impose various restrictions (e.g. regarding number of shares and eligibility for membership). Moreover, most co-operative shares are not listed and not transferable.

Thus, the suggested conversion mechanism for Tier 1 hybrid and Tier 2 capital instruments seems impossible to apply for co-operative banks. In order to make it practicable, more flexibility would be required regarding an instrument to convert into.

[1] The European Association of Co-operative Banks (EACB) is the voice of the co-operative banks in Europe. The EACB represents the interests of 28 co-operative banking associations at the European level. Founded in 1970, the organisation promotes co-operation amongst its members and represents the co-operative banking sector both in EU institutions as well as in dealings with the European Central Bank. With 4,500 institutions and 64,000 branches, co-operative banks are well represented within the European Union and play a leading role in the European economies and financial markets. They have a long tradition in serving 160 million customers, mainly consumers, retailers, SMEs and local communities. The co-operative banks in Europe have 49 million members, employ 746,000 staff members and have an average market share of 21 percent.

[2] The EACB response of 1st October on "Proposal to ensure the loss absorbency of regulatory capital at the point of non viability"

In addition, the EACB fears that if co-operative banks were forced to apply the suggested permanent write-off mechanism <u>only</u>, they would suffer serious competitive disadvantages vis à vis their competitors.

We therefore ask for your support in finding a solution that reflects the concerns and the specificities of European co-operative banks by designing appropriate proposals also suitable for non-joint stock companies.

Yours sincerely,

Piet MOERLAND
President

Hervé GUIDER
General Manager

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Secretariat of the Basel Committee
on Banking Supervision
Bank for International Settlements

CH-4002 Basel

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Brussels, 1st October2010
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Consultation paper *"Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability"*

Ladies, Gentlemen,

The European Association of Co-operative Banks (EACB) welcomes the opportunity to comment on the Consultation paper *"International framework for liquidity risk measurement, standards and monitoring".*

Please find our remarks on the following pages. We are available for any questions.

We will remain at your disposal,

Yours sincerely,

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General Manager

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PRELIMINARY REMARKS

The consultative document mentions 3 options to ensure that all regulatory capital instruments held by banks are capable of absorbing losses in the event the bank cannot support itself in the private market.

1. "Develop national and international bank resolution frameworks that enable losses to be allocated to all capital instruments issued by internationally active banks that have reached the point of non-viability"
2. "Try to identify systemically important banks and prohibit them from including Tier 2 instruments in their regulatory capital"
3. "Require that all regulatory capital instruments include a mechanism in their terms and conditions that ensures they will take a loss at the point of non-viability.

The EACB shares the view of the Basel Committee that option 1 would be highly desirable. However, we do not think that Option 3 would be able to solve the problem at an early stage: One-sided or unilateral modification of the terms of existing capital instruments is not possible. A long transition period of at least 10 years would be necessary. Furthermore we would like to underline that the Commission intends to submit proposals for a bank resolution framework in 2011, which will be along the lines of option 1. Some national jurisdictions in the EU are about to introduce national legislation on resolution frameworks. We therefore ask the Basel Committee to reconsider its choice of options.

PROPOSAL TO ENSURE THE LOSS ABSORBENCY OF REGULATORY CAPITAL

Ranking

We have the impression that the proposal will lead to a change of the ranking of financial instruments. Core Tier 1, common equity and retained earnings should be the first to absorb losses followed by other Tier 1 hybrid instruments and then, when the institution is no more viable Tier 2 instruments. Any change of that order would seriously damage the rights of investors.

However, a write-off of Tier 2 instruments and Tier 1 (hybrid capital) would only make sense before any writing-off of common equity and retained earnings. Otherwise the capital base wouldn't be improved. Thus, tier 1 hybrids and tier 2 capital would be even more loss-absorbent than core tier 1.

If Tier 2 were written-off and the right to be compensated in the form of common stock, in the liquidation the investor would find himself in the same rank as an equity investor. This contradiction can be eliminated only in those jurisdictions where such preference shares can be issued which ensure to their holders similar rights to those of the common stock holders, with the exception that they rank before them in the liquidation process (priority in liquidation preference shares).

Thus we fear, that in many jurisdiction, where the fore-mentioned preferred shares cannot be issued, the proposal leads to a wipe-out of the differences of the ranking of the different financial instruments. Furthermore, it removes the distinction between going-concern and gone-concern capital.
Moreover, the obligation of a permanent write-off seems doubtful. If the institution has economically recovered and any state funds are paid back, a write-on should be possible. Otherwise, the conversion mechanism, which for the Committee seems to be an option only, would become the rule; without conversion any investor in hybrid or Tier 2 capital would be significantly disadvantaged towards shareholders who in case of an

improvement of the situation of the bank would fully participate in dividends or increases of the share value.

Co-operative Banks

Furthermore, we fear that the conversion regime would lead to a serious disadvantage of cooperative banks:

1. In many cooperative banks the number of shares a member can hold is limited. The suggested rules would put this into question.
2. Since in many institutions co-operative shares can only be held by natural persons, the possibility that investors in Tier 1 and Tier 2 capital are subject to a conversion mechanism would create important legal problems.
3. In most cases, cooperative shares are not freely transferable and normally not listed. However, many cooperative banks have issued listed tier 1 hybrids and tier 2 instruments. Thus, even if the obstacles mentioned above could be overcome, investors in Tier 1 hybrids or Tier 2 could find themselves invested into huge amounts of cooperative shares that they cannot sell at any time, but rather have to keep, most possibly even for longer periods.
4. Furthermore many cooperative shares dispose the feature of a call for additional capital cover in case of financial difficulties. While such feature might not be very burdensome for members of cooperatives who tipically hold a very limited number of shares, this could lead to a difficult situation for financial investors who might find themselves faced with a call for high amounts of additional capital.

Thus, the suggested conversion mechanism for Tier 1 hybrid and Tier 2 capital seems extremely difficult to handle for for cooperative banks. In order to make it practicable, flexibility is required regarding an instrument to convert into.

Consolidating co-operative groups

The capital organisation of a cooperative banking group is based on the existence of local/regional banks which are the parent companies of a Central Institution to which they are necessarily affiliated. The pertinent level to be considered is therefore the Group level or national level since the solidarity mechanisms between the cooperative banks are secured by contractual and/or legal cross guarantee systems which implies that the Central Institution would rescue the local/regional banks and the other way round.

The pertinent level at which non-viability should be considered can therefore only be the Group level at which prudential supervision is exercised on the basis of consolidated ratios.

The issuance of convertible instruments envisaged by the consultation document should therefore only be considered at the national level and not the regional and/or local one.

Access to the capital of the cooperative banking group via the envisaged conversion mechanism would have as an immediate effect, the dilution of the ownership structure on the Central Institution. A massive dilution that leads to losing control, would adversely disorganise the governance structure of a cooperative banking group.

This outcome is highly unlikely taking account the strong legal prerogatives of a Central Institution over its affiliated cooperative banks : loss of control by the Central Institution over its cooperative banks would leave the whole group uncontrollable, not even mentioning the difficulties to implement the solidarity mechanisms after such a conversion.

We therefore believe that the Basel Committee should further reflect on this issue.

The only line of research in this field results in a capital instrument for which the conversion from debt to capital would not confer to the outside lender the same rights as the parent companies of the Central body.

The role of this lender would be restricted to the supply of capital, that is a purely capitalist role, without interference in the governance of the Group.

The invention *ex nihilo* of a new category of capital instrument, necessarily classified as Core Tier One, and not conferring all the rights attached to equivalent instruments in classic joint stock companies appears bound to fail.

However, because it is essential to prevent distortions of competition and to take into account the specicificities of the capitalist model of cooperative groups, we believe there is a need to come up with a tailored response, i.e. instruments which could allow economic rights to be separated from governance rights upon conversion. The EACB is at your disposal to contribute to find a technical solution in this matter.

Small banks

If Basel is focused on international banks, we expect that the suggested principles would be implemented for all banks in the EU.

The effects mentioned above might be particularly burdensome for small banks with no access to capital markets.

It may be argued that the write-off would not change the situation for non-systemic co-operative banks: in their case there would be no state-intervention so that non-viability would imply insolvency. Apart from the fact that co-operative banks' solidarity rather exclude such cases, the situation of creditors is significantly worsened. It is just in insolvency that the position of the holders of tier 1 hybrid and tier 2 instruments would be worsened considerably. There is not even a theoretical chance to a share of any assets that remain after senior debt is settled.

Capital markets

We fear that the suggested mechanisms, in particular the write-down mentioned above, will make Tier 1 hybrids and Tier 2 instruments significantly less attractive.

Since according to our analysis investors in these instruments would be strongly disadvantaged towards shareholders, we could expect that this capital would be even more expensive than share capital. Therefore we have doubts about the whole economic concepts of the proposal.

While investment funds may hold tier 1 hybrids and tier 2 instruments issued by cooperative banks in their portfolio today, they may not do so in the future since they are not allowed to hold non-listed instruments (cooperative shares) in their portfolio.

Investment funds which are focused on fixed interest bearing instruments may be precluded from investments in such papers.

Determination of non viability of the relevant authority

We fear that the determination of non-viability will give a high degree of discretion to national authorities.

Since the notion of non-viability seems to be very broad, relevant authorities could even interfere before relevant capital levels are reached.

There is a danger that the relevant authorities “pull the trigger” to avoid state aid intervention as much as possible.

This high level of discretion of national authorities would make the rating and the assessment of such instruments by investors difficult and thus create a negative effect on the market price.

Furthermore, the triggers for the mechanisms could also lead to a situation that several relevant authorities may pull the trigger at the same moment in time. This could have a significant systemic impact.