



8th December, 2011

## **QUESTIONS & ANSWERS**

### **General**

#### **Why has the EBA undertaken a recapitalisation exercise?**

The EBA is acting in the context of a series of coordinated policy measures to restore confidence in the EU banking sector. These include measures to restore confidence to sovereign debt and to provide guarantees to term funding. As stated by the ESRB on 21<sup>st</sup> September, "supervisors should coordinate efforts to strengthen bank capital, including having recourse to backstop facilities, taking also into account the need for transparent and consistent valuation of sovereign exposures". Therefore, this comprehensive package calls for additional capital as a necessary measure to reassure investors about banks' ability to withstand any further shocks and to remain well capitalised against residual credit risk.

#### **Has the EBA conducted a new round of stress tests?**

No. The EBA has not conducted a new round of stress tests. No adverse macro-economic scenarios were applied to the figures provided by the banks. Against the current developments in the markets and the deterioration of the sovereign debt crisis in Europe, the EBA reviewed banks' actual capital positions and sovereign exposures as at end September 2011 and requested them to set aside additional capital buffers. We have however, used the same definition of Core Tier 1 and applied the same tough treatment on trading positions contained in CRD3.

#### **Didn't banks already have a buffer according to the EBA stress test results?**

The 2011 EU-wide stress test was designed to show what would happen to banks in the face of a macro-economic downturn and the associated impact on credit quality to households and the private sector. However, since the publication of its results, the sovereign crisis has deteriorated quite substantially and we are now facing an exceptional situation regarding sovereigns which is having a major impact on EU banks and calls for exceptional measures to be taken.

#### **Which banks are included in the sample?**

The sample includes all the banks that participated in the 2011 EU-wide stress test although the EBA considered it appropriate to exclude a subset of small non cross-border banks from the package. The total sample encompasses 71 banks. However, the bank-by-bank figures disclosed today regard only 65 banks, as for the Greek banks, pre-agreed arrangements under the EU/IMF assistance programme include quantitative capital targets which exceed the results of the EBA's capital exercise.

## **Shortfall**

### **Why is the capital need different from the estimate released in October?**

The figures published on 26th October were indicative only as based on banks' estimates on capital positions and sovereign exposures. The EBA discloses today updated figures based on banks' capital positions and sovereign exposures as at the end of September 2011.

### **Does the overall shortfall also include the temporary capital buffers to be held against sovereign exposures?**

The shortfall presented today is the amount of capital banks need to get both to create the temporary capital buffer against sovereign exposures and to reach the 9% CT1 capital buffer.

### **Will the sovereign buffer be updated again in the coming months?**

No. The part of the buffer to be held against sovereign debt exposures based on current market prices is explicitly defined as of end September 2011 and it is fixed. The sovereign capital buffer is a one-off and temporary measure and once the deployment of the new EFSF's capacity becomes effective in addressing the sovereign debt crisis by lifting sovereign bond valuations from today's distressed prices, the EBA will reconsider the ongoing need for and the size of capital buffers against banks' sovereign exposures. Sales of sovereign bonds will not alleviate the buffer requirement to be achieved by June 2012.

## **Methodology**

### **What is the definition of Core Tier 1 capital used by the EBA in the capital exercise?**

The definition of Core Tier 1 is the same used in the 2011 EU-wide stress test (including existing capital instruments subscribed by governments). This definition of capital comprises the highest quality capital instruments (common equity) and hybrid instruments provided by governments as announced by the EBA for the 2011 EU-wide stress test.

This definition is based on existing EU legislation in the Capital Requirements Directive (CRD). It takes the existing EU definition of Tier 1 net of deductions of participations in financial institutions and it strips out hybrid instruments including existing preference shares. It recognises existing government support measures.

### **Are you changing the definition of Core Tier 1 capital?**

No. The definition of Core Tier 1 remains the same as the one used in the 2011 EU-wide stress test. However, to build these exceptional and temporary buffers, banks may include instruments which are not CT1 capital but appear to be solid enough to absorb potential losses. These are a narrowly defined contingent capital instrument according to a common term-sheet designed by the EBA and published today.

### **How did you calculate the capital buffer?**

The amount of any capital buffer is based on September 2011 sovereign exposure figures and capital positions. Along with a requirement to hold at least 9% CT1 capital, the capital ratio will incorporate the tougher trading book rules under CRD3. One-off, temporary and exceptional buffers will be built up against sovereign debt exposures in the banking book using end September prices.

Banks are expected to build these buffers by the end of June 2012.

### **Have you marked to market the sovereign exposures in all portfolios?**

The EU capital exercise is a one-off exercise. The EBA has not changed the accounting rules or the prudential requirements.

However, for the purpose of this exercise, we asked banks to assess the valuation of their sovereign exposures in the Held-to-Maturity portfolio as well as in the Loans and Receivables portfolio according to market prices. (Sovereign debt held in the Available for Sale part of the banking book are already viewed at market value but the gain/loss is then backed out. The EBA here has simply discarded the instrument that backs this gain/loss out which will anyway be phased out in the coming years. Sovereign debt is already marked-to-market in the trading book).

### **Is the requirement fundamentally driven by the valuation of sovereign exposures at market prices?**

The capital requirement is based on three drivers which, on average for the banks included in the exercise contribute in equal proportions to the capital shortfall:

- the target CT1 ratio of 9%
- the application of Basel 2.5 (ie CRD3) rules for the computation of risk weighted assets (RWAs)
- the sovereign buffer on EEA sovereign exposures arising from the removal of prudential filters on Available for Sale and prudent valuation of Held to Maturity and Loans and receivable portfolios.

The sovereign buffer thus makes up about one third of the buffer. Of this component over 60% relates to assets held in the Available for Sale (AFS) portfolio which, under the current accounting standards, are already marked-to-market and will be marked to market for regulatory purposes under Basel 3. The remaining component of the sovereign buffer can be directly attributed to the marking-to-market of EEA sovereigns in the Held to Maturity (HTM) portfolio.

### **How did you check the quality of data provided by Banks?**

Competent national authorities have performed the first round of checks on banks' submissions. The EBA has conducted a second round of checks aimed at ensuring consistency across the sample as well as conservatism on banks' evaluation of sovereign exposures.

### **What is the valuation you applied on sovereign exposures? How did you calculate them?**

During the exercise, banks have been asked to assess the valuation of their sovereign exposures according to market prices. The EBA has conducted this assessment using publicly available data including bonds yields, sovereign by sovereign and maturity by maturity, for a basket of government bonds.

### **Have you marked-to-market the sovereigns of all countries?**

Sovereign debt exposures for the purpose of the capital exercise are those towards the central, regional and local governments of the European Economic Area (EEA) countries (27 EU countries and Norway, Iceland, Liechtenstein).

### **How do you address the differences in treatment of risk-weighted assets (RWA) in different countries/banks across the EU?**

There are various reasons to explain differences in the treatment of risk-weighted assets.

To some extent this could reflect differences in business models, in particular the fact that capital market activities attracted lower risk weights until now. This is being corrected with the so-called Basel 2.5 requirements, which are already used in our exercise.

Differences could also be driven by the internal models of banks. For the purpose of the EBA's exercise, the Board of Supervisors has agreed to apply the Basel 1 transitional floors across all the banks in the sample. There are many ways to determine the floor so as to accommodate as many practices as possible whilst still having consistency. The EBA has given national authorities a choice of two methods of applying the floor and asked that banks disclose which method they have used. The two methods are described in the methodological note and a separate table shows which option is applied by which national authority.

### **What are the Basel I transitional floors?**

The Basel I transitional floors require credit institutions, which use IRB (Internal rating-based models) for the calculation of risk-weighted exposures, to provide a minimum amount of own funds at all times related to the amount of capital which would have been required under Basel 1.

## **Disclosure**

### **What are the figures being disclosed today? (Errata corrige)**

The EBA published today for each bank the following information: the capital composition, the exposures to sovereigns (central, regional and local governments) in EEA countries, and the composition of risk-weighted assets. In terms of Credit

Default Swaps (CDS), the EBA has disclosed notional values by reference entity (where the reference entity is an EEA sovereign) and provided separate evidence of protection sold and bought by banks. All the figures are provided as of 30 September 2011.

### **Why do you not disclose information for the Greek banks?**

The capital package for Greece has been defined on the basis of the minimum backstop measures provided under the EU/IMF programme so as not to conflict with pre-agreed arrangements under that programme. The assistance programme already defines a set of targets for the banks in question, including quantitative objectives for the Core Tier 1 ratio, which are being monitored on a regular basis. For Greece, the minimum backstop measures exceed the EBA exercise and no new benchmarks have been set for Greek banks. Data for Greek banks are therefore not disclosed.

### **Impact on regulatory rules**

#### **What do you mean by “temporary capital buffer against sovereign debt exposures”?**

The EBA is not proposing changes to the accounting treatment or to the prudential rules. The capital exercise is a one-off exercise and is not to be repeated in the future. The creation of a temporary capital buffer in the form of a capital target to be attained by 30 June 2012 is necessitated and justified by the exceptional circumstances now prevailing, in particular the extraordinary pressure on some euro area sovereigns and the related impact on the cost and availability of bank funding.

#### **Does the EBA propose to raise the minimum regulatory requirement for capital? Are you anticipating Basel III/ CRD IV requirements?**

The EBA is not anticipating Basel III/CRD IV requirements. In order to address markets’ concerns over sovereign debt, the EBA, together with the National supervisory authorities, asked banks to set up exceptional and temporary buffers. CRD IV proposal is currently being discussed by the European Union institutions and is set to be adopted in the course of 2012. The work plan for CRD IV is clearly mapped out and the EBA stands ready to take part in its implementation.

### **Banks’ actions to meet the shortfall**

#### **Where can banks find the capital they may need?**

Banks have at their disposal several means to meet their capital needs to reach the set target: issuing of common equity and contingent capital (if in line with the criteria defined by the EBA in the ad-hoc term-sheet), retaining earnings, cutting on dividends, selling some non-core assets. There is also an opportunity to buy back hybrid instruments and substitute them with stronger capital instruments. This is

why we also allowed the new target to be reached also through contingent capital instruments issued according to the term-sheet approved by the EBA.

If the above measures are not sufficient, government backstops should be made available.

### **What are the capital instruments that will be considered as eligible for the purpose of this exercise?**

The instruments that can be used to create the buffers are firstly those included in the definition of CT1 capital (see definition of Core Tier 1 capital). Moreover, for the purpose of this specific exercise, the EBA will recognise as eligible to meet the buffer also some high quality instruments: existing convertible capital instruments turned into common equity by end of October 2012 and newly issued instruments that meet strict criteria defined in the common term-sheet issued by the EBA.

### **Why did you decide to accept newly issued contingent instruments in the capital buffer?**

Since the EU-wide stress test, the sovereign situation has deteriorated significantly thus calling for exceptional buffers to be set aside. Since buffers are intended to absorb potential (contingent) losses, new contingent convertibles might be considered eligible under very strict and fully harmonised criteria. These instruments should be fully funded and structured consistently as required in the common European term-sheet issued by the EBA.

## **EBA common template for use of the BCCS convertible instrument**

### **Why create a new convertible instrument and not using an existing one?**

If the instrument is to be seen as strong, credible and consistent across all banks it is imperative that all such instruments meet the criteria laid out in the term sheet.

### **What are the main features of the new convertible instrument stated in the common European term-sheet?**

The term-sheet designed by the EBA focuses only on the terms and conditions related to the prudential aspects of the instrument and does not touch the other aspects of the contracts (taxation, applicable (company) law, risk factors, general information etc). The features of the issuance are based on a conversion mechanism. The host instrument is a perpetual hybrid Tier 1 instrument whose features have been made as close as possible to the forthcoming new regulatory requirements (proposal for a Regulation on prudential requirements for credit institutions and investment firms as published by the EU Commission on 20 July 2011). Conversion into ordinary shares becomes compulsory when the triggers, as defined in the term sheet, are breached.

### **How did you define the main features of the term-sheet?**

When designing the term-sheet, EBA considered already existing convertible instruments, benefited from the input of national supervisory authorities and from the input of some market participants.

### **Does this term-sheet prejudice for the new regulatory requirements to be applicable for capital instruments?**

The BCCS features do not prejudice for the future regulatory framework to be applicable in accordance with the final provisions for a Regulation on prudential requirements for credit institutions and investment firms to be adopted by the European Union.

### **Will the instrument be considered as Core Tier 1?**

No. The instrument will be counted for regulatory purposes as a Tier 1 instrument under CRD2 and as an additional Tier 1 instrument under the CRR (provided it meets the eligibility criteria) but not as a Core Tier 1 or Common Equity Tier 1 instrument before its conversion into shares. In the same vein, if the instrument does not convert before 2016, it shall not be used to meet the forthcoming EU requirements for agreed regulatory buffers (capital conservation buffer, countercyclical buffer, potential SIFIs surcharges).

### **Will all the banks be able to issue the Buffer Convertible Capital Securities (BCCS)?**

All banks subject to the EBA Recommendation as listed in Annex II of the Recommendation will be allowed to use the convertible instrument.

### **Shall the instrument be used with the consent of the national supervisor?**

The instrument can be used only with the consent of the national supervisor. All the provisions for which the term sheet indicates that they will be determined on a case by case basis will have to be agreed by the relevant national supervisor (who may ask for specific requirements when none is mentioned in the term sheet).

## **Impact on the real Economy**

### **Are you forcing banks to stop lending?**

As a result of the crisis, the deterioration of credit quality and the difficulties in attracting new funding, banks already started to reduce lending activities. The EBA had already identified a lack of access to term funding and expressed concerns over a potential spiralling effect of forced deleveraging and the ensuing credit crunches. Deleveraging started in mid-2011 as evidenced by the ECB's lending surveys.

A comprehensive policy response is needed to avoid an excessive deleveraging and therefore a credit crunch and to ensure continued lending to the real economy including to SMEs.

National authorities will act in accordance with the EBA's coordination to seek to ensure that such plans do not lead to a reduced flow of lending to the EU's real economy by agreeing to reductions in risk weighted assets as a means of attaining the target only insofar as these are effected through the sale of selected assets. Reductions in risk weighted assets due to the validation and roll-out of appropriate internal models will not, in general, be allowed as a means of addressing a capital shortfall unless these changes are already planned and under consideration by the competent authority.

Ordered deleveraging processes already formally agreed with international organisations or EU institutions before 26 October 2011 should, if submitted to and monitored by the competent authority, also be allowed. The same conditions would apply in some cases to formal restructuring plans.

### **Will you take any specific measures regarding SMEs?**

The current CRD rules already allow for a preferential treatment to be applied to exposures to SMEs which will be kept in place under the CRD IV draft legislative proposal. As stated before, the National authorities and the EBA will monitor that the targets are achieved avoiding excessive deleveraging and a specific look will be given so as to contain the potential impact on SMEs. In this respect, no reduction of credit flow will be accounted as a way to achieve the target

### **What will you do to avoid banks deleveraging in host countries?**

All actions will be subject to a review and approval by national supervisors, and will also be discussed in Colleges of supervisors to ensure that home-host considerations are taken into due account, especially as regards the geographical distribution of any sales of assets. To that end, competent authorities will seek to ensure that throughout the colleges' discussions of capital plans the need to maintain exposure levels of banking groups in all Member States is taken into account, recalling that if and where necessary the EBA will use its mediation role to that effect

### **Plans review process**

#### **What are the next steps? What is the timeline for the recapitalisation process?**

The National supervisory authorities, together with the EBA, will communicate to banks guidance on how to draft their plans. Banks will be required to submit capital plans to their national supervisors by 20th January 2012. These plans will have to be agreed with National authorities and reviewed, shared and consulted with the EBA

and with other relevant competent authorities within colleges of supervisors as appropriate. National authorities will seek to ensure that throughout the colleges' discussions of capital plans the need to maintain exposure levels of banking groups in all Member States is taken into account, recalling that if and where necessary the EBA will use its mediation role to that effect

The implementation of the plans will have to be done before end of June 2012 and closely monitored by the NSAs and the EBA.

### **How will the plans submitted by the banks be reviewed?**

Banks would be required to submit capital plans to their national supervisors before the 20<sup>th</sup> January setting out the proposed mix of actions, including new capital raising, asset disposals and other measures, to meet both the required 9% target buffer and the sovereign buffer, thereby bringing the shortfall to zero by June 2012. Prior to agreeing these capital plans, national supervisory authorities will discuss with relevant colleges of supervisors and consideration will be given at the European (EBA) level as to the impact of the proposed magnitude and nature of any proposed deleveraging.

## **Recommendation**

### **How legally binding is an EBA Recommendation?**

Recommendations are not legally binding. However, according to Article 16.3 of Regulation No 1093/2010 establishing the EBA, the recommendation issued in the context of the recapitalisation package is based on the comply or explain principle.

The competent authorities shall make every effort to comply with Art.16 Recommendations. Within 2 months of the issuance of a recommendation, each competent authority shall confirm whether it complies or intends to comply with it. In the event that a competent authority does not comply or does not intend to comply, it shall inform the Authority, stating its reasons.

### **Is the Recommendation addressed to all competent authorities that took part in the exercise?**

Although both the Bank of Greece and the Norwegian Financial Supervisory Authority supervise banks within the sample, neither has been included in the list of addressees of this Recommendation because, in the first case, the pre-agreed arrangements under the EU/IMF assistance programme include quantitative capital targets which exceed the results of the EBA's capital exercise and, in the second, Norway as an EFTA State of the EEA does not fall within the current competence of the EBA.