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EBA-202X-D-XXXX

DD Month YYYY

Subject: CET1 eligibility – instruments issued by Norwegian institutions

Dear Mr / Mrs,

Following the decision of the Joint Committee EEA Decision, incorporating the Regulation (EU) No 575/2013 (CRR) and the Commission Delegated Regulation (EU) No 241/2014, which were incorporated into the EEA Agreement and entered into force 1 January 2020[1], the three types of CET1 instruments (ordinary shares/equity certificates/members' contribution) issued by Norwegian credit institutions were assessed by the EBA in course of the process to add them to the EBA CET1 list[2]. In particular, the 'minimum dividend' rule for ordinary shares in the Norwegian Public Limited Act (Section 8-4 of the Public Limited Act), some 'loss absorption' features for equity certificates, as well as aspects related to 'direct/indirect funding' and 'redemption rights' attached to some members' contributions in cases investigated raise concerns as to their compliance with the eligibility criteria set out in Article 28 and - where applicable – Article 29 of the CRR.

Ordinary shares

Section 8-4 of the Norwegian Public Limited Act provides shareholders, holding not less than 1/20 of the share capital, with the power to ask the court to stipulate the distribution of higher dividends than those approved by the shareholders' general meeting. Section 7-4(1) of the Norwegian Financial Institutions Act states that the provisions in the Public Limited Liabilities Act applies to financial institutions unless otherwise provided by or pursuant to such Financial Institutions Act. Section 10-6 of the Financial Institutions Act on "Distribution of dividend", unlike it does as regards other sections of the Public Limited Liabilities Act, does not expressly state that Section 8-4 of the Norwegian Public Limited Act does not apply to financial institutions. Therefore, there is legal uncertainty on whether such Section 8-4 does also apply to financial institutions.

By contrast, Article 28(1)(h)(v) CRR requires that *'the conditions governing the instruments do not*

[1] https://www.efta.int/eea-lex/32013R0575 and https://www.efta.int/eea-lex/32014R0241, respectively.

[2] The process has been announced in paragraph 36 of the CET1 report (LINK).

include any obligation for the institution to make distributions to their holders and the institution is not otherwise subject to such an obligation'. In addition, Article 28(1)(h)(vii) CRR requires that '*the cancellation of distributions imposes no restrictions on the institution'*. These articles are meant to ensure the flexibility of payment of distributions with regard to capital instruments, in order for them to be eligible as CET1 capital.

EBA's assessment concluded that the provisions of Norwegian Public Limited Act would not be in line with the eligibility criteria of Article 28 CRR and therefore, amendments to Section 10-6 of the Norwegian Financial Institutions Act are required to clarify the exclusion of credit institutions from the scope of Section 8-4 of the Norwegian Public Limited Act thereby safeguarding the full flexibility concerning dividend payments by credit institutions.

Equity certificates

Some concerns arise as regards two issues relating to the equity capital structure which is made up of equity certificates (the owner capital plus its reserves, i.e. premium fund and dividend equalisation fund), which qualifies as own funds instruments, and ownerless capital (plus its compensation fund).

Firstly, the technical analysis of Section 10-19 (1) to (3) of the Financial Institutions Act revealed that, on a going concern basis, the retained earning allocated to the equalisation fund absorb the first and greatest portion of loss as long as it is greater than the ownerless capital. However, if the ownerless capital is higher than the dividend equalisation fund, then it is the ownerless capital that absorbs proportionately the greatest share of losses and not the equity certificates holders.

By contrast, Article 28(1)(i) CRR requires that '*compared to all the capital instruments issued by the institution, the [CET1] instruments absorb the first and proportionately greatest share of losses as they occur, and each instrument absorbs losses to the same degree as all other Common Equity Tier 1 instruments.'* This provision ensures that CET1 instruments are the primary instruments to absorb losses on a going concern.

The interaction between the equity certificates and ownerless capital was considered a complex structure. EBA's CET1 monitoring report (para 77) underlines that complex financial structures could increase the risk of non-compliance with CET1 requirements. Going forward, it is necessary that Finanstilsynet ensures that the concerned institutions build up their dividend equalization fund, in particular when it is at a level lower than the ownerless capital.

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Secondly, Section 10-4 of the Financial Institution Act does not explicitly require the reduction of the ownerless capital being subject to the competent authority's prior approval, unlike any reduction of equity capital.

On the contrary, Article 28(1)(f)(ii) CRR makes the institution's discretional repurchasing of CET1 instruments or other means of reducing CET1 capital being subject to the competent authority's prior approval in accordance with Article 77 CRR.

Therefore, EBA's assessment concluded that an amendment to Section 10-4 of the Financial Institution Act is necessary to ensure that reduction of the dividend equalization fund itself, rather than solely the reduction of the equity capital in general, is being subject to the competent authority's prior approval.

Members' contributions

Two elements have been identified as raising strong concerns.

First, the case investigated showed that institution's bylaws require the borrowers to subscribe a minimum percentage respectively of the loan amount or of the risk-weighted loan amount in members' contributions. This is combined with the possibility for borrowers'/members' right to have their participation fully refunded (if not used to cover losses) once the members fully redeem their loans, depending on a surplus above the sum of all capital requirements (Pillar 1, Pillar 2 and buffer requirements).

By contrast, Article 28(1)(b) CRR prohibits a direct or indirect funding of institutions' CET1 instruments, which should ensure that capital with loss absorbing capacity is effectively contributed. Article 9(5) of the RTS on own funds (Commission Delegated Regulation (EU) No 241/2014) provides a derogation in the specific cases of mutuals, cooperative societies and similar institutions, where there is an obligation under national law or the statutes of the institution for a customer to subscribe capital instruments in order to enter into business with the institution.

The assessment of these provisions has been made against precedents of direct/indirect funding already assessed, with the conclusion that any subscription requirement calculated in relation to the loan appears as not in conformity with Article 28(1)(b) CRR and Article 9(5) of the RTS on own funds (please, see paragraphs 104-108 of the EBA CET1 Report).

In addition, and as noted in paragraph 90 of the EBA CET1 monitoring report CET1 instruments are perpetual (Article 28(1)(e) CRR) and the provisions governing the instruments do not indicate expressly or implicitly that the principal amount of the instruments would or might be reduced or repaid other than in the liquidation of the institution, and the institution does not otherwise provide such an indication (Article 28(1)(g) CRR). The principal amount of the instruments may not be reduced or repaid except in the cases referred to in Article 28(1)(f) CRR, that is, in the case of liquidation and discretionary repurchases or other discretionary means of reducing capital, when the institution has received prior supervisory permission according to Article 77 CRR. In the specific cases of mutuals, cooperative societies, savings institutions and similar institutions Article 29(2)(b) CRR provides 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*'. This limitation is further defined in Articles 10 and 11 of the RTS on own funds. These articles are meant to safeguard the permanence of the capital instruments, or in the case a redemption right is required under national law, the institution's discretion to limit the redemption.

In this regard, it was concluded that also the institution should have the possibility to refuse the redemption of the shares, even when its capital adequacy is above a certain level of capital. Otherwise, an expectation is created that under specific circumstances the instruments will be redeemed, and as such the flexibility of the institution to refuse such redemption is undermined.

For all the issues identified in this letter, we would be grateful that you let us know the remedial or mitigating actions possibly envisaged for the different types of instruments, with a corresponding tentative timeline, mindful of the fact that some of these steps might require some time to be processed and implemented.

Yours sincerely,

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