FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

European Banking Authority (EBA)
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CET1-instruments

Thank you for giving us the possibility to comment on the draft letter concerning CET1-eligibility of instruments issued by Norwegian institutions. As this is a matter of significant importance for Norwegian banks and the Norwegian banking sector, we find it necessary to express our strong concerns on the content of the draft letter, particular in relation to the assessment of the equity certificates.

Background on the capital structure in savings banks in Norway
The first savings bank in Norway was established in 1822. Savings banks were established as self-owned institutions (a kind of foundations) which, upon establishment, received donations from the municipality where they were established. The reason why the municipalities had money to start savings banks, was that they previously were required to keep grain warehouses that would cover the need for seed. When the money-economy made the grain magazines inappropriate, many municipalities sold the grain and started a savings bank with the grain money. At most there were over 600 savings banks. The capital that the municipalities once gave to the bank (without becoming owners), and the return on this capital every year after, is what we now call "ownerless capital". "Ownerless capital" is included as CET1 item, cf. Article 26 (1)(c) of the CRR.

Some savings banks needed more capital in the late 1980s. Therefore, a separate legislation on equity certificates was prepared, which opened for the issuance of equity certificates in 1988. A key part of the regulation was to prevent the new investors from getting access to the return on the capital that the municipalities had previously donated. Today a majority of the 94 savings banks have issued equity certificates. The ownerless capital in saving banks has no owners/holders (in the same way as a foundation).

The return on ownerless capital can therefore, if not retained, only be given as gifts (donations) to non-profit purposes. A voting limit of 40 per cent for owners of equity certificates was also set so that the new investors would not exercise a dominant influence. 20 savings banks have their equity certificates listed on Euronext Oslo Stock-exchange and 7 savings banks are listed on Euronext Growth Oslo. The savings banks may only have one type of CET1-instrument, which is the equity certificate.

Questions to the draft letter

As described above, savings banks that have issued equity certificates have two types of equity. One is the “ownerless” equity, which consists of retained earnings built up by the bank over the years. There are no capital instruments issued in relation to the "ownerless" equity. The other is certificate-holders’ part of the equity in the bank, consisting of equity certificate capital and the related reserves (the dividend equalization fund and the premium fund).

In the draft letter, EBA refers to the requirement in CRR article 28(1)(i) as the legal basis for the required amendments:

"(i) compared to all the capital instruments issued by the institution, the 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".

EBA concludes that this provision ensures that CET1-instruments are the primary instruments to absorb losses on a going concern.

As mentioned above, the ownerless capital is not a capital instrument issued by the institution and it is unclear to Finanstilsynet (NFSA) what this means legally in relation to Article 28(1)(i) of the CRR, since the ownerless capital is only retained earnings included as CET1-item, cf. Article 26 (1)(c) of the CRR. NFSA asks EBA to clarify this.

The draft conclusion from EBA says:

"Going forward it is necessary that Finanstilsynet ensures that the concerned institutions to build up their dividend equalization fund, in particular when it is at a level lower than the ownerless capital."

It is unclear what this means in practice, both in relation to *the level* of the dividend equalization fund the institutions should aim for, *when* this should be achieved and *what the status* of the equity certificate instrument will be in the period when the dividend equalization fund needs to be built up.

Consequences of the statement

We are concerned that the statement (although quite vague) may lead to a solution that is non-feasible.

Norwegian law states that profits shall be divided between the certificate-holders’ equity and the ownerless capital by their share of CET1. The only way to increase the dividend equalization fund is by retaining the part of the future profits belonging to the equity certificates. Meaning that if the certificate-holders' equity share of the total CET1 is low, only a small amount of total profits can be added to the dividend equalization fund. This means that it will take time for banks with a low share of certificate-holders' equity compared to the ownerless capital to achieve a significantly higher dividend equalization fund.

As mentioned above, a majority of the savings banks in Norway have both certificate-holders' equity and ownerless capital. The ratio between the certificate-holders' equity and the ownerless capital varies a lot. Most of these banks have a smaller dividend equalization fund than the ownerless capital. On average, these banks need to increase the dividend equalization fund by an amount which equals 64 per cent of their CET1 today if EBA's indication that an equalization fund equal to the ownerless capital should be the "target". Another way to reduce the "gap" indicated in EBA's letter, will be in a first step to increase the share of equity certificates in total CET1, by converting part of the ownerless capital to equity certificates, and then in a second step retain earnings allocated to the equity certificates. Equity certificates issued upon conversion of ownerless capital to equity certificate capital shall be transferred free of charge to a financial foundation, which may sell part of these certificates to other investors. This will have implications for the ownership of many savings banks and may lead to structural changes in the saving banks sector which may change the sector drastically.

The consequence of retaining profits in the dividend equalization fund to a larger extent than retaining profits allocates to the ownerless capital, is that there will be a significant change in the balance between the ownerless capital and the certificate-holders' part of the equity over the years, including an increase in the CET1 which can be significant if the certificate-holders' equity share of the total CET1 is low. It is not realistic to assume that no dividend can be paid on equity certificates over a period of many years without reducing significantly its attractivity in the market. This will also mean that the instrument will not be available in situations where banks need to raise additional capital.

NFSA understands that EBA considers the capital structure in Norwegian savings banks with equity certificates complex. However, EBA has not elaborated on why ownerless capital is considered a CET1-instrument in relation to Article 28(1)(i) of the CRR.

Some savings banks have issued Additional Tier 1 capital. NFSA agrees that the dividend equalization fund must be large enough to ensure that equity certificates absorb losses before additional Tier 1-instruments.

If EBA is of the opinion that the ownerless capital is a CET1-instrument in relation to Article 28(1)(i) of the CRR, and on the basis of this requires the dividend equalization fund to be built up to the same level as the ownerless capital, this will have significant implications which is not thoroughly assessed.

For your information, NFSA has already put forward regulatory amendments in order to limit the possibility of reducing the dividend equalization fund. NFSA has proposed restrictions on the right to transfer assets from the dividend equalization fund in the case of a bonus issue by transfer from the dividend equalization fund to the equity capital. In addition, NFSA has publicly stated that it will consider proposing to amend section 10-18 of the Financial Institutions Act to clarify that the dividend equalization fund cannot be reduced without NFSA's consent, and NFSA will emphasize the need for savings banks to build up the dividend equalization fund.

The Ministry of Finance has publicly informed (in September 2021) that it will consider the capital structure in the savings bank sector and other regulatory issues related to savings banks. EBA's assessment of the current regulation of equity certificates and considerations on needed amendments will be an important input to this work.

NFSA emphasizes that this is a matter of significant importance for Norwegian banks and the Norwegian banking sector. A statement from EBA may cause significant concerns in the market and create immediate problems for banks that need to raise new capital.

Ordinary shares
Please note that NFSA does not have concerns on the assessment of the ordinary shares and are ready to propose amendments in the law.

Members' contributions in Kredittforeningen for Sparebanker
[redacted]

Summary
As EBA's assessment of the equity certificates and the consequences for the CET1-list is a particularly important issue for the Norwegian banking sector, we ask you to clarify the issues above in due course. NFSA recognize that an assessment has been discussed in EBA at different levels. However, the reasoning behind the final assessment, and EBA's statement in the draft letter regarding the equity certificates and the ownerless capital, are not well documented. Particularly in a matter of significant importance, it is crucial that the legal reasoning behind the assessment is explicit and clear, and it is important that a statement does not create unnecessary uncertainty in the markets.

NFSA looks forward to discussing the concerns raised in this letter with EBA.

On behalf of Finanstilsynet

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Deputy Director General

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Head of Section

This document has been electronically approved and does not require handwritten signatures.