FIRST COMMISSION REPORT
TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

on the implementation of the own funds Directive (89/299/EEC)
SUMMARY

This is the first Commission report to the Council and the European Parliament on the implementation of the Own Funds Directive (89/299/EEC), which, as provided for in Article 2 (2) of this Community text, will be submitted to the European Parliament and to the Council.

This report describes the way in which the provisions of the Directive have been implemented by the Member States. The report is partially based on a study, which has been prepared for the Commission by an external consultant. While the consultant’s study focuses, in particular, on the implementation of the many optional provisions in the Directive, this report also sheds some light on the impact of the Directive in practice and on potential areas for improvement.

The report also tries to highlight the differences which exists between the Own Funds Directive and the definition of capital set out in the Basle Capital Accord (the capital framework designed for internationally active banks in the G10 countries).

The conclusions of this document propose lines for possible action to be taken in order to achieve a more harmonised definition of own funds. The document proposes a new examination of the Own Funds Directive to be taken by the Banking Advisory Committee and its groups. This examination should include ways to limit distortions of competition and strengthening of the European banking system.

The Commission and the EU Member States concerned are also continuing to play an active role in the Basle Committee on Banking Supervision and its groups in order to assure a similar definition of own funds world-wide and a homogeneous application of regulatory capital requirements. This will help to preserve the international competitiveness of European credit institutions. The works in the Basle Committee are likely to offer useful reflections and suggestions for a future review of the Own Funds Directive.
1. INTRODUCTION

Article 2 (2) of the Council Directive of 17 April 1989 on the own funds of credit institutions (89/299/EEC) provided that the Commission shall, not more than three years after the date referred to in Article 9 (1), submit a report to the European Parliament and to the Council on the application of this Directive, accompanied, where appropriate, by such proposals for amendment as it shall deem necessary. According to the penultimate recital of the Directive, the report should be drawn up “with the aim of tightening its provisions and thus achieving greater convergence on a common definition of own funds”.

However, by the date by which the above-mentioned report was due, 1 January 1996, the Commission was still awaiting the outcome of a study on the implementation of the Directive, which was being carried out by a consultant at the request of the Commission. In order to be able to incorporate the findings of the consultants’ study and to draw the appropriate conclusions from that study, the Commission considered it appropriate to delay preparation of the report until the Commission had received the consultants’ study and it had verified its accuracy.

Furthermore, the Commission considered it appropriate to delay preparation of the report until the adoption of the amended Capital Adequacy Directive, taking into account the strict links of Directive (89/299/EEC) with that Directive.

The Banking Advisory Committee has taken note of the consultants’ study and several Member States submitted additional comments. The Commission assumes that the consultants’ findings, which were not commented on by Member States before 31 December 1997, are correct.


The report attempts to describe and assess the way in which the provisions of this Community text have been implemented as well as to present possible measures to be taken at European Union level in order to achieve a more harmonised definition of own funds to prevent distortions of competition and reinforce the strength of the European Union banking system with the ultimate benefit for consumer confidence and security.
The following annexes are attached to this report:

- Annex I: Table of national implementation measures
- Annex II: Instruments eligible for inclusion in Tier 1 Capital
- Annex III: Interpretation note XV/1100/95-rev.6
2. IMPLEMENTATION OF THE DIRECTIVE

2.1. GENERAL

The Own Funds Directive has now existed for ten years. The Directive was a natural step already provided for in the First Council Directive on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (77/780/EEC). Article 6 of that Directive stipulates that “Pending subsequent co-ordination, the competent authorities shall, for the purposes of observation and, if necessary, in addition to such coefficients as may be applied by them, establish ratios between the various assets and/or liabilities of credit institutions with a view to monitoring their solvency and liquidity and the other measures which may serve to ensure that savings are protected.” As a consequence of this provision of the First Banking Directive, the Banking Advisory Committee has played an important role in the preparation of the Own Funds Directive. Together with the GTIAD, it has continued to do so during the time the Own Funds Directive has been in force.

The definition of own funds prescribed by the Own Funds Directive is based on the work in the Basle Capital Accord of 1988. The Basle Capital Accord was the result of the work within the Basle Committee on Banking Supervision. The Basle Capital Accord was designed for internationally active banks. The Basle Committee comprises eight EU Member States (Belgium, France, Germany, Italy, Luxembourg, Netherlands, Sweden and United Kingdom) plus the United States, Canada, Japan and Switzerland. Many other countries have also adopted the Basle Capital Accord for banks.

2.2. THE AIM OF THE DIRECTIVE

The own funds of a credit institution can serve to absorb losses which are not matched by a sufficient volume of profits and also serve as an important yardstick for the competent authorities, in particular for the assessment of the solvency of credit institutions and for other prudential purposes.

The own funds of a credit institution also serve to ensure the continuity of credit institutions and to protect savings. The harmonisation of the rules concerning definition and calculation of own funds promotes the supervision of credit institutions and contributes to further harmonisation in the banking sector.

The Own Funds Directive is part of a wider effort to harmonise minimum prudential standards for financial institutions in the EU with the dual aim of safeguarding the safety and soundness of the financial system and to establish a level playing field for financial institutions competing in the single market.

2.3. THE STRUCTURE OF THE DIRECTIVE

The Own Funds Directive determines the composition and the basic standards for the own funds of credit institutions. The Directive specifies the qualifying criteria for certain own funds items. The Member States remain, however, free to apply more stringent provisions.
The Directive distinguishes between, on the one hand, items constituting original own funds (Tier 1 in Basle terminology) and, on the other, those constituting additional own funds (Tier 2 in Basle terminology). The Directive reflects the fact that items constituting additional own funds are not of the same nature as those constituting original own funds. The amount of the additional own funds included in own funds must not exceed the original own funds. The amount of certain items of additional own funds included must not exceed one half of the original own funds.

In order to avoid distortions of competition public credit institutions must not include in their own funds, guarantees granted to them by the Member States or local authorities.

The general principle of article 2 paragraph 1 of the Directive stipulates that subject to the limits imposed in Article 6, the unconsolidated own funds of credit institutions shall consist of the following eight items:

(1) capital within the meaning of Article 22 of Directive 86/635/EEC, in so far as it has been paid up, plus share premium accounts but excluding cumulative preferential shares;

(2) reserves within the meaning of Article 23 of Directive 86/635/EEC and profits and losses brought forward as a result of the application of the final profit and loss.

The Member States may permit inclusion of interim profits before a formal decision has been taken only if these profits have been verified by persons responsible for the auditing of the accounts and if it is proved to the satisfaction of the competent authorities that the amount thereof has been evaluated in accordance with the principles set out in Directive 86/635/EEC and is net of any foreseeable charge or dividend;

(3) revaluation reserves within the meaning of Article 33 of Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3)(g) of the Treaty on the annual accounts of certain types of companies, as last amended by Directive 84/569/EEC;

(4) funds for general banking risks within the meaning of Article 38 of Directive 86/635/EEC;

(5) value adjustments within the meaning of Article 37 (2) of Directive 86/635/EEC;

(6) other items within the meaning of Article 3;

(7) the commitments of the members of credit institutions set up as co-operative societies and the joint and several commitments of the borrowers of certain institutions organised as funds, as referred to in Article 4 (1);

(8) fixed-term cumulative preferential shares and subordinated loan capital as referred to in Article 4 (3).

The following five items shall be deducted in accordance with Article 6:

(9) own shares at book value held by a credit institution;
(10) intangible assets within the meaning of Article 4 (9) (“assets”) of Directive 86/635/EEC;

(11) material losses of the current financial year;

(12) holdings in other credit and financial institutions amounting to more than 10 % of their capital, subordinated claims and the instruments referred to in Article 3 which a credit institution holds in respect of credit and financial institutions in which it has holdings exceeding 10 % of the capital in each case.

Where shares in another credit or financial institution are held temporarily for the purposes of a financial assistance operation designed to reorganise and save that institution, the supervisory authority may waive this provision;

(13) holdings in other credit and financial institutions of up to 10 % of their capital, the subordinated claims and the instruments referred to in Article 3 which a credit institution holds in respect of credit and financial institutions others than referred to in point 12 in respect of the amount of the total of such holdings, subordinated claims and instruments which exceed 10 % of that credit institution’s own funds calculated before the deduction of items 12 and 13.

Pending subsequent co-ordination of the provisions on consolidation, Member States may provide that, for the calculation of unconsolidated own funds, parent companies subject to supervision on a consolidated basis need not deduct their holdings in other credit institutions or financial institutions which are included in the consolidation. This provision shall apply to all the prudential rules harmonised by Community acts.

2.4. THE IMPACT OF THE DIRECTIVE

It is important to underline the considerable impact of this Council Directive since it harmonises, at the European Union level, of the definition of own funds of credit institutions. Common basic standards for the own funds of credit institutions are a key factor in the creation and the supervision of the internal market on financial institutions.

The Directive contributes significantly to the soundness of credit institutions in Europe and to the establishment of a level playing field between credit institutions in the European Union with the ultimate benefit for consumer confidence and security.

2.5. LINKS WITH OTHER DIRECTIVES


1 The OFD (Art. 1) also refers to the First Banking Coordination Directive (77/780/EEC and amendments) for the definition of credit institutions.
The Own Funds Directive is necessary for the implementation of the Second Council Directive on the co-ordination of laws, regulation and administrative provisions relating to the taking up and pursuit of the business of credit institutions (89/646/EEC) given that the latter Directive stipulates the minimum own funds requirement for authorisation and on going business as a credit institution. The Second Banking Directive also sets limits measured in own funds on qualifying holdings by credit institutions.

The Solvency Ratio Directive (SRD), which entered into force at the same time as the Own Funds Directive (OFD), prescribes a minimum solvency ratio for credit institutions, i.e. a minimum ratio between the own funds and the risk-weighted assets of such institutions. While the risk-weighted assets are defined in the SRD, the latter relies on the OFD for the determination of recognisable own funds elements.


The Own Funds Directive stipulates that whenever in the course of supervision it is necessary to determine the amount of the consolidated own funds of a group of credit institutions, that calculation shall be effected in accordance with the Directive on the supervision of credit institutions on a consolidated basis (92/30/EEC).

The Directive also stipulates that the precise accounting technique to be used for the calculation of own funds must take account of the provisions of Directive (86/635/EEC) on the annual accounts and consolidated accounts of banks and other financial institutions which incorporates certain adaptations to the provisions of Directive (78/660/EEC) and (83/349/EEC) based on Article 54(3)(g) of the Treaty on consolidated accounts.

The Directive (92/121/EEC) on the monitoring and control of Large Exposures of credit institutions for example, limiting large exposures to a maximum of 25 % of the own funds of a credit institution. A credit institution may not incur large exposures which in total exceed 800 % of its own funds. A credit institution must report all large exposures to their competent authority. The Directive is applied on consolidated basis.

Any analysis of the impact of the Own Funds Directive, in economic terms, will to a large degree reflect the joint impact of other Council Directives. The connection between the Own Funds Directive and other Council Directives is described when relevant later on in this report.

2.6. **AMENDMENTS OF THE DIRECTIVE**

The Own Funds Directive has been amended twice. First in 1991 in order to include the “funds for general banking risk” in original own funds Directive (91/633/EEC).
The second amendment was decided by the Council in 1992 in Directive (92/16/EEC) in order to include a temporary derogation for Danish mortgage credit institutions and to modify the procedure in Art. 8 (Directive 92/16/EEC). The temporary derogation for Danish mortgage credit institutions is valid until the year 2001.

The Commission has also included the OFD in a draft proposal for a Directive, which would codify several Directives into one single Directive.

2.7. IMPLEMENTATION OF THE DIRECTIVE BY NON MEMBER STATES

The Directive applies to Iceland, Liechtenstein and Norway under the EEA Agreement and the EFTA Surveillance Authority prepares a report on the implementation of the Directive by these countries.

2.8. IMPLEMENTATION OF THE DIRECTIVE BY THE MEMBER STATES

All Member States have informed the Commission of the implementation of the Directive in accordance with Art. 9(1). No problems have been registered with respect to transposition of Art.1. A table which summarises the national implementation measures can be found in the Annex. Some national implementation measures are somewhat stricter than the minimum standards required by the Directive, particularly with regard to further restrictions on eligible own funds and/or requirements of additional deductions from own funds. Twelve Member States have implemented such stricter requirements.

2.9. CURRENT STATE OF PLAY

During the last year a discussion has started both among banking regulators, supervisors and the industry as to whether the present rules for credit institutions under the Own Funds Directive and the Solvency Ratio Directive should be reviewed. The 1988 Basle Capital Accord has also come under review.

A number of technical issues has arisen regarding the current framework simply because of the fact that it is now ten years old and does not cover new developments. These might be addressed by either interpretation or revision of the existing requirements.

One problem regarding the composition and quality of capital stems from innovations in the banking industry in the design of capital instruments. These innovative capital instruments are proposed by banks for inclusion particularly in original own funds (Tier 1) because they are cost effective. However, they often include features which tend to erode the concept of the existing strict definition of capital and intensify the need for regulators to clarify the terms and elements of the definition.

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2 This option is explicitly provided for in the first paragraph of Art. 2 (2).
Work on the capital review has been underway for some time both in the EU in the BAC, the Working Group on the Interpretation and Application on the Banking Directives (GTIAD) and in the Technical Working Sub-group of BAC on Capital and internationally, in the Basle Committee. All these committees have been considering the issues regarding the future of capital regulation and are currently articulating to decide how to take aspects of this work forward.

2.10. ORIGINAL OWN FUNDS (TIER 1)

The definition of Original Own Funds (also called Tier 1 or core capital) can be found in, item (1) subscribed capital, item (2) reserves and allocated final results and item (4) Funds for General Banking Risks in Article 2, paragraph 1 in the Directive. (Concerning all the listed items in Article 2, paragraph 1, see chapter 3. “The structure of the Directive” in this report.)

These three items represent the strongest form of capital with the highest capacity to absorb losses. The Directive therefore allows the use of Original Own Funds for regulatory capital purposes without limits.

Item (1): Subscribed capital

(1) capital within the meaning of Article 22 of Directive 86/635/EEC\(^3\), in so far as it has been paid up, plus share premium accounts but excluding cumulative preferential shares;

Transposition in the Member States

Article 2, 1 item (1) has been transposed in all Member States. In 1996 this item represented, for different EEA Member States, between 11.0 % and 60.0 % of the total capital of credit institutions (average for all Member States: 26.2 %). Its share is particularly low in E, NL, A and SW, while it has a very high share in EL and P.

Due to restrictions in national law on the direct issuance of capital denominated in foreign currency as well as for tax reasons, preferential shares are often issued through a subsidiary or Special Purpose Vehicle (SPV). The capital raised by such entities is “up-streamed” to the (parent) credit institution. The Commission considers that only capital raised by the entity as Tier 1 can be recognised as Tier 1 capital of the (parent) credit institution. In the case of losses in the bank, investors in the preferential shares issued by the SPV should absorb these losses, on a going concern basis, in the same way as investors in directly issued shares.

Capital instruments eligible as Original Own Funds should not contain provisions requiring the issuing institution to make payments to investors in excess of distributable profit. If payments (redemption or interest payments) are linked to the credit standing of the issuing credit institution, these payments can, in times of crisis,

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\(^3\) Article 22 of Directive 86/635/EEC:

Liabilities : Item 9 - Subscribed capital

This item shall comprise all amounts, regardless of their actual designations, which, in accordance with the legal structure of the institution concerned, are regarded under national law as equity capital subscribed by the shareholders or other proprietors.
worsen the solvency of the institution even further. Therefore, any such links to the credit institution’s credit standing should not be accepted for Tier 1 purposes.

The Council Directive (98/31/EC) amending Council Directive (93/6/EEC) on the Capital Adequacy of Investment Firms and Credit Institutions stipulates in its amendment of Annex V, paragraph 2 (annexed to this report) that the competent authorities may permit those institutions which are obliged to meet the own funds requirements laid down in Annexes I, II, III, IV, VI, VII and VIII to that Directive (annexed to this report) to use an alternative definition when meeting those requirements only.

**Comparison with the Basle Capital Accord**

According to the information available to the Commission, the transposition of this provision has not encountered significant problems, except for the exclusion of cumulative preference shares from Original Own Funds. Supervisors in many countries have been approached by banks with a view toward a recognition of certain preference share structures as Original Own Funds (Tier 1) and some supervisors are considering accepting them as Tier 1. Since both the Directive and the Basle Accord exclude cumulative preference shares from Tier 1, banks increasingly design them to include non-cumulative features, while retaining the tax advantages.

Subscribed capital had been generally accepted as regulatory capital. The Directive defines in Article 2 in more precise terms which capital instruments qualify as “subscribed capital”. The corresponding provision in the Basle Accord is not identical with the Directive. In particular, the Basle Accord requires shareholders’ equity to be permanent and (non-cumulative) preference shares are “perpetual”. The Basle text is obviously stricter than the EU Directives in that it refers to the “perpetual” nature of capital. The justification of this is that the EU Directive has to take into account all legal forms which banks within the EU may adopt.

Since some banks have issued a range of innovative capital instruments, such as instruments with step-ups, with the aim of generating Tier 1 regulatory capital that is both cost efficient and can be denominated, if necessary in local currency, the Basle Committee on Banking Supervision decided at its meeting on 21st October 1998 in Sydney to limit acceptance of these instruments for inclusion in Tier 1 capital. Such instruments will be subject to stringent conditions and limited to maximum of 15% of Tier 1 capital. (See Annex : Instruments eligible for inclusion in Tier 1 Capital.)

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4 Equity capital (Issued and fully paid ordinary shares/common stock and non-cumulative perpetual preferred stock, but excluding cumulative preferred stock).


Item (2) : reserves and allocated final results

(2) reserves within the meaning of Article 23 of Directive 86/635/EEC and profits and losses brought forward as a result of the application of the final profit or loss. The Member States may permit inclusion of interim profits before a formal decision has been taken only if these profits have been verified by persons responsible for the auditing of the accounts and if it is proved to the satisfaction of the competent authorities that the amount thereof has been evaluated in accordance with the principles set out in Directive 86/635/EEC and is net of any foreseeable charge or dividend;

Transposition in the Member States

Reserves and allocated end year results represent the second element of Original Own Funds (Tier 1) and had also been generally accepted as regulatory capital. However, again, the Directive defines, by its reference to Article 23 of the Bank Accounts Directive (86/635/EEC) in more precise terms which items can qualify as reserves. In addition, the Directive allows the inclusion of interim profits under a strict set of conditions.

Article 2, paragraph 1, item (2) has been transposed in all Member States. In 1996 this item represented, for different EEA Member States, between 6.8 % and 76.8 % of the total capital of credit institutions (average for all Member States: 43.4 %). This item represents a particularly large share of total capital in DK, E, NL, A and SW. The discretion of including interim profits has been adopted by 12 Member States. B, DK and E have not adopted this provision. Belgium takes into account interim profits in the trade portfolios as Tier 3 item to cover market risks as prescribed in Annex V of the CAD.

The Commission is not aware that the transposition of this provision has encountered significant problems, except for the requirement for verification of interim profits by external auditors prior to inclusion in Original Own Funds under Art. 2, 1 (2). All Member States now agree with the Commission that, in accordance with Directive 86/635/EEC the “persons responsible for the auditing of the accounts” are the external auditors and not the internal auditors. The Commission also believes that it is essential that interim profits be verified directly by external auditors before inclusion in Tier 1 in addition to periodical reviews of procedures. However, the external auditing of interim profits does not necessarily mean a full auditing of the accounts as at the end of each year.

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5 Article 23 of Directive 86/635/EEC:
Liabilities : Item 11 - Reserves
This item shall comprise all the types of reserves listed in Article 9 of Directive 78/660/EEC under Liabilities item A.IV, as defined therein. The Member States may also prescribe other types of reserves if necessary for credit institutions the legal structures of which are not covered by Directive 78/660/EEC. [Art. 9 of Directive 78/660/EEC refers to legal reserves, reserves for own shares, reserves provided for in the articles of association and other reserves.]
Comparison with the Basle Capital Accord

The comparative wording in the Basle Accord is slightly different\(^6\) from the Directive. In substance however, the only difference is that the Directive stipulates the conditions for the inclusion of interim profits in more detail than Basle.

**Item (4) : Funds for General Banking Risks**

| (4) funds for general banking risks within the meaning of Article 38 of Directive 86/635/EEC; |

The Funds for general banking risks is an item which has been established by Directive 86/635/EEC and which is designed to cover “the particular risks associated with banking”.

Transposition in the Member States

Although funds for general banking risks are recognised in most Member States they only play a significant role in B, F, I, L, P and FIN. In 1996 this item represented, for different EEA Member States, between 0.0 % and 5.9 % of the total own funds of credit institutions (average for all Member States: 1.9 %). According to the information available to the Commission, the transposition of this provision has not raised any particular problems.

Comparison with the Basle Capital Accord

Even though funds for general banking risks is an item that does not exist under denomination outside the Union, its character as Tier 1 capital is specifically recognised in the Basle Capital Accord. The Basle Accord describes in detail the conditions for the inclusion of certain items in the general provisions or general loan-loss reserves (such as funds for general banking risk). The Basle Accord specifies that all elements designed to protect a bank from identified deterioration of specific assets, in particular those subject to country risk, in real estate lending and other problem sectors, are excluded from capital i.e. should in principle not be included in the item “general provisions / general loan-loss reserves”. In addition, “general provisions / general loan-loss reserves” are subject to a limit of 1.25 percentage points of risk-weighted assets. Furthermore the following conditions apply:

- allocations to the funds must be made out of post-tax retained earnings or out of pre-tax earnings adjusted for all potential tax liabilities;
- the funds and movements into or out of them must be disclosed separately in the bank’s published accounts;
- the funds must be available to a bank to meet losses for unrestricted and immediate use as soon as they occur;

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\(^6\) Disclosed reserves created or increased by appropriations of (post-tax) retained earnings or other surplus, e.g. share premiums, retained profit (including, at national discretion, allocations to or from reserve during the course of the year from current year’s retained profit), general reserves and legal reserves (Tier 1).
losses cannot be charged directly to the funds but must be taken through the profit and loss account.

The same conditions apply by the strict rules in the accountants Directive 86/635/EEC for the funds for general banking risks.

2.11. ADDITIONAL OWN FUNDS (TIER 2)

Additional Own Funds (also called Tier 2 or supplementary capital) include capital elements which are available to absorb losses as well, but which are not regarded as having the same strength as Original Own Funds. They are therefore subject to several limitations (see below).

Some elements of Additional Own Funds were used only in a few Member States before adoption of the Directive. The Directive has put special emphasis on defining the conditions for recognition of such capital elements. In order to limit the use and to avoid any deterioration other Member States have subsequently introduced new Tier 2 elements as well.

The capital elements, which can be recognised as Additional Own Funds, are listed in items (3) and (5) to (8) of Article 2. Items (3), (5) to (7) which are considered to be of a higher quality than item (8), are often referred to as “Upper Tier 2”, while the latter is usually called “Lower Tier 2”. The differences in the quality of various “levels” of capital are reflected in the limitations placed upon their use. Additional Own Funds comprise the following items:

Item (3) : revaluation reserves

(3) revaluation reserves within the meaning of Article 33 of Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies, as last amended by Directive 84/569/EEC.

In the context of credit institutions, revaluation reserves most likely result from the revaluation of tangible fixed assets and financial fixed assets. Revaluation reserves can only be created under the conditions described in Article 33 (1) (c) of Directive 78/660/EEC. (See Annex to this report.)

Transposition in the Member States

Most Member States allow the inclusion of revaluation reserves in supplementary capital. In 1996 they represented, for different EEA Member States, between 0.0 % and 5.6 % of the total own funds of credit institutions (average for all Member States : 2.3 %).

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7 OJ L 222, 14-8-1978, p. 11.
8 OJ L 314, 4-12-1984, p. 28.
Comparison with the Basle Capital Accord

The content of this element in the Basle Accord\(^9\) is not identical with that of the Directive. The main substantive difference is that the Basle Accord explicitly prescribes a discount of 55% on the difference between historic cost book value and market value\(^{10,22}\).

**Item (5) : Value Adjustments**

| (5) value adjustments within the meaning of Article 37 (2) of Directive86/635/EEC; |

Value adjustments may be done in accordance with the Directive and represent an under-valuation of certain asset items, which are not held as financial fixed assets nor included in a trading portfolio, where such under-valuation is required by “the prudence dictated by the particular risks associated with banking”.

Transposition in the Member States

Although value adjustments are recognised in most Member States, they only play a significant role in B, D and L. In 1996 value adjustments represented, for different EEA Member States, between 0.0% and 6.4% of the total capital of credit institutions (average for all Member States: 1.8%). According to the information available to the Commission, the transposition of this provision has not posed particular problems.

Comparison with the Basle Capital Accord

The Basle Accord does not contain specific provisions on such types of value adjustments. However, the general provisions on the inclusion of general provisions or general loan-loss reserves apply (see item 4, footnote).\(^{11}\) Accordingly it is only a subordinated difference between the Basle and the EU.

**Item (6) : Other items**

| (6) other items within the meaning of Article 3; |

Article (3) lists a number of “other items” which may be included in additional own funds. Article 3 (1) stipulates that the concept of own funds used by a Member State may include other items provided that they have certain specified characteristics.

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\(^9\) Revaluation reserves resulting:
(a) from a formal revaluation, carried through to the balance sheets of banks’ own premises; or
(b) from a notional addition to capital of hidden values which arise from the practice of holding securities in the balance sheet valued at historic costs, may be included in supplementary capital if the assets are considered by the supervisory authority to be prudently valued, fully reflecting the possibility of price fluctuations and forced sale.

\(^{10}\) A discount of 55% on the difference between the historic cost book value and market value is applied to hidden reserves to reflect concerns both about market volatility and about the tax charge in case of realisation. Latent reserves arising in respect of the under-valuation of banks’ premises are not be included.

\(^{11}\) Reserves which, though unpublished, have been passed through the profit and loss account and which are accepted by the bank’s supervisory authorities (as Tier 2).
Article 3 (2) stipulates that securities of indeterminate duration and other instruments that fulfil some particular conditions may also be accepted as other items.

Article 3(1). The concept of own funds used by a Member State may include other items provided that, whatever their legal or accounting designations might be, they have the following characteristics:

(a) they are freely available to the credit institution to cover normal banking risks where revenue or capital losses have not yet been identified;

(b) their existence is disclosed in internal accounting records;

(c) their amount is determined by the management of the credit institution, verified by independent auditors, made known to the competent authorities and placed under the supervision of the latter. With regard to verification, internal auditing may be considered as provisionally meeting the aforementioned requirements until such time as the Community provisions making external auditing mandatory have been implemented.

According to Art. 3 (2), “other items” can also include securities of indeterminate duration (“perpetuals”):

Article 3(2). Securities of indeterminate duration and other instruments that fulfil the following conditions may also be accepted as other items:

(a) they may not be reimbursed on the bearer's initiative or without the prior agreement of the supervisory authority;

(b) the debt agreement must provide for the credit institution to have the option of deferring the payment of interest on the debt;

(c) the lender's claims on the credit institution must be wholly subordinated to those of all non-subordinated creditors;

(d) the documents governing the issue of the securities must provide for debt and unpaid interest to be such as to absorb losses, whilst leaving the credit institution in a position to continue trading;

(e) only fully paid-up amounts shall be taken into account.

To these may be added cumulative preferential shares other than those referred to in Article 2 (1) (8).

As described under item (1), securities of indeterminate duration and similar instruments as well as cumulative preferential shares are potentially very attractive capital instruments for credit institutions due to their cost-effectiveness and tax-efficiency in many Member States. However, as discussed above, the Directive is clear in that such items can only be recognised as additional own funds and not as original own funds.
Transposition in the Member States

Many of the “other items” are closely linked to the particularities of national accounting systems so that even between Member States interpretations of this provision differ to some extent. A summary table of Member States’ interpretations of Art. 3 (1) with regard to the inclusion in own funds of capital gains on portfolios (positive difference between market value and purchase price) is attached as Appendix. 12

“Other items” as own funds (referring to elements cited in Art 3(1)) are used by 10 Member States. B, DK, EL, NL and FIN have not adopted this article. (See Annexed summary table in the interpretation note XV/1100/95). The Commission is in the interpretation note XV/1100/95-rev.5 from May 1997 proposing a commonly agreed interpretation of Article 3 (1) which would clarify the rules for including in “other items” the positive difference between the market value and the cost of acquisition (see item (3) – revaluation reserves).

In the form of general provisions, this item in 1996 represented, for different EEA Member States, between 0.0 % and 10.4 % of the total capital of credit institutions (average for all Member States : 1.0 %). In the form of other elements, this item in 1996 represented, for different EEA Member States, between 0.0 % and 12.1 % of the total capital of credit institutions (average for all Member States : 2.8 %).

Most of the Member States have adopted Article 3(2). In 1996 this item represented, for different EEA Member States, between 0.0 % and 13.5 % of the total capital of credit institutions (average for all Member States : 4.1 %).

Comparison with the Basle Capital Accord

The wording in the Basle Accord is not identical to the text of the Directive. In substance however there is no divergence between the Directive and the Basle Accord in this respect 13 regarding other items. Discussions on a refinement and clarification of the conditions for the recognition of hybrid capital instruments has been taken place with the Member States within the GTIAD.

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12 XV/1100/95-rev.5.
13 Hybrid debt capital instruments may be included in supplementary capital, if
   - they are unsecured, subordinated and fully paid-up;
   - they are not redeemable at the initiative of the holder or without the prior consent of the supervisory authority;
   - they are available to participate in losses without the bank being obliged to cease trading (unlike conventional subordinated debt);
   - although the capital instrument may carry an obligation to pay interest that cannot permanently be reduced or waived (unlike dividends on ordinary shareholders’ equity), it should allow service obligations to be deferred (as with cumulative preference shares) where the profitability of the bank would not support payment.
Cumulative preference shares, having these characteristics, would be eligible for inclusion in this category.
**Item (7) : Commitments of members of co-operative societies**

> the commitments of the members of credit institutions set up as co-operative societies and the joint and several commitments of the borrowers of certain institutions organised as funds, as referred to in Article 4 (1);

The detailed provisions on the recognition of the commitments of the members of credit institutions set up as co-operative societies are laid down in Art. 4 (1):

**Article 4(1).** The commitments of the members of credit institutions set up as co-operative societies referred to in Article 2 (1) (7), shall comprise those societies’ uncalled capital, together with the legal commitments of the members of those co-operative societies to make additional non-refundable payments should the credit institution incur a loss, in which case it must be possible to demand those payments without delay.

The joint and several commitments of borrowers in the case of credit institutions organised as funds shall be treated in the same way as the preceding items.

All such items may be included in own funds in so far as they are counted as the own funds of institutions of this category under national law.

**Transposition in the Member States**

D, NL, and A have adopted this article. The transitory period referred to in Article 4a14 continues to apply to DK until 1 January 2001. In 1996 this item represented, for different EEA Member States, between 0.0 % and 2.9 % of the total capital of credit institutions (average for all Member States : 0.6 %). The transposition of this provision has not posed particular problems.

**Comparison with the Basle Capital Accord**

The Basle Accord does not stipulate provisions on the commitments of members of co-operative societies, because the Basle Accord was intended to apply only to certain internationally operating banks in the G-10 countries and therefore does not cover banks organised as co-operative societies.

**Item (8) : fixed-term cumulative preferential shares and subordinated loan capital**

> fixed-term cumulative preferential shares and subordinated loan capital as referred to in Article 4 (3).

Member States or the competent authorities may include fixed-term cumulative preferential shares referred to in Article 2(1)(8) and subordinated loan capital referred to in this provision of own funds, if binding agreements exist under which, in the event of the bankruptcy or liquidation of the credit institution, they rank after the claims of all other creditors and are not to be repaid until all other debts outstanding at the time have been settled.

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14 Inserted by Directive 92/16/EEC.
**Fixed-term cumulative preferential shares**

The detailed provisions on the recognition of fixed-term cumulative preferential shares are laid down in the first paragraph of Art. 4 (3):

*Article 4(3). Member States or the competent authorities may include fixed-term cumulative preferential shares referred to in Article 2 (1) (8) and subordinated loan capital referred to in that provision in own funds, if binding agreements exist under which, in the event of the bankruptcy or liquidation of the credit institution, they rank after the claims of all other creditors and are not to be repaid until all other debts outstanding at the time have been settled.*

**Transposition in the Member States**

Fixed-term cumulative preference shares are deemed to be very attractive capital instruments for credit institutions, because they provide a cheaper source of capital than regular shares due to their cost-effectiveness and tax-efficiency in many countries. Credit institutions thus have a strong incentive to get them recognised as regulatory capital. Consequently, their use has been growing significantly since the adoption of the Directive.

The quality of fixed-term cumulative preference shares as a capital element is reduced by their limited maturity, which means that the capital may not be available when needed, and by their cumulative nature, which may lead to a “backlog” of outstanding payments owed to investors.

Therefore, fixed-term cumulative preference shares can only be recognised as additional own funds and not as original own funds. The Commission considers it essential that shares recognised as Tier 1 are truly non-cumulative, i.e. the credit institution will not be liable for payments to holders of those instruments in case of losses.

Fixed term cumulative preference shares have been adopted under Art. 4 (3) by 11 countries. They have not been adopted by DK, F, I and A.

**Comparison with the Basle Capital Accord**

In substance there is no divergence between the Directive and the Basle Accord in the recognition of cumulative preferential shares. However, the Basle Accord lists them under a separate category called “hybrid debt capital instruments”. The implementation of this provision has been the subject of discussion both in the European Union and the Basle Committee.

**Subordinated loan capital**

The detailed provisions on the recognition of subordinated loan capital are laid down in the second paragraph of Art. 4 (3):
Subordinated loan capital must also fulfil the following criteria:

(a) only fully paid-up funds may be taken into account;

(b) the loans involved must have an original maturity of at least five years, after which they may be repaid; if the maturity of the debt is not fixed, they shall be repayable only subject to five years' notice unless the loans are no longer considered as own funds or unless the prior consent of the competent authorities is specifically required for early repayment. The competent authorities may grant permission for the early repayment of such loans provided the request is made at the initiative of the issuer and the solvency of the credit institution in question is not affected;

(c) the extent to which they may rank as own funds must be gradually reduced during at least the last five years before the repayment date;

(d) the loan agreement must not include any clause providing that in specified circumstances, other than the winding up of the credit institution, the debt will become repayable before the agreed repayment date.

Transposition in the Member States

“Subordinated loan capital” has been adopted by all Member States. In 1996 this item represented, for different EEA Member States, between 0.0 % and 27 % of the total capital of credit institutions (average for all Member States: 15.8 %). In most Member States, subordinated loan capital accounts for 10-20 % of credit institution’s regulatory capital, making it one of the most significant capital elements. The Commission therefore regards it as important that the above conditions on the eligibility of subordinated loan capital are strictly respected.

Comparison with the Basle Capital Accord

The wording in the Basle Accord is not identical to the text of the Directive. The main substantive difference is that the Basle Accord explicitly prescribes a cumulative discount factor of 20 % per year during the last five years to maturity. The Directive does not mention a specific discount factor. The Commission and most Member States do not consider the word “gradual” in the Directive as necessarily implying reductions in equal and uniform amounts, but in any case by degrees which are agreed by the supervisory authorities. Notably, higher reductions in the initial years would be prudent.

2.12. DEDUCTIONS

Items (9) to (13) are deducted from own funds for the purpose of calculation of the solvency ratio, because these items reduce the capital available to the credit

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15 Includes conventional unsecured subordinated debt capital instruments with a minimum original fixed term to maturity of over five years and limited life redeemable preference shares. During the last five years to maturity, a cumulative discount (or amortisation) factor of 20% per year will be applied to reflect the diminishing value of these instruments as a continuing source of strength. These instruments are not normally available to participate in the losses of a bank which continues trading. For this reason these instruments will be limited to a maximum of 50% of tier 1.

16 See GTIAD note XV/1115/96.
institutions. While items (9) to (11) are deducted from original own funds (items 1, 2 and 4), items (12) and (13) are deducted from total own funds (items 1 to 8).

**Item (9) : Own shares**

(9) own shares at book value held by a credit institution;

Own shares do not represent capital injected into the credit institution by outside investors. They have to be deducted from own funds because the credit institution would have to absorb possible losses on those shares itself.

**Transposition in the Member States**

The deduction of own shares has been transposed in all Member States. In 1996 own shares represented, for different EEA Member States, only between 0.0 % and 0.6 %, if compared to the total capital of credit institutions (average for all Member States : 0.1 %).

**Comparison with the Basle Capital Accord**

The Basle Accord does not contain provisions on own shares.

**Item (10) : Intangible assets**

(10) intangible assets within the meaning of Article 4 (9) ('assets') of Directive 86/635/EEC;

**Transposition in the Member States**

The deduction of intangible assets has been transposed in all Member States. In 1996 intangible assets represented, for different EEA Member States, between 0.0% and 10.3%, if compared to the total capital of credit institutions (average for all Member States: 1.8%). Intangible asset deductions are particularly high in Greece, Spain and Italy. According to the information available to the Commission, the transposition of this provision has not raised any substantial problem.

**Comparison with the Basle Capital Accord**

There is a slight difference with the text in the Basle Accord insofar that the Directive requires not only the deduction of goodwill but also of formation expenses.

**Item (11) : Material losses**

(11) material losses of the current financial year;

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17 - Formation expenses, as defined by national law and in so far as national law permits their being shown as an asset;
- goodwill, to the extent that it was acquired for valuable consideration.
Transposition in the Member States

Material losses of the current financial year have to be deducted in all Member States. In 1996 material losses represented, for different EEA Member States, between 0.0 % and 4.3 %, if compared to the total capital of credit institutions (average for all Member States: 1.1 %). According to the information available to the Commission the transposition of this provision has not raised any particular problems.

Comparison with the Basle Capital Accord

The Basle Accord does not contain provisions on the deduction of material losses of the current financial year.

Items (12 and 13) : Holdings in other credit and financial institutions

| (12) | holdings in other credit and financial institutions amounting to more than 10% of their capital, subordinated claims and the instruments referred to in Article 3 which a credit institution holds in respect of credit and financial institutions in which it has holdings exceeding 10 % of the capital in each case. Where shares in another credit or financial institution are held temporarily for the purposes of a financial assistance operation designed to reorganise and save that institution, the supervisory authority may waive this provision ; |
| (13) | holdings in other credit and financial institutions of up to 10 % of their capital, the subordinated claims and the instruments referred to in Article 3 which a credit institution holds in respect of credit and financial institutions other than those referred to in point 12 in respect of the amount of the total of such holdings, subordinated claims and instruments which exceed 10 % of that credit institution's own funds calculated before the deduction of items 12 and 13. |

Pending subsequent co-ordination of the provisions on consolidation, Member States may provide that, for the calculation of unconsolidated own funds, parent companies subject to supervision on a consolidated basis need not deduct their holdings in other credit institutions or financial institutions which are included in the consolidation. This provision shall apply to all the prudential rules harmonised by Community acts.

Transposition in the Member States

This requirement to deduct holdings in other credit and financial institutions has been implemented in all Member States. In 1996 “over-10 %” deductions represented, for different EEA Member States, between 0.0 % and 3.8 %, if compared to the total capital of credit institutions (average for all Member States: 1.3 %). “Under-10 %” deductions represented, for different EEA Member States, between 0.0 % and 4.6 % of the total capital of credit institutions (average for all Member States: 1.0 %).

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18 This provision has subsequently been taken over in Directive 92/30/EEC.
The option of a temporary waiver for financial assistance operations in case of holdings over 10% has been implemented in 6 Member States (B, D, EL, L, FIN, UK). The waiver for credit institutions included in consolidated supervision has been adopted in 6 countries (A, D, EL, FIN, IT, SW).

Comparison with the Basle Capital Accord

Under the Basle Accord, investments in subsidiaries engaged in banking and financial activities, which are not consolidated in national systems, have to be deducted. Banks' holdings of capital issued by other banks or deposit-taking institutions, where no deduction is applied, bear a solvency risk weight of 100%. The fact that banks' holdings of capital issued by other banks do not have to be deducted from capital represents a significant difference with the Directive, which requires deduction for the holdings mentioned in items (12) and (13).

2.13. RESTRICTION ON THE USE OF CERTAIN ITEMS

(a) unrestricted and immediate availability to cover losses

Article 2 (3) imposes very important additional conditions on the use of items 1 to 5:

3. The items listed in points 1 to 5 must be available to a credit institution for unrestricted and immediate use to cover risks or losses as soon as these occur. The amount must be net of any foreseeable tax charge at the moment of its calculation or be suitably adjusted in so far as such tax charges reduce the amount up to which these items may be applied to cover risks or losses.

Transposition in the Member States

All Member States have transposed this provision. The Commission insists that this provision represents an essential element of the Directive. Member States have to take into account Article 2 (3) when deciding whether a particular instrument is eligible as one of the items listed in points 1 to 5.

Comparison with the Basle Capital Accord

The wording is not identical to the Basle Accord. There is however no divergence in substance.

(b) public guarantees

Article 4 (2) prevents state guarantees to public credit institutions from being counted as own funds:

2. Member States shall not include in the own funds of public credit institutions guarantees which they or their local authorities extend to such entities.

Transposition in the Member States

No Member State includes in the own funds of public credit institutions guarantees which they or their local authorities extend to such entities. The exemption regarding Belgium has lapsed.
Comparison with the Basle Capital Accord

The Basle Accord does not recognise public guarantees as own funds.

(c) consolidation rules

Article 5 contains detailed rules on the eligibility of certain items upon consolidation:

Until further co-ordination of the provisions on consolidation, the following rules shall apply.

1. Where the calculation is to be made on a consolidated basis, the consolidated amounts relating to the items listed under Article 2 (1) shall be used in accordance with the rules laid down in Directive 83/350/EEC. Moreover, the following may, when they are credit (‘negative’) items, be regarded as consolidated reserves for the calculation of own funds:

   – any minority interests within the meaning of Article 21 of Directive 83/349/EEC, where the global integration method is used,
   – the first consolidation difference within the meaning of Articles 19, 30 and 31 of Directive 83/349/EEC,
   – the translation differences included in consolidated reserves in accordance with Article 39 (6) of Directive 86/635/EEC,
   – any difference resulting from the inclusion of certain participating interests in accordance with the method prescribed in Article 33 of Directive 83/349/EEC.

2. Where the above are debit (‘positive’) items, they must be deducted in the calculation of consolidated own funds.

Transposition in the Member States

This article has been adopted by all Member States. DK has not adopted the discretion in the second sentence of Article 5 (1). Although “further co-ordination of the provisions on consolidation” has taken place in the form of Directive 92/30/EEC, the latter has not made changes to the provision referred to in Art. 5 of the Own Funds Directive. Therefore, Art. 5 continues to apply. The Commission has only limited information as to whether the Member States have had problems in the application of this article.

Comparison with the Basle Capital Accord

The provision corresponding to Article 5 in the Basle Accord only has speaks of minority interest, the other items are not mentioned. The Commission has only

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19 In the case of consolidated accounts, equity capital (Tier 1) also includes minority interests in the equity of subsidiaries which are less than wholly owned.
limited information as to whether the Member States have had problems in the application of this article.

(d) quantitative restrictions

Article 6 contains quantitative restrictions on the use of certain items:

<table>
<thead>
<tr>
<th>Article 6(1). The items referred to in Article 2 (1), points 3 and 5 to 8, shall be subject to the following limits:</th>
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<tr>
<td>(a) the total of items 3 and 5 to 8 may not exceed a maximum of 100 % of items 1 plus 2 and 4 minus 9, 10 and 11;</td>
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<tr>
<td>(b) the total of items 7 and 8 may not exceed a maximum of 50 % of items 1 plus 2 and 4 minus 9, 10 and 11;</td>
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<tr>
<td>(c) the total of items 12 and 13 shall be deducted from the total of the items.</td>
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</tbody>
</table>

Transposition in the Member States

This article has been adopted by all Member States.

Comparison with the Basle Capital Accord

The wording is slightly different in the Basle Accord. The only substantial divergence is the specification in the Basle Accord of a discount factor of 55 % for latent gains on unrealised securities. Article 6 (2) has been deleted by Directive 91/633/EEC and the provisions of Article 6 (3) have lapsed.

| Article 6(4) The competent authorities may authorise credit institutions to exceed the limit laid down in paragraph 1 in temporary and exceptional circumstances. |

Transposition in the Member States

Article 6 (4) has been adopted by 6 Member States (D, EL, E, F, I, P). Italy has specified that its rules allow excesses only in the case of “other positive elements”: In this case they may not exceed 1.25 % of risk-weighted assets.

Comparison with the Basle Capital Accord

The Basle Accord does not contain a provision on temporary exemptions.

20 Inserted by Directive 91/633/EEC.
21 Inserted by Directive 91/633/EEC.
22 (i) The total of tier 2 (supplementary) elements will be limited to a maximum of 100% of the total of tier 1 elements;
(ii) subordinated term debt will be limited to a maximum of 50% of tier 1 elements;
(iii) asset revaluation reserves which take the form of latent gains on unrealised securities will be subject to a discount of 55%.
3. CONCLUSIONS

Continued attention both at the national and at the Community level are still necessary. Due to the cost advantages (often based on favourable tax treatment) of new capital instruments, credit institutions have an incentive to replace existing capital of high quality (permanent subscribed capital) with new capital instruments of lower quality. It is advisable that Member States ensure that new capital instruments, such as instruments with step-ups, intended to serve as Tier 1 regulatory capital, do not weaken the capital base of credit institutions. This is the case even if the Directive may not appear to explicitly exclude those instruments from being recognised as own funds. If Member States have doubts regarding the eligibility of certain “hybrid” capital instruments it is prudent to discuss these instruments in the appropriate EU forum in order to obtain a clearer understanding of the problems.

In order to avoid the erosion of the capital base it could be advisable to limit the share of new capital instruments recognised as Original Own Funds. The Basle Committee on Banking Supervision has carefully observed this development and at its meeting on 21st October 1998 decided to limit acceptance of new capital instruments for inclusion in Tier 1 capital. Such instruments will be subject to stringent conditions and limited to a maximum of 15% of Tier 1 capital. At Community level action has been taken in order to achieve a more harmonised definition of own funds in parallel with reflections, suggestions and considerations undertaken in the framework of the Basle Committee on Banking Supervision. A review of the Own Funds Directive has indeed started in the Banking Advisory Committee and its groups. This examination will include ways to limit distortions of competition and strengthening of the European banking system.

The Commission and the EU Member States continue to play an active role in the Basle Committee on Banking Supervision and its groups in order to assure a similar definition of own funds world-wide and a homogeneous application of regulatory capital requirements. This will help to preserve the international competitiveness of European Union credit institutions with the ultimate benefit for consumer confidence and security.
## ANNEX I

Table of national implementation measures

### DIRECTIVE 89/299

[Date d'échéance/Deadline 1-1-1991]

complétée par/Completed by **Directive 91/633** [Date d'échéance/Deadline 1-1-1993]

modifiée par/modified by **Directive 92/16**

### Fonds propres / Own funds

• Arrêté de la Commission bancaire et financière du 5 Décembre 1995 concernant le règlement relatif aux fonds propres des établissements de crédit (adopté par Arrêté ministériel du 31 Décembre 1995).  
• Besluit van de Commissie voor het Bank- en Financiewezen van 5 december 1995 over het reglement op het eigen vermogen van de kredietinstellingen (goedgekeurd bij ministerieel Besluit van 31 december 1995). |
• Lov No. 306 af 16.05.1990 - LA af 16.05.1990, S. 983 (EN)  
| EL | • Décret du Gouverneur de la Banque de Grèce n° 2053 du 18.03.1992 - JO 49/A/92 |
**DIRECTIVE 89/299**

[Date d'échéance/Deadline 1-1-1991]

complétée par/Completed by **Directive 91/633** [Date d'échéance/Deadline 1-1-1993]

modifiée par/modified by **Directive 92/16**

**Fonds propres / Own funds**

(Following)

| ES | • Ley 13/85 de 25.05.1985 - BOE 28.05.1985, modificada por Ley 13/92 de 01.06.1992 - BOE n. 132, 02.06.1992, p. 18548-18556 |
|    | • Ley 13/1992, de 1 de junio de Recursos Propios y Supervisión en Base Consolidada de las Entidades Financieras - BOE n. 132 de 02.06.1992 |
|    | • Circular del Banco de España n. 5/1993, de 26.03.1993, a Entidades de Crédito, sobre determinación y control de los recursos propios mínimos - BOE n. 84 de 08.04.1993 |
|    | • Real Decreto 538/1994 de 25.03.1994 modificada Real-Decreto 1343/92 - BOE n° 76 de 30-3-94) |
|    | • Real Decreto 2024/1995, de 22 de diciembre, por el que se modifica el Real Decreto 1343/1992, de 6 de noviembre, por el cual se desarrolla la Ley 13/1992, de 1 de junio de Recursos Propios y Supervisión en Base Consolidada de Entidades Financieras. |
| FR | • Arrêté ministériel du 20.03.1990 portant homologation du règlement du Comité de la Réglementation bancaire n° 90-02 en date du 23.02.1990 (JORF du 01.04.1990, p. 3992) |
| IR | • Notice from the Central Bank of Ireland of 16.07.1991 on Supervision Requirements and Standards  
• Notice from the Central Bank of Ireland of 30.01.1992 on Supervision Requirements and Standards  
• Notice from the Central Bank of Ireland of 13.02.1996 on Supervision Requirements and Standards |
• Circolare (Banca d'Italia), n. 4, 29.03.1988, 75° aggiornamento (18.12.1991), 82° aggiornamento (04.02.1992)  
• Circolare (Banca d'Italia) n. 155, (Istruzioni per la Compilazione delle segnalazioni sul patrimonio di vigilanza e sui coefficienti prudenziali), 18.12.1991 + 1° aggiornamento (04.02.1992)  
• Decreto legislativo 01.09.1993, n. 385 (Suppl. 230 alla GU n. 92 - 30.09.93) [Testo unico delle leggi in materia bancaria e creditizia] |
| LU | • Loi du 05.04.1993 relative au secteur financier (Mémorial A, n° 27, 10.04.1993)  
• Circulaire IML 96/127 du 10 mai 1996 portant définition de ratios de fonds propres |
| NL | • Solvabiliteitsrichtlijnen opgesteld door de Nederlandsche Bank op grond van art. 20 van de Wet toezicht kredietwezen (Stcr 1991, 52) |
**DIRECTIVE 89/299**

*Date d'échéance/Deadline 1-1-1991*

complétée par/Completed by **Directive 91/633** [Date d'échéance/Deadline 1-1-1993]

modifiée par/modified by **Directive 92/16**

**Fonds propres / Own funds**

(Following)

<table>
<thead>
<tr>
<th>ÖS</th>
<th>Banking Act / Bankwesengesetz (part of Finanzmarktanpassungsgesetz 1993), BGBL. Nr. 532/1993 as corrected by BGBL. Nr. 639/1993</th>
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<tr>
<td></td>
<td>Regulation on monthly reports / Monatsausweis-Verordnung BGBL. Nr. 773/1993</td>
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<td></td>
<td>Banking Supervisory Report / Verordnung über den bankaufsichtlichen Prüfungsbericht BGBL. Nr. 92/1994</td>
</tr>
</tbody>
</table>

|    | Aviso nº7/95, in DR, II, de 21.9.95 |

| SF | Act on credit institutions / Laki luottolaitostoiiminnasta / Kreditinstitutslag 1607/63 (30.12.1993) |
|    | Act relating to the activities of Foreign Credit and Financial Institutions in Finland / Laki ulkomaisen luotto- ja rahoitusalaioksen toiminnasta Suomessa / Lag om utländska kreditinstituts och Finansiella instituts verksamhet i Finland 1608/93 (30.12.1993) |
|    | Cooperative Banks Act / Osuuspankkilaki / Andesbankslagen 1271/90 (28.12.1990) |
|    | Administrative provisions by Financial Supervision |
| SV | The Banking Business Act / Bankrörelselagen : 1987 : 617 *  
The Banking Companies Act / Bankaktiebolagslagen / 1987 : 618 *  
The Act on Credit Market Companies / Lagen om Kreditmarknadsbolag / 1992: 1610 *  
The Act on Limited Companies / Aktiebolagslagen : 1975 : 1385 *  
The Regulation on Solvency Ratio in Banks and other Credit Institutions / Förordningen om kapitalkravet i banker och andra kreditinstitut : 1989 : 1096 *  
The Financial Supervisory Authority's Provisions on Report of Information concerning Assessment of Own Funds and Capital Cover / Finansinspektionens föreskrifter om rapportering av uppgifter om beräkning av kapitalbas och kapitalkrav / FFFS 1992 : 32 * |
|---|---|
Building Societies :  
Prudential Note 1992/1 of the Building Societies Commission under the Building Societies Act 1986  
SI 1988/777  
SI 1991/702  
SI 1991/1729  
SI 1992/1611  
SI 1992/1612  
Banking Ordinance 1992 - Administrative notice no. 2 of 25-9-1992 (Gibraltar) |
Instruments eligible for inclusion in Tier 1 Capital

1. The Basle Committee on Banking Supervision has taken note that over the past years some banks have issued a range of innovative capital instruments, such as instruments with step-ups, with the aim of generating Tier 1 regulatory capital that is both cost-efficient and can be denominated, if necessary, in non-local currency. The Committee has carefully observed these developments and at its meeting on 21st October 1998 decided to limit acceptance of these instruments for inclusion in Tier 1 capital. Such instruments will be subject to stringent conditions and limited to a maximum of 15% of Tier 1 capital.

2. As its starting point, the Committee reaffirms that common shareholders' funds, i.e. common, stock and disclosed reserves or retained earnings, are the key element of capital. Common shareholders' funds allow a bank to absorb losses on an ongoing basis and are permanently available for this purpose. Further, this element of capital best allows banks to conserve resources when they are under stress because it provides a bank with full discretion as to the amount and timing of distributions. Consequently, common shareholders' funds are the basis on which most market judgements of capital adequacy are made. The voting rights attached to common stock also provide an important source of market discipline over a bank's management. For these reasons, voting common shareholders' equity and the disclosed reserves or retained earnings that accrue to the shareholders' benefit should be the predominant form of a bank's Tier 1 capital.

3. To provide supervisors and market participants with sufficient information to ensure that the integrity of capital is maintained, the Committee agrees that, as set forth in its recent report "Enhancing Bank Transparency", banks should periodically publicly disclose each component of Tier 1 capital and its main features.

4. In order to protect the integrity of Tier 1 capital, the Committee has determined that minority interests in equity accounts of consolidated subsidiaries that take the form of SPVs should only be in Tier 1 capital if the underlying instrument meets the following requirements which must, at a minimum, be fulfilled by all instruments included in Tier 1:

- issued and fully paid;
- non-cumulative;
- able to absorb losses within the bank on a going-concern basis;
- junior to depositors, general creditors and subordinated debt of the bank;
- permanent;
• neither be secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors; and

• callable at the initiative of the issuer only after a minimum of 5 years with supervisory approval and under the condition that it will be replaced with capital of same or better quality unless the supervisor determines that the bank has capital that is more than adequate to its risks.

5. In addition, the following conditions have also to be fulfilled:

• the main features of such instruments must, be easily understood and publicly disclosed;

• proceeds must be immediately available without limitation to the issuing bank, or if proceeds are immediately and fully available only to the issuing SPV, they must be made available to the bank (e.g. through conversion into a direct issuance of the bank that is of higher quality or of the same quality at the same terms) at a predetermined trigger point, well before serious deterioration in the bank's financial position;

• the bank must have discretion over the amount and timing of distributions, subject only to prior waiver of distributions on the bank’s common stock and banks must have full access to waived payments; and

• distributions can only be paid out of distributable items; where distributions are preset they may not be reset based on the credit standing of the issuer.

6. Moderate step-ups in instruments issued through SPVs, as well as in directly issued Tier 1 instruments meeting the requirements set forth in paragraphs 4 and 5, are permitted, in conjunction with a call option, only if the moderate step-up occurs at a minimum of 10 years after the issue date and if it results in an increase over the initial rate that is no greater than, at national supervisory discretion, either:

• 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or

• 50 percent of the initial credit spread, less the swap between the initial index basis and the stepped-up index basis.

7. The terms of the instrument should provide for no more than one rate step-up over the life of the instrument. The swap spread should be fixed as of the pricing date and reflect the differential in pricing on that date between the initial reference security or rate and the stepped-up reference security or rate.

8. National supervisors expect banks to meet the Basle minimum capital ratios without undue reliance on innovative instruments, including instruments that have a step-up. Accordingly, the aggregate of issuances of non-common equity Tier 1 instruments with any explicit feature - other than a pure call option - which might lead to the instrument being redeemed is limited - at issuance - to 15% of the consolidated bank's Tier 1 capital.
9. Any instruments authorised or issued under existing national rules of Tier 1 which no longer qualify under the above interpretation will be grandfathered; the same will apply to any issues of such instruments in excess of the 15% limitation.

10. This interpretation will be subject to review as part of a broader, effort already underway to reassess the present framework for evaluating banks’ capital adequacy. In this respect, the Committee retains its flexibility to make any changes to this interpretation.

Basle, 27th October 1998
ANNEX III

CONTRIBUTIONS FROM THE DELEGATIONS

CONCERNING THE INTERPRETATION OF ARTICLES 2(1)(6) AND 3(1)

OF THE OWN FUNDS DIRECTIVE
Summary table of Member States’ contributions concerning interpretation of Articles 2(1)(6) and 3(1) of the Own Funds Directive : possibility of including in own funds any capital gains on portfolios (positive difference between market value and purchase price)

<table>
<thead>
<tr>
<th>Country</th>
<th>Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>Belgium has not made use of the possibility provided for in Article 2(1)(6) and Article 3(1). Belgium is of the opinion that the positive difference between market value and purchase price does not fall within the scope of Article 3(1) for the following reasons : - it does not meet all the criteria defined by this article; - the inclusion of Article 3(1) was meant to meet specific national situations in the Member States which could not be harmonized; broadening the scope of Article 3(1) to the above-mentioned ‘capital gains’ would render Article 2(1), (1) to (5), of the Directive obsolete; - the argument that including such ‘capital gains’ would bridge the gap between those Member States which apply the mark-to-market valuation rule and those which do not, is not entirely to the point since marking-to-market in principle applies to the trading portfolio, whereas Article 3(1) would allow a wider application. Belgium is of the opinion that the inclusion in the own funds of such ‘capital gains’ would require an amendment of the Directive. However, from a prudential point of view the inclusion of these ‘capital gains” would require additional conditions to be met (e.g. application of a discount.)</td>
</tr>
<tr>
<td>DK</td>
<td>Article 3(1) has not been transposed into Danish law but Denmark has implemented Article 36(2) of Directive 86/635/EEC on the annual accounts of banks, with the result that the positive difference forms part of the first-category capital. The possibility given by Article 36.2 of Directive 86/635/EEC is used.</td>
</tr>
</tbody>
</table>
On the basis of articles 2 (1) (6) and 3 (1) of the OFD, Germany has authorised the inclusion of non realised reserves on certain assets in own funds, under certain conditions and within specific limits. These assets are basically property and equivalent rights and securities.

- As far as property and equivalent rights are concerned, 45 % of the difference between book value and ‘Beleihungswert’ i.e. the value for mortgage purposes as calculated in accordance with statutory requirements, can qualify as own funds.

- As far as securities are concerned, 35 % of the difference between book value and

  a) in case of securities listed on an exchange or market fulfilling certain conditions, the quoted value ;

  b) in case of non listed securities, the value of these securities which represent participations in certain companies belonging to the association of “Kreditgenossenschaften” or savings banks and which have a balance sheet of at least 20 million German Marks ;

  c) the repurchase price of participations in separate securities or property funds issued in accordance with law on “Kapitalanlagegesellschaften” or of participations in a separate securities fund issued by a non-German UCITS in accordance with the provisions of the UCITS Directive,

can qualify as own funds. In respect of these securities the lower of the quoted value on the balance sheet date and the average of the quoted value of this balance sheet date and the previous three balance sheet dates, is taken as the relevant value. The same applies to the securities referred to under b) and c) above.

In addition certain general qualitative requirements for credit institutions apply. In particular institutions must have a core capital quota of 4,4 and non realised reserves are eligible for being included in own funds only up to an amount of 1,4 % of risk weighted assets. Furthermore, non realized reserves have to be calculated for all property and equivalent rights and securities as a result of which any losses on these assets will also be taken into account (exclusion of cherry picking).

Finally, there are certain provisions which are aimed at ensuring compliance with the requirements of article 3 (1) of the OFD.
Spain considers that the inclusion of capital gains in own funds is not allowed and would require amendment of the Own Funds Directive.

Its position is based on the following arguments:

- wherever the Own Funds Directive allows differences similar in nature to capital gains to be incorporated in one form or another, it is for accounting items which are not hidden and which are furthermore subject to conditions concerning their stability and actual existence, or to accounting checks, which are in no way required by Community legislation in the case of the capital gains concerned;

- when the Own Funds Directive was being drafted, the marking to market of hidden reserves was deliberately limited to revaluation reserves governed by the Community accountancy rules. Article 3(1) related to own funds items that could not be harmonized given the specificity of national situations;

- parallels cannot be drawn with the Basle agreement since the recommendation on capital gains contained in that agreement spells out and harmonizes the concept of capital gains;

- a hidden reserve would not meet the requirements of Article 3(1) because:
  - the accounting rules used for valuing assets do not allow any scope for using capital gains to cover capital losses;
  - since these capital gains are by nature hidden, the corresponding entries in the accounts do not satisfy the accounting principles enshrined in the Community directives and cannot therefore be regarded as non-accounting information lying outside the scope of the internal accounting records;
  - in accordance with the principle of surveillance by the competent authorities, these authorities would have to accept in advance a marking-to-market valuation. This type of control does not appear to be compatible with the surveillance powers which have been harmonized at Community level and which are based on ex-post checks on banking activity.

Spain makes very limited use of Article 3.1.

The Council's initial intention was to include in Article 3(1) only hidden reserves resulting from taxable profits where these are large enough in order, in particular, to cushion variations in profits. Hidden reserves of this type are used to cover unforeseen future losses, which means that they result from the valuation of securities at a level lower than that allowed by law.

The wording of Article 3(1) could indeed be given a broader interpretation so as to include the positive difference but it is absolutely essential to lay down, perhaps in an explanatory note, an appropriate maximum limit in order to cover any fluctuations in the market value of securities.

The possibility given by Article 36.2 of the Directive 86/635/EEC is not used.
The following can be included in own funds as "other items":

- guarantee funds that are fully mutualized (i.e. available to cover the institution's entire counterpart risk);
- other guarantee funds of a mutual nature and public funds guaranteeing categories of credit transactions, within a limit of 8% of the risks they cover (inclusion of these funds is thus limited to coverage of the own funds requirement specific to the risks they cover);
- non-refundable grants from public or private sources;
- the hidden reserve appearing in the financial accounts for leasing transactions, with or without option to buy (except where the accounts are consolidated, in which case this already appears in the consolidated reserves).

Inclusion of capital gains on securities is not possible for the following reasons:

- Article 3(1)(b) requires that the existence of other items in own funds be disclosed in the institution's internal accounting records, which is not the case here since the differences are hidden. Internal accounting records must be understood to mean the institution's detailed accounts as opposed to merely the account items which are published;
- neither may hidden differences be regarded as freely available within the meaning of Article 3(1)(a);
- inclusion of hidden capital gains in own funds, whereas the book value of the assets to which they relate continued to appear in the denominator of the solvency ratio, would unacceptably distort calculation of the latter;
- inclusion of hidden capital gains would in any event exert an excessive impact on calculation of the ratio, which would be undesirable.

The following items may be included in accordance with Articles 2(1)(6) and 3(1):

- items which, in the opinion of the central bank, may be freely used to cover normal banking risks, whose existence is disclosed in internal accounting records and which are verified by auditors. Where these conditions are met, general provisions may be included up to 1.25% of the assets at risk.

Where the positive difference corresponds to capital gains that have not been realized, the central bank is not in favour of including them under the above provisions of the Directive, particularly in the case of illiquid assets or assets held on a long-term basis since such non-realised capital gains can prove difficult to turn into actual profits.
| IT | For other items in additional own funds, banks licensed in Italy  
- may include the amount of any funds for credit risk which are entered as liabilities in the bank’s balance sheet and are exclusively prudential and non-corrective in nature. Such funds are intended to cover credit risks which are only hypothetical. The implicit profits are taken into consideration only with the aim of compensating for implicit losses. If losses exceed profits, 50 % of the net amount is deducted from the own funds. If profits exceed losses, the net amount is not integrated into the own funds. |

| L | Luxembourg has made use of the faculty provided for in Article 3 paragraph 1 by allowing inclusion in the own funds of the part of the “items with a reserve share” which is made up of realised profits not subject to tax. Luxembourg considers moreover that Article 3 paragraph 1 does not prevent the inclusion of the hidden reserves on securities in the own funds. However this possibility was not retained in the Luxembourg rules. |

| NL | The Netherlands has not made use of this possibility. |

| AT | Austria made use of Article 3(1) in one respect, namely in connection with the revaluation reserve.  
Revaluation reserves are unrealised reserves representing 45 % of the following value differences:  
- difference between the book value and the current market value of property, rights equivalent to real property, and buildings. If the current market value is less than the book value, the revaluation reserves must be reduced by the difference;  
- difference between the book value and the market value of securities authorised for official dealing on a stock market or traded on another organised market that is recognised;  
- difference between the book value and the bid price for units in capital investment funds.  
Revaluation reserves may be taken into account only if the calculation of value differences includes all assets items under 1 to 3.  
Pursuant to Article 23(14)(4) of the Banking Law, revaluation reserves are included in own funds up to a maximum of 1.5 % of the basis of assessment within the meaning of Article 22(2) (sum of the weighted assets and off-balance-sheet items) provided that core capital is at least 4.5 % of the basis of assessment. |
Subject to the prior agreement of the Bank of Portugal, additional own funds may include asset items which meet the following conditions:

- they may be freely used to cover normal banking risks, and the losses or capital losses have not yet been identified;
- their existence is disclosed in the institutions’ accounts;
- their amount is verified by a "revisor oficial de contas".

These measures were introduced in order to allow credit institutions with their registered office in Portugal to include in their own funds a proportion of the provisions which they have to set aside to cover general credit risks.

No credit institution has, however, so far requested the Bank of Portugal's agreement for this purpose.

Finland has not made use of the possibility provided for in Article 3(1) of the Own Funds Directive and does not allow the positive difference between market value and purchase price to be included in the profit and loss account or in own funds.

Article 3(1) has not been transposed into Swedish law but Sweden has implemented Article 36(2) of Directive 86/635/EEC on the annual accounts of banks, with the result that the positive difference forms part of the first-category capital.

The possibility given by Article 36.2 of Directive 86/635/EEC is used.

The United Kingdom does not intend to make use of this possibility since UK accounting practice generally involves marking securities to market, portfolio items being valued at their purchase cost less the provision necessary for lasting depreciation. The creation of a hidden reserve corresponding to the difference between the purchase cost and the market value of securities in the portfolio would therefore be contrary to such accounting practice.

The UK has no objection to other Member States including such reserves in the second-category capital where the conditions listed in Article 3(1) are met.

It takes the view, however, that such a practice is not prudent, unless these revaluations are heavily discounted.

The possibility given by Article 36.2 of Directive 86/635/EEC is used.

Article 3(1) has not been transposed into Icelandic law but Iceland has implemented Article 36(2) of Directive 86/635/EEC on the annual accounts of banks, with the result that the positive difference forms part of the first-category capital.

Liechtenstein has not made use of this possibility and does not allow the difference between market value and purchase price to be included in own funds.

Norway has not made use of this possibility and does not allow the difference between market value and purchase price to be included in own funds.
ADDENDUM

**Subject:** Other items referred to in articles 2 (1) (6) and 3 (1) of the Own Funds Directive (OFD)

1. **INTRODUCTION**

On the issue whether or not a positive difference between the market value and the cost of acquisition can be included in the own funds of credit institutions it became clear in the GTIAD of July 1996 that a majority of delegations was in favour of excluding them from the own funds. Some delegations, however, favour or are at least not against an approach which is in conformity with Basle could (“haircut method”, according to points 16 and 17 of the Capital Accord).

In view of the above the Commission’s services have drafted a clause amending article 3 (1) of the OFD.

2. **PROPOSED DRAFT AMENDMENT**

The proposed amendment would consist of Article 3 (1) (d):

“A discount of 55 % is to be applied to those other items which consist of the difference between the higher market value and the value as determined in accordance with Directive 86/635/EEC. Value corrections applied to such items in accordance with Article 37 (2) of that Directive or allocations to the Fund for general banking risks in accordance with Article 38 can not be included in that difference.”

3. **EXPLANATION**

The draft amendment is more in line with the Basle approach. It has been limited to the difference between basically market value and “historic cost” as it is the case in the Basle Capital Accord where these categories are qualified as revaluation reserves.

The treatment proposed here is also more in line with that of those Member States using the options available under Article 33 of Directive 78/660/EEC for revaluation reserves or values higher than “historic cost” e.g. as available under Article 36 of Directive 86/635/EEC.

The limitation to these categories entails, however, that other assets may still qualify as ‘other items’ in the meaning of this article without any haircut. If it is the intention to apply the hair cut rule to all other items, the draft clause should be extended accordingly.

The second sentence of the draft amendment serves to avoid double counting. These amounts are already included in the calculation of own funds under Article 2 (1) points 5 and 4 respectively.