

A Public Notice

announcing a

PROVISION OF A GENERAL NATURE regarding deductions from own funds

of 22 July 2021

Pursuant to Article 20d(1) of Act No. 21/1992 Coll., on Banks, as amended by Act No. 135/2014 Coll., (hereinafter referred to as the “Act on Banks”), and Article 9a(1) of Act No. 87/1995 Coll., on Credit Unions and Certain Related Measures and on the Amendment of Czech National Council Act No. 586/1992 Coll., on Income Taxes, as amended, as amended by Act No. 135/2014 Coll. (hereinafter referred to as the “Act on Credit Unions”), the Czech National Bank as a competent administrative authority hereby issues this provision of a general nature regarding Article 36(1)(g), Article 56(b), Article 66(b) and Article 478(3) of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, as amended (hereinafter referred to as the “Regulation”):

I. Banks and credit unions shall, pursuant to the Regulation, deduct the amounts of exposures in the form of direct, indirect or synthetic holdings of equity instruments of financial sector entities from Common Equity Tier 1, Additional Tier 1 and Tier 2 where investment in own funds by financial sector entities results in the creation of reciprocal cross holdings designed to inflate the own funds of these banks or credit unions.

II. Banks and credit unions shall deduct the full amount (100%) of the items referred to in Article 478(3)

Justification

1. Pursuant to Article 20d(1) of the Act on Banks and Article 9a(1) of the Act on Credit Unions, the Czech National Bank may issue a provision of a general nature based on, and within the limits of, the directly applicable legislative act of the European Union governing prudential requirements where this directly applicable legislative act allows a competent authority to grant an exemption or modify the application of the rules set for banks or a set of banks defined by type, or for credit unions or a set of credit unions defined by type. The Regulation is the directly applicable legislative act of the European Union governing prudential requirements.

2. In line with its legal mandate, the Czech National Bank shall apply the power to modify the application of the set rules based on, and within the limits of, the Regulation.

3. In this provision of a general nature, the Czech National Bank shall stipulate what it considers to be the holdings designed to inflate artificially the own funds of an institution¹ through reciprocal cross holdings with financial sector entities.²

4. The Czech National Bank proceeds from Article 36(1)(g) of the Regulation, under which institutions shall deduct direct, indirect and synthetic holdings of Common Equity Tier 1 instruments of financial sector entities from their Common Equity Tier 1 items where those entities have a reciprocal cross holding with the institutions that the competent authority considers to have been designed to inflate artificially the institutions' own funds. The definition of a reciprocal cross holding is given in point 122 of Article 4(1) of the Regulation.

5. The Czech National Bank proceeds from Article 56(b) of the Regulation, under which institutions shall deduct direct, indirect and synthetic holdings of Additional Tier 1 instruments of financial sector entities from their Additional Tier 1 items where those entities have a reciprocal cross holding with the institutions that the competent authority considers to have been designed to inflate artificially the institutions' own funds.

6. The Czech National Bank thus proceeds from Article 66(b) of the Regulation, under which institutions shall deduct direct, indirect and synthetic holdings of Tier 2 instruments of financial sector entities from their Tier 2 items where those entities have a reciprocal cross holding with the institutions that the competent authority considers to have been designed to inflate artificially the institutions' own funds.

7. The holdings can be direct, indirect or synthetic, where it is irrelevant for the substance of the provision to be fulfilled whether one of the reciprocal cross holdings is direct and the other indirect or synthetic, for example. The definitions of an indirect holding and of a synthetic holding are given in point 114 and point 126 of Article 4(1) respectively.

8. In the Czech National Bank's opinion, the criteria of the substance of an artificial increase in own funds in the case of a reciprocal cross holding between an institution and a financial sector entity are fulfilled where the holding is primary in nature and is most often acquired as part of subscription of an instrument. Therefore, an artificial increase in own funds is in substance an act whereby both the institution and the financial sector entity become the initial acquirers of an equity instrument of another entity. A transfer of own equity instruments acquired earlier by institutions also qualifies as an initial acquisition, as their nominal values must be deducted from the institutions' own funds. The result of the transfer of own equity instruments is thus an increase in own equity of the institution concerned.

9. The criteria of the substance of an artificial increase in own funds are also fulfilled where reciprocal cross holdings consist of different components of own funds, i.e. in a situation where one institution invests in Common Equity Tier 1 capital and the other in Additional Tier 1 capital, for example.

10. Where the amounts of equity investments within a reciprocal cross holding are not the same, institutions are obliged to deduct such an equity investment in the amount corresponding to the reciprocal cross holding.

¹ Point (3) of Article 4(1) of the Regulation.

² Point (27) of Article 4(1) of the Regulation.

11. In line with its legal mandate, the Czech National Bank shall also apply the power to stipulate, for each of the selected group of deductions from Common Equity Tier 1, Additional Tier 1 and Tier 2 items, the extent to which these deductions must be applied.

12. The Czech National Bank shall thus apply Article. 478(3) of the Regulation, under which competent authorities shall determine and publish an applicable percentage for each of the selected group of deductions from Common Equity Tier 1, Additional Tier 1 and Tier 2 items.

13. Pursuant to Article 478(2) of the Regulation, the applicable percentages for items that existed prior to 1 January 2014 may in 2021 reach at least 70%, in 2022 at least 80% and in 2023 at least 90% of the amounts required to be deducted from 2024 at the latest, unless the amounts change.

14. The basis for determining the amounts of the deductions referred to in Article 478(3) of the Regulation in the ranges specified in Article 478(2) of the Regulation is an assessment of the potential impacts of the planned regulation, which the Czech National Bank conducted in 2013. The assessment of the impacts of the regulation was based on information provided directly from the institutions supervised by the Czech National Bank. Emphasis was placed on data on an individual basis. The relevant data were obtained from all banks and a large majority of credit unions. Given the degree of involvement of the key institutions, the data can be regarded as highly representative overall. The result of the assessment is an impact study. This study was set parametrically in such a scope to reflect the requirements which regulated institutions will be obliged to meet after the end of the transition period. This period is defined in the Regulation. During the transition period, the competent supervisory authorities shall be entitled to set the requirements in mostly a smaller scope than shall be that applied after the end of that period. The impact study showed that the amount of own funds of most institutions has been sufficient to comply without any limits with the full scope of the requirements set out in the Regulation since the requirements became applicable. The existing approach pursuant to the CNB's provision of a general nature regarding capital deductions of 16 October 2014, Ref. No.: 2014/47553/CNB/560, is therefore unchanged.

15. Based on the above facts, the Czech National Bank has concluded that, for objective reasons, there is no need to relax the scope of the requirements applied under the Regulation in the area of capital and capital ratios during the transition period. It is neither desirable to relax the scope of the requirements imposed on banks and credit unions in view of ensuring the sound operation of the financial system in the Czech Republic and maintaining financial stability. The fact that the requirements would be relaxed only during the transition period may not be in this respect accepted as a relevant argument, as the scope of the requirements will be broadened after the transition period ends. The practical consequence of this would be the need to create and maintain higher minimum own funds. Ultimately, this could result in a situation where some institutions, which would use the opportunity to maintain lower minimum own funds during the transition period, would subsequently have to increase them so as not to breach their legal duties. The Czech National Bank therefore deems it very important to actively prevent such situations from occurring, for which it uses the relevant powers conferred on it by individual legislative acts.

16. As regards information submitted to the Czech National Bank (pursuant to Part Seven of the Regulation) and disclosure (pursuant to Part Eight of the Regulation), this provision of a general nature shall also be taken into account as of the reference date of 30 June 2021.

17. The draft of this provision of a general nature was displayed on 14 June 2021 and removed on 23 July 2021. No comments were made regarding the draft.

Effect

This provision of a general nature shall take effect on 23 July 2021.

imprint of official stamp

Marek Mora
Deputy Governor

signed electronically

Vojtěch Belling
Executive Director, Financial
Regulation and International
Cooperation Department

signed electronically