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**REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND  
THE COUNCIL**

**on the review of the appropriateness of the definition of "eligible capital" pursuant to  
Article 517 of Regulation (EU) No 575/2013**

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## 1. INTRODUCTION

The capital requirements applicable to investment firms with limited investment services, the prudential treatment of an institution's qualifying holdings outside the financial sector and the definition of institutions' 'large exposures' and its limits have been based, until 31 December of 2013, on the notion of 'own funds'<sup>1</sup>.

The 'own funds' definition was substituted from 1 January 2014 with the definition of 'eligible capital' for the purposes to be used in the above mentioned fields regulated by Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms of 26 June 2013 (hereafter also Capital Requirement Regulation or CRR).

The definition of 'eligible capital' was introduced without conducting an impact assessment. For this reason, the implementation of the new regime is however subject to a three-year transitional period (ending on 31 December 2016)<sup>2</sup> and it is subject to review before its full implementation.

The report fulfils the obligation laid down in Article 517 of the Capital Requirement Regulation, according to which the Commission shall review and report to the European Parliament and the Council on the appropriateness of the definition of 'eligible capital' being applied for the purposes of Title III of Part Two and Part Four of the CRR and whether deemed appropriate, submit a legislative proposal.

The report is based on the opinion issued by the European Banking Authority (EBA) in consultation with national competent authorities on 17 February 2015<sup>3</sup>.

## 2. THE DIFFERENCE BETWEEN 'ELIGIBLE CAPITAL' AND 'OWN FUNDS'

Article 4(1)(71) of the CRR has introduced a new capital base, called 'eligible capital' for the application of Title III of Part Two, Part Four and Article 97 of the same Regulation.

According to this article, 'eligible capital' is defined as the sum of Tier 1 capital and Tier 2 capital. However, the amount of Tier 2 capital recognized as 'eligible capital', at the end of the transitional period, cannot exceed one third of Tier 1 capital<sup>4</sup>.

The concept of 'eligible capital' is thus more constraining than the concept of 'own funds' due to the fact that the amount of Tier 2 capital instruments in excess of the one-third threshold cannot be recognized as 'eligible capital'<sup>5</sup>.

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<sup>1</sup> Article 4 (1) (118) of Regulation (EU) No 575/2013/EU of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, (OJ L 176, 27.6.2013, p. 1).

<sup>2</sup> Article 494 of Regulation (EU) No 575/2013/EU of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, (OJ L 176, 27.6.2013, p. 1).

<sup>3</sup> EBA Opinion on *the review of the appropriateness of the definition of 'eligible capital' pursuant to Article 517 of Regulation (EU) N. 575/2013*, 17 February 2015.

<sup>4</sup> The definition of 'eligible capital' used for the purposes of calculating qualifying holdings slightly differs from the one used for other purposes.

On the contrary, there is no limit for the inclusion of Tier 2 capital in the ‘own funds’, which simply consists in the sum of Tier 1 capital and Tier 2 capital<sup>6</sup>.

The notion of ‘eligible capital’ was introduced in the CRR to limit credit institutions and investment firms’ incentives to reduce the regulatory constraints by issuing only Tier 2 capital (e.g. supplementary Tier 2 capital would allow these institutions to increase the size of exposures to their counterparties or the volume of their qualifying holdings in an easier manner than by issuing Tier 1 capital).

The quality of Tier 2 capital is, in fact, lower than the Tier 1 one. Whilst Tier 1 capital is used to absorb losses in going concern situation, Tier 2 Capital can only be used to absorb losses in gone concern situations.

### **3. THE SCOPE OF APPLICATION OF THE CONCEPT OF ‘ELIGIBLE CAPITAL’**

From the 1<sup>st</sup> of January 2014, ‘eligible capital’ has been used as capital base for the purposes of:

1. *Determining the prudential treatment for qualifying holdings outside the financial sector.*

Under the new regime, Article 89 of the CRR specifies that competent authorities shall apply alternatively two different prudential treatments to qualifying holdings in undertakings carrying on non-financial activities:

- prohibiting (i) every qualifying holdings from exceeding 15% of the institution’s *eligible capital* and (ii) the total portfolio of qualifying holdings from exceeding 60% of the institution’s *eligible capital*.
  - applying a 1250% risk weight to the amounts exceeding the 15% and 60% thresholds.
2. *Determining the capital requirements for investment firms with limited investment services.* Investment firms referred to in Articles 95(1), 96(1) and point 2(c) of Article 4(1) of CRR shall hold *eligible capital* of at least one quarter of the fixed overheads of the preceding year as laid down in Article 97 of CRR.
  3. *Defining a large exposure.* A large exposure is an institution’s exposure to a single counterparty the value of which is equal to or exceeds 10% of the institution’s *eligible capital* as laid down in Article 392 of CRR.
  4. *Setting the maximum amount above which institutions are not allowed to be exposed to a single counterparty.* An institution’s exposure to a single counterparty is not allowed to exceed 25% of its *eligible capital* (unless otherwise stated) as laid down in Article 395 of CRR.

According to Article 494 of the CRR, the implementation of the ‘eligible capital’ definition is subject to a transitional regime of three years which has started in 2014. Whilst in 2014, credit institutions and investment firms were still allowed to recognize Tier 2 capital as

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<sup>5</sup> Article 4 (1) (71) of Regulation (EU) No 575/2013/EU of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, (OJ L 176, 27.6.2013, p. 1).

<sup>6</sup> Article 4 (1) (118) of Regulation (EU) No 575/2013/EU of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, (OJ L 176, 27.6.2013, p. 1).

'eligible capital' up to 100% of Tier 1 capital, from 2015 they are allowed to recognize Tier 2 capital as 'eligible capital' up to 75% and in 2016 up to 50% of Tier 1 capital.

Once the transitional period will be finished, the EU system will limit Tier 2 capital recognized as 'eligible capital' to one third of Tier 1 capital, approximating Union requirements to the recently issued Basel standards on large exposure, which exclude Tier 2 capital from being considered for the purpose of the application of the large exposure regime<sup>7</sup>.

#### **4. THE APPROPRIATENESS OF THE NOTION OF 'ELIGIBLE CAPITAL'**

The European Banking Authority (EBA) and national authorities have been consulted in order to gather information on the impact of the new regime on institutions. The experience gained during the first year of application of the 'eligible capital' notion has not revealed any particular concern. The EBA concluded in its opinion that it is neither "*aware of any concerns raised by institutions regarding the use of the definition*" nor "*of any empirical evidence that would lead to the conclusion that the new stricter capital base for the large exposures regime would have significant detrimental impact on institutions' exposures*".

The results of the assessment are related, however, to the limited experience gained so far. The new system has applied since 2014 and it will be fully implemented only in 2016.

A proper collection of data could be performed only at the end of the transitional period.

#### **5. CONCLUSION**

The analysis of the available information has not revealed to date any particular issue which may call into question the appropriateness of the use of the 'eligible capital' definition for the purpose of Title III of Part Two, Part Four and Article 97 of the Capital Requirement Regulation.

It does not appear thus suitable at this stage to put forward any legislative proposal amending the current system.

The Commission, in cooperation with the European Banking Authority (EBA) will however continue monitoring the application of the new regime and further reflect, on the basis of the data gathered, on whether the definition of 'eligible capital' should be maintained.

The experience gained by competent authorities in the implementation of the 'eligible capital' definition during the transitional period will contribute to the reflection of the Commission on whether amendments to the current system would be appropriate.

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<sup>7</sup> BCBS, *Supervisory framework for measuring and controlling large exposures*, April 2014, available at <http://www.bis.org/publ/bcbs283.pdf>.