The voice of banking
& financial services

European Banking Authority
Tower 42 (Level 18)
25 Old Broad Street
London EC2N 1EX

18 May 2013

Dear Sirs,

BBA response to EBA CP on Own Funds - Part Three

Introduction

The British Bankers' Association ("BBA") is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 220 banking members from 60 countries on the full range of the UK and international banking issues. All the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

The BBA is pleased to respond to this consultation.

Key messages

Ensuring a level playing field

The draft RTS is in some places super-equivalent to the international agreement reached in Basel (for example, in relation to indirect and synthetic holdings and minority interest). It is vitally important that rules imposed in the EU are aligned with those on a global level. This is particularly important with regards to deductions from own funds; adopting a broader scope and applying excess conservatism could have a material impact on bank capital ratios, which in turn could have a negative impact on growth, stability and competitiveness in the EU.

Introduction of new concepts

The EBA has introduced potentially new requirements through this RTS process. Issues of particular concern include multiple layers of intermediate holdings and look through, deduction for own capital instruments, deduction of large notional amounts in derivatives contracts with no correlation to risk, and potential defined benefit pension funds look through.

We believe it is inappropriate to introduce new concepts at this stage of CRD IV implementation, particularly considering the significant capital impacts of some of these matters, and the lack of a QIS-type process to assess the potential quantitative impacts of these measures. Furthermore, this would also move the EU regulations further away from global standards, compounding the issue raised above regarding the need for harmonisation.

Further clarity on objectives and definitions

There is a lack of clarity in regards to the objectives the proposals seek to achieve. The rules must clear so as to avoid unintended consequences (for example, the double counting of deductions), and ensure all firms apply the same interpretation. We recommend that the EBA provides more details on the theory behind the rules, particularly regarding deductions for indirect and synthetic holdings of financial sector entities.

There are also a number of terms in the paper that are very much open to interpretation. It is critical that the EBA provides more detailed definitions to ensure consistency of approach across all institutions. Some examples of these are provided in the Annex.

Maturity restriction in the deduction for financial sector entity holdings

The restriction on inclusion of short positions in the calculation of holdings in financial sector entities, as set out in Articles 45(a)(i), 59(a)(i) and 69(a)(i) of the CRR, raises a number of issues which the draft RTS do not address; these Articles restrict short positions included in the calculation to those which have a maturity of at least one year, or which match the maturity of long positions.

This maturity restriction, if applied under the most punitive interpretation to all positions, can lead to capital deductions which do not represent the actual risk of the positions concerned. Specifically, where applied to liquid trading book positions, the deduction can be very large and volatile, whereas in reality the positions may be completely hedged. We would therefore urge the EBA to consider providing further guidance around the application of this restriction, in order to ensure it is implemented consistently and without unfairly penalising firms with low-risk trading book models. Please see the Annex for further details.

Article 14f and CRR

In Article 14f paragraph 1 of the RTS the proposed assessment process for a bank holding greater than 10% CET1 instruments in paragraph 1 is inconsistent with CRR art. 40(a), and the Basel 3 document paragraph 84. In CRR Art 40(a) indirect and synthetic holdings are not included in the assessment of the greater than10% holding, only for the purposes of calculating exposure are indirect and synthetic holdings included [CRR article 33(1) h) and i)]. As such, the provisions of Article 14f are not appropriate. We would ask the EBA to reconsider Article 14f.

Minority interest

The RTS needs to establish scope of the requirements. In particular we seek clarity on two issues that are not addressed the consultation.

Firstly, we seek confirmation that the MI in the main operating subsidiary of an EU parent holding company is not restricted. In the situation of groups headed by EU parent holding companies, Article 84 indicates that the minority interest calculation must be undertaken by the 'institution'. As Top Bank is not a subsidiary of an institution, Top Bank is responsible for meeting the requirements on a consolidated basis (including the parent holding company); because Top Bank will contain virtually all of the operations and risk bearing exposures of the group, it is inappropriate to restrict the minority interest. Failure to adopt this interpretation will result in the CRR explicitly favouring one group structure over another. Further the introduction of structural reform measures, such as Liikanen, have the potential to increase the incidence of holding companies and need to be taken into account.

Secondly, we would ask for confirmation that third country holding companies are regarded as eligible subsidiaries. Ambiguity exists because of the way Articles 81 and 82 are worded, which refer to national application of the CRR. Third countries will implement Basel III rather than EU legislation. Since recital 38 indicates that there is an intention to include intermediate holding companies and Basel III text provides quite a broad definition of 'bank', it would appear that such entities are regarded as eligible, provided they are subject to equivalent regulation.

Determination of exposures for non-delta one derivatives

The proposal of using a full notional as the exposure value for synthetic positions (in the case of non-delta one derivative contracts such as options) results in an inaccurate reflection of the risk position (in some cases understating it). This has the potential to create substantial unintended consequences (we provide further discussion under Q05 in the annex).

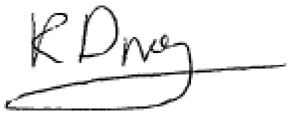
Conclusion

While the BBA fully supports the need to achieve harmonisation of reporting, we have a number of concerns regarding the approach laid out in this paper in order to achieve this objective. Annex 1 to this letter contains our formal response to the questions laid out in the consultation.

The BBA would be very happy to further assist the EBA in relation to the above.

Yours sincerely

Robert Driver



Robert Driver
Policy Advisor
Prudential Capital & Risk
Tel: 020 7216 8813
Email: robert.driver@bba.org.uk

Annex 1

Q01: Are the provisions of Article 14a sufficiently clear? Are there issues which need to be elaborated further?

The provisions are not entirely clear, with the main reason for this being insufficient definitions regarding some of the key concepts. For example, the definition of “indirect holding” under CRR Art 4 is ambiguous, and the draft RTS further extends that ambiguity. Another example is the meaning of “shall include but are not limited to any exposure”; we are concerned a definition construed by vague criteria will be open to varying interpretation, which will not support harmonised reporting.

The term “exposure” in this context also requires further definition to ensure correct and consistent application. The Basel framework (and FAQ 15 in particular) refers to an “investment” in an intermediate entity, which is different from a concept of “exposure”.

We believe what the Basel framework and the CRR originally meant to address under the deduction of financial sector entities rule was not making the mistake of double counting the regulatory capital within the system. For example, Article 74 of the CRR determines that institutions shall not deduct from any element of own funds direct, indirect or synthetic holdings of capital instruments issued by a regulated financial sector entity that do not qualify as regulatory capital of that entity. The RTS provisions conflict with this CRR article.

Further details also need to be provided as to how exposure is to be measured when the bank may have long and short positions that, for example, could be offset.

It is not clear from the article what exactly falls under the term “intermediate entity” so further details need to be provided. As a principle, a regulated entity (not only an “institution” subject to the requirements of the CRR) should be excluded from the definition of intermediate entity. We also believe such concept should be narrowed down to entities undertaking significant financial investment activity but excluding pension funds.

Further details should also be provided on what constitutes “the losses an institution would incur”, “not materially different” and “supporting the investment risk” means. The EBA also needs to provide significantly more detail on exactly how losses should be defined and constructed.

Q02: Provisions included in paragraph 1of the following Article 14a refer in particular to pension funds. These provisions have to be read in conjunction with the deductions referred to in Article 33(e) of the CRR. Would you see any cases where there might be an overlap between the two types of deductions? Please describe precisely these situations and the nature of the problem.

We believe the requirement to look through to the assets of the pension fund managed by the firm is disproportionate and ignores the safeguards already built into such schemes. For example:

(i) the activities of professional fund managers actively managing their equity portfolio.
(ii) diversification/offsetting effects from other assets within the scheme (e.g. substantial allocations to high quality liquid fixed income assets); and
(iii) stress-testing buffers built into pension funds off the back of substantial haircut scenarios applied to asset classes.

These safety measures affect both the valuation of the fund and the annual contribution cost paid by the bank for its pension fund; furthermore, both of these items already directly impact a bank’s Core Tier 1 under the requirements of CRR. Therefore, the new requirement introduced in the draft RTS (which is not present or implied by the CRR) to look through the defined benefit pension fund to capture the indirect holdings is, in our view, an unnecessary penalty.

If required at all, we would suggest the RTS seeks to capture pension funds with unusually high FI exposures (which could be argued to be a source of systemic contagion), and exempt financial institutions where FI investments represent no more than a set percentage of the pension fund assets.

Notwithstanding our position that this deduction should not be required, we are also concerned with the drafting as it currently stands. There is potential for inappropriate ‘double counting’ of deductions where the immediate entity is a pension fund. Where there is a pension fund asset, there will be direct double counting as a result of the deduction in Article 36. Further, as a result of the accounting framework, the pension cost and any pension liability will also impact CET 1. Therefore either pension funds should be excluded from scope, or there needs to be explicit guidance on how to address the double counting.

Both the pension fund assets and associated Financial Sector Capital Instruments can be separately deducted, even though the Capital Instruments value contributes to the level of pension fund assets. For example, consider a pension scheme where Assets = 130, Liabilities = 100 and the value of Investments in Capital Instruments of Financial Sector entities(included in the Assets) = 20.

Under CRR and the proposed RTS, the net asset in the scheme (= [Assets – Liabilities] = [130 -100] = 30) would be deducted from CET1. In addition the Investments in Capital Instruments of Financial Sector Entities of 20 would also potentially result in an additional deduction of 20 from CET1. Hence CET1 deductions could total 50.

A method to avoid potential double count can be illustrated if we reverse the order of applying the potential deductions:

- Deduct the value of Investments in Capital Instruments of Financial Sector Entities of 20, then the value of assets in the pension scheme would be revised downwards to [130-20] = 110 under the scenario that such assets are written down to zero value.

- The remaining value of net Assets in the scheme would be [Revised Asset – Liabilities] = [110-100] = 10. This would be deducted from CET1.

As such total CET1 deductions in this case would be 30. Under this approach, the double count of deductions from Investments in Capital Instruments of Financial Sector Entities has been avoided. The rationale for the deduction under Article 36(1)(e) is that assets arising from pension funds cannot be claimed by the banks to cover losses on the bank's balance sheets and protect depositors. However, those assets have value within the scheme and will be used to reduce any future payments into the fund. We believe it is wrong to assume that the bank will be directly exposed to losses corresponding to the nominal amount of the investments the funds may have in financial sector entities. Where there is a pension fund liability there is no need to require a deduction for investments in financial sector entities.

We would also request clarity on how often it is proposed that the pension fund assets are to be revalued. For example, under UK GAAP, the actuarial valuation of pension fund assets is required only once a year; we would ask the EBA to clarify whether this would this be sufficient for the purpose of the deduction.

Q03: Please provide also some input on the potential impact? What would be the size of the deduction of defined benefit pension funds under the treatment proposed in the following Article? Would the treatment cause a change in the investment policy of the pension fund with regard to such holdings, or have any other consequences for the operation of the defined benefit pension scheme?

We believe the impact is likely to be very high, the extent of which will depend on what is captured within the definition of "exposure".

A great deal of bank legacy vehicles positions hold significant amounts of financial institution capital instrument which might not presently be on regulatory balance sheets; this would have the effect of adding to the holdings in the entity providing funding to those vehicles. Although the EBA gives an alternative of deducting the entire exposure to the intermediary where full details of investment mandates or look through are opaque, this would not be applicable for own sponsored issues, and is of limited value.

In general, we are concerned that there is a strong possibility that banks will change their pension schemes to avoid being impacted by these rules are currently drafted. This would also occur where schemes are held in separate legal vehicles where trustees control the schemes, as the sponsoring bank would seek to influence investment strategy to avoid the rule impact. This would be of great concern as it will have an unintended consequence of creating concentration risk in the pension schemes in non-financial sector investments, increasing the risk to which current and future pensioners are exposed.

Q04: Do you agree with the examples of synthetic holdings provided in paragraph 2of the following Article 14a? Should other examples be added to this list?

We believe the examples are incomplete in that the RTS does not explain how in each case the amount to be deducted would be derived, and there needs to be further explanation of the prudential objective being addressed by such deductions. There is also a lack of reference to short synthetic positions which would be relevant to calculate a net position.

We would ask the EBA to confirm whether it feels that combinations of options (for example, synthetic futures) or other options strategies create synthetic holdings that are to be considered in the deduction.

Q05: Are the provisions contained regarding synthetic holdings in paragraph 2 of the following Article 14a and in Article 14e sufficiently clear? Do you agree that the amount to be deducted shall be the notional amount? Would you see any situations where another amount shall be used?

We believe the provisions are not clear, and we do not believe the use of notional amount is the appropriate measure in all cases.

The paper proposes that for synthetic holdings which arise from long positions in products with optionality the full notional should be used as the exposure value. This proposal would not provide an accurate reflection of the risk position. For example, if you consider the maximum loss principle of a long call option, it would not be the notional amount.

An example of this situation where using the notional amount would not be appropriate would include those where the position has a delta equivalent value of less than 100%. It should be noted that in these cases, the delta equivalent is preferable, because the use of notional values is not uniformly conservative. For example, where a short option position is used to hedge a cash instrument (and the maturity of the derivative exceeds one year), use of notional for the short option may understate the net exposure.

The EBA nevertheless needs to consider the potential economic consequences of taking the nominal of all synthetic long positions with the very limited offset currently permitted risks a significant repeat counting of underlying financial institutions capital. With regard to looking through indices, the EBA should give consideration to enabling better offset to be permitted. For example, if a bank holds a long position in the FTSE 100 via a future with less than 1 year maturity & a short position via a future with more than 1 year maturity, if any particular financial institution within the index does fail, the amount of loss to which the bank is exposed is the net position.

Furthermore, the use of notional values of synthetic holdings on first analysis seems to be inconsistent with the Basel framework and the EBA’s intention to assess loss in the case of failure of the financial institution or the index security proposals. It also fails to recognise the differences between trading book and non-trading book approaches, a potentially significant oversight. We would recommend the EBA take these issues into consideration when reviewing the proposals.

Q06: Are the provisions relating to the deduction of serial or parallel holdings through intermediate entities sufficiently clear? Do you see any unexpected consequences? Are there issues which need to be elaborated further?

As detailed above, there needs to be further guidance on definitions, for example, exactly what firms should consider as an "intermediate entity".

From a practical implementation perspective, the greatest problem is that information is not available, or not available with the appropriate levels of granularity to apply the look through approach (for example it may be possible in the case of liquid exchange traded funds, but difficult to achieve elsewhere).

The paper is also not clear on tranches positions (i.e. how the transition through the debt waterfall would work in practice). Further guidance needs to be provided on who would bear the losses in which situations, and what principles firms need to apply in each circumstance.

Further clarity should be provided as to what should be considered as funding, and when a deduction will need to be applied. For example, there is potential confusion about what might be regarded as a funding exposure, with the resulting consequences that there is potential for firms to apply inappropriate or different interpretations to this principle.

Q07: Are the provisions of Article 14d relating to a structure-based approach sufficiently clear? Are there issues which need to be elaborated further?

We do not believe the approach is sufficiently clear. It is based on assumptions that do not correlate with reality (i.e. where the information required is not available and hence the method would not be possible to apply at the outset)

The issues pointed out under Q06 above also apply to this approach, inevitably resulting in overly punitive, duplicative, deductions.

Q08: Are the provisions of Article 24b sufficiently clear? Are there issues which need to be elaborated further?

The BBA has no comments on this question.

Q09: What in your view is the best means for ensuring that the benchmark rate is not materially affected by the credit standing of an individual participating institution? The criterion of minimum number of contributors or that of minimum representativeness of the market or both?

The BBA has no comments on this question.

Q10: What would be the minimum number of contributors to ensure this absence of correlation? If a minimum representativeness of the market was chosen as an alternative route, how to ensure and calculate this representativeness? Would the percentage of 60% be sufficient?

The BBA has no comments on this question.

Q11: How would you treat minority interests arising from an institution permitted, under Article 8 of the CRR, to incorporate a subsidiary in the calculation of its solo requirement (individual consolidation method)?

We seek clarification regarding the MI recognised in the group consolidation for the large licenced operating bank (Top Bank), the immediate subsidiary of an EU parent financial holding company (Hold Co), which is a small non-operating entity. Art 84 of the CRR is only addressed to the 'institution' rather than a holding company. In groups such as those described above, Hold Co is not "an institution" as defined by Article 4(3). The top-most "institution" will be Top Bank.

In this situation, as the top-most licensed institution, Top Bank has the duty to ensure that the entire Group (including its holding company parent) meet regulatory requirements on a consolidated basis (according to Article 11), hence Top Bank will prepare the Group return. In building up the consolidation to the level of Top Bank, the minority interest capital will have to be assessed by applying the Art 84 calculation at the level of each regulatory institution leading up to Top Bank. However in completing the final adding of the consolidated Top Bank to the small Hold Co, it is clear that Top Bank is not "a subsidiary of an institution", because Hold Co is not an institution. Thus the minority capital to be applied in the Group Consolidation will be the same as the amount calculated in the consolidated Top Bank return – i.e. any minority equity which arises only at the level of the Top Bank consolidation calculation will be reflected in full and not be subject to any restriction.

The EBA draft RTS does not address the issue described above. It clarifies that the "eligible" minority equity of a subsidiary (which is itself a parent), will require to be calculated using the Art 84 calculation, but does not consider the situation of an entity which is not a subsidiary of an institution.

As the Top Bank entity described earlier will contain virtually all of the operations and the risk-baring exposures of the Group, it is our view that it is not appropriate to reduce its capital resources when completing the final addition (i.e. the Group-level consolidation) of a small holding company whose exposures will be all intragroup.

We recommend that the EBA address the issue faced by groups headed by an EU parent financial holding company by affirming the existing wording of Art 84 – namely that application of the Art 84 calculation is only necessary when "an institution" is considering the level of subsidiary minority equity it may consolidate into its regulatory position. If considering a Group-level consolidation, the relevant eligible minority equity will be the sum of

(i) that arising from subsidiaries of the top institution, calculated using sequential application of the Art 84 calculation, plus;

(ii) the unadjusted value of any minority equity arising in the top institution itself.

As regards the specific question on individually consolidated entities, we think that Articles 81 and 82 (a)(ii) indicate that such entities are eligible. As a result of being part of the individual consolidation they will be subject to the requirements of the Regulation. Furthermore such entities will also be subject to the strict requirements of Article 9, which includes case by case assessment.

Q12: How would you treat minority interests arising from a subsidiary not subject to supervision on a sub-consolidated basis although it is the parent undertaking of other institutions? If the subsidiary would be allowed to undertake the calculation referred to in Article 79(1) on the basis of its sub-consolidated situation, some conditions would have to apply in order to secure this calculation in the absence of a supervision on a sub-consolidated basis. What would you propose as conditions?

Minority interests within subsidiaries should be eligible regardless of whether they are supervised on a sub-consolidated basis. Where sub-consolidations are not already required, there will not be capital requirements set on which to perform the calculation, neither will there be supervisory reporting against which any calculation can be reconciled. However, provided that the scope of consolidation covers all the entities that would be required by any additional sub-consolidation, it should be possible to deem the requirement to sub-consolidate to have been met by the consolidations already required.

There is also a lack of clarity over the position of third country subsidiaries or sub-groups, particularly where these are headed by a holding company. It is not clear whether third country holding companies are eligible because they are subject to local regulation, most likely implementation of Basel III, rather than EU law. Given that recital 38 clearly indicates that as a matter of principle intermediate holding companies are eligible. Articles 81 and 82 also require the entity to be subject to the CRR by virtue of nationally applicable law. Transposition of the Regulation within the EU is unnecessary because it is directly applicable, thereby suggesting that third country entities were envisaged as being eligible by policy makers. Structural reform initiatives are likely to mean that the incidence of holding companies within banking groups is likely to increase.