

POSITION PAPER



**ESBG response to the
EBA Consultation Paper on Draft
Regulatory Technical Standards on Own
Funds under Articles 33(2), 69a(6) and
79(3) of the draft Capital Requirements
Regulation (CRR)– Part three
(EBA/CP/2013/17)**

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The European Savings and retail Banking Group (ESBG) welcomes the opportunity to share its views on the EBA Consultation Paper on Draft Regulatory Technical Standards on Own Funds (Part Three). Please find below our responses to selected questions.

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

In general, we want to point out that the provisions regarding indirect and synthetic holdings laid down within Part 3 of the Regulatory Technical Standards on Own Funds are strongly linked to the Disclosure Requirements according to Part 2 of Regulatory Technical Standards of Own Funds published by the EBA on 7 June 2012.

We would highly appreciate that the EBA provides us with more detailed information in respect of disclosure of deductible items due to indirect and synthetic holdings, especially for the purposes shown on page 56 and 57 of Part 2 of Regulatory Technical Standards issued on 7 June 2012, especially due to the fact that the indirect as well as the synthetic holding could affect more than one of balance sheet items, e.g. Trading Portfolio Assets, Financial Assets designated at fair value, Available for sale financial assets, etc.

We believe that the provisions on indirect holdings and synthetic holdings should be considered separately within disclosure and therefore kindly ask the EBA if it is planned to update the disclosure requirements respectively or to set out additional provisions on how to consider the provisions of Part 3 of the Regulatory Technical Standards on own funds within the disclosure according to Part 8 of the Capital Requirements Regulation.

In addition, we consider that the EBA has no mandate to extend the definition of indirect holdings of Art. 4 Para.1 (114) CRR. Accordingly, “including senior exposures” and the addition “but are not limited to” should be deleted.

The existence of an indirect holding requires that in the case of a permanent write-off of the (indirect) holding in the financial sector entity the loss incurred by the institution is not substantially different from the loss that would result from a direct holding (Art. 4 Para. 1 (114) CRR). It should be made clear that in the case of structures in which an institution holds an interest in a financial sector entity (target entity) via an intermediate entity, the loss from this indirect holding is not always to be equated to that from a direct holding in the financial sector entity and hence an indirect holding within the meaning of CRR does not exist at any rate. For example, it is conceivable that the intermediate entity holds a large number of participations but just one in a financial sector entity. These holdings contain large amounts of hidden reserves. The intermediate entity has to write off its holding in the target entity. Due to the existing hidden reserves in the intermediate entity, however, write-off of the value of the holding of the institution in the intermediate entity is not necessary



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which is also certified by the public accountant. It should be made clear that no deductible indirect holding exists in such a case.

With respect to the application of Art.14a- Para. 1 (c) (i) (f) of the draft standard, it should be clarified that any financial holding is to be deducted only once in a joint liability group or a network of institutions.

Where own funds are provided to an intermediate entity which are used to acquire holdings in an institution (target entity), exclusively the holding in the target entity is relevant to the treatment of the entire holding structure in the case of “single-purpose entities”.

Furthermore, we understand that the relevant value to be used is the book value of the items.

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

The examples given in paragraph 2 are sufficiently clear.

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?

The provisions laid down in paragraph 2 regarding synthetic holdings are sufficiently clear.

We doubt that the notional amount should be used for determination of the respective deductible amount.

The investment via synthetic holding is directly linked to the value of the respective capital instrument.

We strongly believe that the amount to be deducted should be linked to the amount representing the Fair Value of the instrument held via synthetic holding.

There are different cases which would cause double-counting in different circumstances.

The fair value reflects the current carrying amount of an instrument based on the applicable accounting standards.

In case the fair value is below the notional amount the differential amount already impacts the CET1 of an institution.

Deduction of the notional amount, which in this case would be the higher amount of notional amount versus carrying amount, would mean that the negative impact of the carrying amount should be taken into account for a second time.



We also assume that the application of prudent valuation as defined within the CRR would have a negative impact on three points within the carrying amount:

- Negative impact within the balance due to consideration of the lower carrying amount;
- Deduction of additional difference within the carrying amount in case measurement based on prudent valuation would result into a lower carrying amount than under applicable accounting standards;
- Deduction of the notional amount according to Article 14 of the RTS on own funds – part 3 – disregarding the negative impact on CET-1 due to measurement according to accounting standards as well as according to prudent valuation.

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?

The provisions relating to the deduction of serial or parallel holdings through intermediated entities are clear. However, the following comments can be made.

Article 14c-:

We cannot comprehend the calculation by tranches as per Art. 14c-Para.1 b) because it is not clear why the calculation has to be done separately for the different tranches. The degree of complexity of the calculation increases without the benefit of clarification. Therefore, a sample calculation should be added to make the intention and functioning clear. In particular, it should be considered in this regard that the individual claim items may involve different seniority levels. For possible sample calculations, please refer to the appendix to this document. The calculations there also show that the existing calculation formula sometimes lead to improper results.

The EBA standard does not state whether the deduction is based on the book value and hence takes account of possible depreciation. This should be clarified.

Article 14f-:

- To check whether an institution owns more than 10% of the Common Equity Tier 1 instruments issued by the financial sector entity, the institution is to add up the gross amounts of its direct, indirect and synthetic holdings in a financial sector entity in the form of instruments of the Common Equity Tier 1 and finally compare the sum to the Common Equity Tier 1 issued by the respective entity (Para. 1). This contradicts the wording of Art. 43 (a) CRR where the express condition is laid down that the institution owns more than 10% of the Common Equity Tier 1 instruments issued by the respective entity. That is, expressly only the direct holdings are made reference to there. Article 43 (a) CRR in particular addresses the specific effect on the investing entity in the sense of the holding of direct holdings. The EBA does not have a mandate for the proposed extension. Moreover, it



is also not necessary because Art. 43 (b) and (c) CRR already cover the constellations of a significant holding (close links and consolidation for account rendering purposes) that are not based on direct participation.

Furthermore, we would like to point out that a different concept taking into account all net positions would not only lead to a discrepancy with the other two cases mentioned in Art. 43 CRR. It also would lead to a virtually insolvable operational and calculation problem. This results from the fact that the calculation of gross as well as net positions would be based on book values (direct and most indirect positions) and notionals (synthetic positions). For the calculation of the CET1 investment ratio they would have to be compared with the CET1 of the financial sector entity, which could be calculated based on the other entity's balance sheet, pillar 3 report, if available, or publicly available information on the number of shares or subscribed capital. Almost certainly this will lead to misleading results that do not make sense from an economic perspective. A concept based on direct positions would allow one to concentrate on some special cases that could be calculated far more accurately.

- A mere adding up of the (gross) long positions is not appropriate. This will provide a completely distorted view in particular of items of the trading book. It is likely that far more available real equities will be deducted than actually exist. In addition, such an approach leads to very volatile positions which in particular would most likely result in frequent changes of the position's status between "significant" and "not significant".

We therefore argue in favour of using only the direct holdings, in accordance with the provisions of the CRR, to determine a significant holding. The net long position should be taken into account for items of the trading book.

Article 14g-:

As we understand it, the heading of this Article ("Holdings of additional tier 1 and tier 2") is not appropriate, or ambiguous, because Art. 14g- Para. 2 also deals with the order of deductions for "Common Equity Tier 1 instruments". We interpret the statements to the effect that the EBA's aim here was to lay down the provisions for a "corresponding deduction approach" the objective of which is to base deductions on the respective capital classes of the target investments (and not the intermediates) and to regulate the order of deductions within the individual capital components.

Assuming this, we believe it to be reasonable to change the Article's heading to "Corresponding deduction approach". The first paragraph in its present form would do justice to this interpretation. In the current context and wording, however, the second paragraph is ambiguous at best.

The proposed provision allows multiple deductions in the banking system. Example: The intermediate entity has 10 shareholders; each of which is holding 100 of the equity capital. This intermediate entity has 300 CET1, 400 AT1 and 300 T2 own stock. According to the provision, each of the 10 shareholders would have to appropriate 100 CET1 deductions, i.e. a sum total of 1,000



(more than actually invested in CET1). However, it would be proper if each shareholder was required to appropriate 30 CET1, 40 AT1 and 30 T2 as deductions.

Furthermore, it is not understandable why Para. 2 applies only to pension funds. We therefore propose to adjust Article 14g- as follows:

Article 14g-:

‘Holdings of Additional Tier 1 and Tier 2 Corresponding deduction approach

- 1. The methodology outlined in Articles 14a to 14e will be applied to Additional Tier 1 holdings for the purposes of Article 53(a), (c), (d) (f) and to Tier 2 holdings for the purposes of Article 63(a), (c), (d) of Regulation xx/xx [CRR].*
- 2. For the purposes of Article 14a 1 b), The corresponding deduction approach shall be carried out as follows within each tier of capital:in case the intermediate entity holds Common Equity Tier 1 instruments of the institution, those shall be deducted first. If the deduction of Common Equity Tier 1 instruments of the institution to be deducted as a result of the calculation above is less than the total funding provided deductible exposure by the institution to the intermediate entity, other holdings of Common Equity Tier 1 instruments issued by other financial sector entities shall be considered for the deduction. For deductions of Additional Tier 1 instruments and Tier 2 instruments, similar principles shall apply. Similarly, in case the intermediate entity holds Common Equity Tier 1 instruments, Additional Tier 1 instruments and Tier 2 instruments of financial sector entities, and where the institution is not able to determine the maximum percentage for its investment in the respective tiers of capital, the Common Equity Tier 1 instruments shall be deducted first, the Additional Tier 1 instruments shall be deducted second, and the Tier 2 instruments last.”*

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

The provisions of Article 14d relating to a structure-based approach are sufficiently clear.

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 supervision on a sub-consolidated basis. What would you propose as conditions?

Minority interests in intermediate holdings which are neither directly nor indirectly subject to the CRR, should be allowed to be taken account of at the level of the entity obligated to consolidate to



the extent of Art. 81 Para. 1 CRR, provided that the entity obligated to consolidate can dispose of the minority interests by way of contract or in actuality.

Q13 cross-cutting comments

Definition of “financial sector entity”:

Another problem is not directly connected with this Consultation Paper but was, however, addressed at the hearing on the draft RTS on 24 June 2013 and in respect of which the EBA working group has asked for written input:

(i) Mixed Activity Holding Companies (MAHC) and (j) Mixed Activity Insurance Holding Companies (MAIHC) appear to have been included in the definition of the term “financial sector entity” in Art. 4 Para.1 (27) CRR without foreseeing the effects of this alteration.

Because: the definitions of MAHC or MAIHC also encompass parent companies which are not themselves part of the financial sector (such as automobile manufacturers or power companies) and fully assign them to the financial sector if they have even one subsidiary which is either an institution (e.g. an auto bank or an energy trader) or an insurance company — and this irrespective of the volume of such activities.

The inclusion considerably reduces the Common Equity Tier 1 in the case of institutions that hold shares in or lend money to such entities and, at the same time, an increase of the risk-weighted assets of the institutions occurs. These provisions are not provided for by the Basel Committee and mean a considerable worsening of the competitive position of European Banks. The provisions of Basel III merely speak of “capital of banking, financial and insurance entities”.

At the same time, these rules result in substantial disadvantages to the real economy entities affected: The credit terms for these entities, their access to fresh equity capital and the liquidity of their shares will considerably worsen. This will possibly affect the major part of the larger industrial and service provision enterprises as almost all of them have an institution or an insurance company as one of their group companies.

As a result, loans to these entities need to be backed with more equity capital of the lending bank (asset value correlation factor) and interests held in them have to be deducted from Common Equity Tier 1 of the bank investing in the share capital. This will mean stricter credit terms for these entities and the possibility for them to access equity capital, as well as the liquidity of their shares, will worsen because banks will no longer be able to invest in them.

We very much plead in favour of deleting (i) and (j) from the Level 1 text (i.e. the CRR text) and call on the EBA to support this request vis-à-vis the Level 1 rule makers. Moreover, we suggest that the EBA draws up an interpretation aid for this provision in the form of a guideline which at least introduces *de minimis* thresholds that define levels beyond which a “Mixed Activity Holding



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Company” is active in the financial sector in such a way that classification of the entire group as a financial sector entity is justified. For reasons of practicability, the thresholds should relate to the group's balance sheet total, i.e. if the share of institutions in a mixed activity group exceeds a certain value, the entire group would have to be classified as a financial sector entity. Regarding the amount, the U.S. rules might be used for orientation:

In these rules, a prerequisite for “financial institutions” is a main activity in the area of “financial activities” which is assumed to be given if either a minimum of 85% of the total annual turnover or a minimum of 85% of the balance sheet total result from financial activities.

Finally, the definition of “financial institution” is also too wide (Art. 4 Para. 1 (26) CRR), namely in the subform “an entity which is not an institution and whose main activity is to acquire holdings (...)”. According to the wording, pure holding companies that merely hold interests outside the financial sector and also do not deal with holdings might likewise be encompassed by this and holdings in them are deducted from an institution’s Common Equity Tier 1 by virtue of Art. 4 Para.1(27) (b) only because they are organised as holding companies.

The ESBG therefore believes that it is appropriate to exclude the cases described in the paragraph above of pure industrial holding companies from treatment as “financial institution” for the purpose of capital deduction.



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APPENDIX

Example regarding question 6, Article 14c:

In our opinion, the current version of the RTS is sometimes vague or results in multiple deductions:

Example 1:

Institution A holds EUR10,000 of CET 1 of the intermediate which has a total of EUR100,000 CET1.

Institution B holds EUR90,000 of CET 1 of I,

Institution C holds EUR10,000 T2 of I, I has a total of EUR20,000 T2.

I has invested EUR10,000 in institution D.

Deduction amount in acc. w. Art 14 c RTS:

Institution A:

Financing share: $10/100 = 1/10$

Amount acc. to. Art. 14 (1) b) i: EUR10,000 (CET 1 instruments which I holds in D) – *lower amount*

Amount acc. to. Art. 14 (1) b) ii: EUR100,000 (all CET1 instruments at I)

Deduction: $EUR10,000 * 1/10 = EUR1,000$

Institution B:

Financing share: $90/100 = 9/10$

Amount acc. to. Art. 14 (1) b) i: EUR10,000 (CET 1 instruments which I holds in D) – *lower amount*

Amount acc. to. Art. 14 (1) b) ii: EUR100,000 (all CET1 instruments at I)

Deduction: $EUR10,000 * 9/10 = EUR9,000$

Institution C:

Financing share: $10/20 = 1/2$

Amount acc. to. Art. 14 (1) b) i: EUR10,000 (CET 1 instruments which I holds in D) – *lower amount*

Amount acc. to. Art. 14 (1) b) ii: EUR20,000 (all T2 instruments at I)



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Deduction: $\text{EUR}10,000 * 1/2 = \text{EUR}5,000$

Result:

A total of $(1+9+5=)$ EUR15,000 has to be deducted although just EUR10,000 are invested in the target company D.

The institutions A and C each have invested EUR10,000 but in different capital classes. Although C has invested in a lower risk capital class, C has to deduct 5 times more than A. The RTS does not state that the indirect holding mediated via the tier 2 capital is to be deducted only from tier 2 capital.

The example shows that the existing wording leads to improper results. The EBA should recheck the meaning of the regulations based on concrete calculations.



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About WSBI-ESBG – The European Voice of Savings and Retail Banking

WSBI-ESBG (European Savings and retail Banking Group) is an international banking association that represents one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,631 billion, non-bank deposits of €3,500 billion and non-bank loans of €4,200 billion (31 December 2011). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

WSBI-ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. WSBI-ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.



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