17 July 2013

The Banking Stakeholder Group comments 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 III (EBA/CP/2013/17)

The EBA Banking Stakeholder Group (BSG) welcomes the opportunity to provide comments 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 III.

The BSG response is divided in three parts, the general comments on proposed articles, the answers to the specific questions within the draft RTS and in addition to this, we would like to raise some general issues about the Regulatory Technical Standards currently being developed by the EBA in relation to deductions to Common Equity Tier 1 capital from significant and non-significant investments in financial sector entities.

1. General comments on the draft regulatory technical standard on own funds – part III

The BSG appreciates the EBA intentions to clarify the way to identify and calculate the deductions for the indirect and synthetic holdings in financial institutions, which was indeed not sufficiently clear in the RTS part 1 last year. However, there are a number of issues of concern.

Firstly, it is the BSG opinion that the new draft RTS seems to go further than what the EBA mandate in the CRR provides for. The mandate in the CRR only refers to holding, which in our opinion normally means some form of ownership or other form of direct control or influence.

Secondly, the draft RTS does not take account of the operational burden in identifying indirect and synthetic holdings and may lead to significant undue quantitative impacts in terms of valuation of the exposures.

Thirdly, as regards synthetic holdings in the form of options, the BSG is concerned that this draft RTS stipulates that the exposure shall be the notional amount of the relevant instruments. In the BSG's view, the amount to be taken into account for synthetic exposures should in the form of options be the 'delta' value. Delta calculations are a risk-sensitive approach for calculating exposures which are in line with an institutions internal risk management processes and the use of such an approach will avoid undue complexity. We therefore urge the EBA to allow reliance on the delta in this RTS.

Fourthly the use of the look through approach (LTA) as a default solution is burdensome and costly, particularly for the smaller institutions. For large institutions, implementing the LTA to all the funds in their investment portfolio is almost impossible.

As an alternative, the draft RTS allows using the structure-based approach to estimate the value of the indirect holdings. Structure-based approach requires taking into account separately the amount that the intermediate entities hold in own CET1 instruments and the amount that the intermediate entities hold in the CET1 instruments of other financial sector entities on an aggregate basis. Such information is not readily available. In addition, the notion of "financial sector" is specific to the CRR. If an institution does not know these two amounts, they may be estimated as the maximum amounts that the intermediate entities are able to hold on the basis of their investment mandates. The latter is not available information as funds do not publish it. When the institution is not able to determine on the basis of the investment mandate the maximum amount, the draft RTS requires a full deduction in the same way as the institution's own shares, which is the most punitive capital treatment . We conclude therefore that this is not a real alternative which has been given. We urge EBA to take into account the following suggestions with respect to the LTA:

- It would be advisable to provide the following exemptions from the definition of indirect holdings in the RTS. Since the paragraph 1 of the article 14a only provide non-exclusive examples, the BSG encourages EBA to specify explicitly the exemptions to avoid any confusion or unintended consequences, especially in the following cases:
    - For avoidance of doubt, confirmation that entities already subject to the prudential supervision under article 49 of the CRR are exempted from the scope of application of article 14a. Indeed, the application of the LTA would negate the treatment provided for in art 49 of the CRR in respect of entities included in the scope of supplementary supervision and in the scope of the consolidated / aggregated supervision pursuant to Art 49 (3a).
    - For avoidance of doubt, confirmation that controlled but non-consolidated companies (i.e. companies below the accounting consolidation thresholds and included in the scope of prudent consolidation) – for which the institution is already submitted to prudential requirements under the CRR - are exempted from the provisions of article 14a.
    - The parent mixed activity holding company of the institution or the subsidiaries of the parent mixed activity holding company: The way the mixed activity holdings defined as part of FSEs in the CRR seems to suggest that for instance most of industrial groups in automotive with insignificant financial activities are also counted in . We firmly believe that it is not the intention of the EBA to require banks to deduct indirect holding to these corporates which would lead banks to reduce any indirect investment in them. We are aware that tying back the broader definition of FSE in the CRR to the Basel 3 text is not part of the mandates of EBA. However considering the potential detrimental impact to the EU economy, we urge EBA to exclude the mixed activity holdings from indirect holdings. Additionally, although it is not listed explicitly in the article 14a(C)(i), we would like to ensure that the mixed-activity insurance holding companies are also excluded. Defined benefits pension funds: as the LTA will not be operationally manageable in most cases, this treatment is highly likely to have consequences on pension funds investment policy with regards to financial sector entities and may lead to large disinvestments from this sector and/or unwanted concentration of the fund investments on other types of investments which are exempted from such a treatment. This would have the undesirable outcome of increasing risk for current and future pensioners.

- Article 41 of the CRR states that assets in excess of liabilities are to be deducted from CET 1. Applying the look through approach according to this draft RTS may therefore result in a partial double deduction for defined benefit pensions funds, with an even greater impact where the institution could not apply the LTA.

- The draft RTS does not specify whether the proposed approach is applicable to trading book or not. For trading book positions, for which the holding period is supposed to be short, applying the cumbersome LTA does not make sense. Moreover, net long exposure of the trading book to a mutual fund or similar entity is negligible if not flat: any long position would be held as a hedge to, or would hedge, a short position in the same underlying. If the EBA insisted on implementing this approach to trading book indirect holdings, we believe as a minimum that the netting of short and long positions should be allowed. In relation to holdings in funds, we would like the draft RTS to clarify that the requirements eventually apply to a net long position: in particular, if a long position in a given fund matches a short position in the fund, no LTA shall be needed.

- Finally, for entities which are not exempted, it would be highly advisable to provide materiality thresholds beyond which the LTA needs to be performed. The BSG supports the approach that was set out at article 26 of the draft RTS on own funds part 1 issued in July 2012, where 2 criteria were provided in order to determine the low materiality of such positions: (i) low net exposure to the capital of the financial sector entity relative to the institution's total own funds, and (ii) a holding period of short duration, where the strong liquidity of the instrument can be evidenced. This would also allow for a solution to the trading book issue mentioned above.

Fifthly, the proposed assessment process for a bank holding more than 10% of CET1 instruments in paragraph 1 of article 14f- introduces some changes to the level 1 text (article 4043(a) of the CRR) and is not consistent with paragraph 84 of the Basel III Accord. Indeed, indirect and /synthetic holdings are not included in the assessment definition of a significant investment in a financial sector entity, as provided in the CRR level 1 text, nor in the Basel 3III Accord . As a consequence, this should be reflected in the RTS

Sixthly, it is important that the regulatory technical standard rules reflect the ranking of creditors (senior debt exposure is only exposed to losses after equity/subordinated debt holders) and maximum loss potential when determining the methodology for determining indirect exposures to capital instruments of financial sector entities.

BSG does not have any particular comment on the broad market indices. As far as the minority interest is concerned, we would like to ensure that minority interests from subsidiaries in third countries are indeed recognized. This RTS refers generally to "subsidiaries" without specifying whether they are inside or outside the EU. The relevant articles 84, 85 and 87 of the CRR on the other hand stipulate that "any additional local supervisory regulations in third countries" should be taken into account in determining the attribution of this excess capital to the minority interests of the subsidiary. Our understanding from the level 1 text is therefore that all the subsidiaries in the third countries within the scope of prudential consolidation of the EU parent are in the scope for this purpose. We believe that it is worth that this RTS clarifies this point in line with the CRR.

2. Answers to the specific questions

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

The BSG is concerned that the wording in article 14a. could be interpreted in a more extensive way than what the mandate in the CRR provides for. The mandate in the CRR only refers to holdings. A holding should normally be either some form of ownership or some other form of direct control or influence over the entity in question.

In the FAQ on the Basel III Accord, published in Dec. 2011, the BCBS confirmed that indirect holdings refer to investments: “an indirect holding arises when a bank invests in an unconsolidated intermediate entity that has an exposure to the capital of an unconsolidated bank, financial or insurance entity and thus gains an exposure to the capital of that financial institution”. As a consequence, the proposed wording in the draft RTS which includes “any exposure” could be interpreted in a broad manner which would not be consistent with the Basel III Accord

Moreover, it is arguable questionable whether the provision of funding, senior, to an entity or a fund would qualify as a holding unless that entity or fund needs to be included in the accounting consolidation due to the fact that the institution is deemed to have control over it even in the absence of ownership. A potential economic risk linked to the financial position of the entity is not a sufficient condition, this risk also holds true for the provision of direct senior funding to financial institutions. It is the BSG’s view that the provisions of funding to an entity or to a fund should not be included in the definition of an indirect holding set out at Art. 14a of the RTS

Regarding clarity of article 14a; the wording of the scope seems unnecessarily wide (disregarding our hesitations regarding mandate above). It would be helpful if it could be clarified what could constitute a holding that isn’t actually included in “any exposure, including senior exposures” and “where the loss is not materially different form a direct holding”.

In addition to the suggestions set out at the general section comment above regarding exemptions that should be provided with respect to certain defined pension benefit funds, is the BSG’s view that it needs to be clarified under paragraph 14a (1b) that if an institution has no control or direct influence, by law or otherwise, over investments made in a pension fund, investment in that pension fund should not be considered as an indirect holding within the meaning of the CRR.

In support of this suggestion, it is worth underlining that, unless an institution has influence over the investment policy of the pension fund, investments made through funds, which lie outside of the control of an institution, could have a seriously detrimental effect on the capital position of that institution (if classified as indirect holdings) – even in the absence of any risk materializing or any incurred – just based on the fact that investments in the fund were in financial sector entities.

The BSG suggest clarifying what would constitute "a support to the investment risk" with regards to defined benefit pension funds. Any company having a defined benefit pension plan always supports that plan since pension obligations exists irrespective of there being a fund to assure those obligations or not. However, incurring a financial loss on an investment in a defined benefit pension fund doesn't necessarily mean that there is a need for financial support.

Finally, as highlighted in the general comments section, it would be of advisable to clarify that:

- entities already subject to the prudential supervision under article 49 of the CRR are exempted from the scope of application of article 14a (entities in the scope of supplementary supervision and in the scope of the consolidated supervision / aggregation pursuant to Art 49 (3a));

- companies below the accounting consolidation thresholds and included in the scope of prudential consolidation, are exempted from the provisions of article 14a.

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.

When deductions according to article 33(e) (Pension Funds assets) and deduction according to the proposed provisions for indirect investments from Defined benefit pension funds occur, there will be a direct overlap between the two. 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.

As an 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 draft 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 potential double count can be illustrated if we reverse the order of applying the potential deductions:
    - if we firstly 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.
- In this second example, where calculation is made in reverse order, the total CET1 deductions would be 30. Under this approach, the double count of deductions from investments in capital instruments of financial sector entities is thus avoided
- However in case a pension scheme is in deficit, this potential double counting issue regarding investments in capital instruments of financial sector entities for CET1 deductions does not exist.

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?

As included in the answer to Q01 above, it is our view that defined benefit pension funds should not be included in the scope of indirect holdings unless there is a direct influence over the investments made through the fund in question.

If these defined benefit funds are included, it is likely that sponsoring banks would request changes in investment strategy to reduce their potential capital deductions from financial sector capital instruments. Such changes to investment strategy would introduce increases in risk in the pension schemes (through lower sector diversification) for current and future pensioners, particularly over the long-term horizon that needs to be considered for pension purposes. Such an unintended consequence should be avoided.

Q04: Do you agree with the examples of synthetic holdings provided in paragraph2 of the following Article 14a? Should other examples be added to this list?

It is the BSG's view that the proposed wording goes beyond the mandate given in the CRR. Deductions referred to at Art. 33(i)[1] relate to holdings in CET1-instruments, whereas the draft RTS use the notion of "capital instruments" which encompasses other categories of capital instruments. This should hold true irrespective of direct or indirect holdings.

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?

Neither the Basel 3 text nor the level 1 CRR text specifies what the exposure value to be taken into account for deduction purposes. The Basel FAQ of December 2011 stipulates however that "Exposures should be valued according to their valuation on the balance sheet of the bank. In this way the exposure captured represents the loss to Common Equity Tier 1 that the bank would suffer if the capital of the financial institution is written-off." This makes sense for cash positions but not for derivatives or exposures through indices for which the valuation on the

[1] Article 36(i) in the OJEU's version.

balance sheet cannot be relied upon. Unfortunately, the absence of the clear determination of what the exposure value is at the international level puts on the EBA a heavy burden of having to provide a precise and common definition in Europe as well as avoiding unfair competitive disadvantage for European institutions compared to other jurisdictions.

Regarding indirect and synthetic holdings, the Basel FAQ provides that banks *should capture the loss that it would suffer if the capital of the entity is permanently written-off, and subject this potential loss to the same treatment as a direct exposure*. However, it is worth noting that it did not specify that the notional amount should be used in order to calculate the amount to be deducted for synthetic holdings.

In the case of options, the use of notional amount as exposure value has major drawbacks and does not allow to properly assessing the exposure of the financial institution to capital instrument of financial sector entities. Itwould lead to unmanageable and disproportionately significant amount of deduction from CET 1 capital. The consequences for equity capital markets activities in Europe would be unintended, as thet would become unprofitable and would probably decline significantly. In addition, the use of the notional amount as the exposure value would lead to inconsistent risk management behaviour between financial sector and non-financial sector equity markets, as the notional amount of the instruments would lead to major undue quantitative impacts, uncorrelated with the real nature of the underlying risks. Using the notional rather than being conservative, may lead to excessive net short positions and consequently a capital amount at stake which could be unmanageable.

Consequently, it is the BSG's view that the amount to be taken into account for synthetic exposures in the form of options shall be the 'delta' value. Delta calculations provide an accurate, risk-sensitive and economic approach for calculating exposures and are consistent with internal practices in institutions. We therefore urge the EBA to allow reliance on the delta in the RTS on own funds.

Besides, the list of synthetic holdings provided at Article 14a paragraph 2 should include any instrument providing long or short exposures to capital instrument of financial sector entities. This is absolutely necessary in order to ensure the adequate computation of net long positions in accordance with articles 42 (a) and 45(a) of the CRR. Below, we therefore suggest a broader wording, referring to the definition of financial instruments in section C of annex 1 of MIFID.

Article 14a-
Indirect and synthetic holdings for the purposes of Article 33(1) (f),(h) and (i) of Regulation xx/xxx [CRR]

1. Indirect holdings of capital instruments pursuant to Article 33(1) (f) (h) and (i) of Regulation xx/XX/EU [CRR], shall include but are not limited to, any exposure, including senior exposures, to an intermediate entity that has an exposure to Common Equity Tier 1 instruments issued by a financial sector entity where, in the event the Common Equity Tier 1 instruments issued by the financial sector entity were permanently written off, the loss that the institution would incur as a result would not be materially different from the loss the institution would incur from a direct holding of those Common Equity Tier 1 instruments issued by the financial sector entity. Intermediate entities shall be entities

other than institutions in the meaning of article 4(4) of Regulation xx/XX/EU [CRR] and shall include: […]

Indirect holdings may be computed after netting long and short positions in the entities listed above.

2. Synthetic holdings shall include:

(a) any holding in a financial instrument as defined in Section C of Annex I of MIFID, which provides exposure to ~~investments in total return swaps on~~ a capital instrument of a financial sector entity, unless it qualifies as an indirect holding as defined at paragraph 1.
(b) guarantees or credit protection provided to a third party in respect of the third party's investments in a capital instrument of a financial sector entity,
(c) ~~call options purchased by the institution on a capital instrument of a financial sector entity,~~
~~(d) put options sold by the institution on a capital instrument of a financial sector entity or any other actual or contingent contractual obligation of the institution to purchase its own capital instruments,~~
~~(e) investments in forward purchase agreements on a capital instrument of a financial sector entity.~~

Article 14e-
Calculation of synthetic holdings for the purposes of Article 33(1) (f),(h) and (i) of Regulation xx/xxx [CRR]

1. Regarding synthetic holdings referred to in paragraph 2 of Article 14a, the amount to be deducted from Common Equity Tier 1 items referred to in points (f), (h) and (i) of Article 33(1) of the Regulation xx/XX/EU [CRR]shall be the delta equivalent notional value of a financial instrument with a non-linear risk profile and the notional value for other instruments at the date of minimum capital requirements calculation

The deduction shall take place from the date of signature of the contract between the institution and the counterparty signature of the contract between the institution and the counterparty.

For equity index products, regarding the netting of positions with a residual maturity lower than one year, we would like to recommend the use of buckets. Thus, we suggest allowing the netting between long and short positions of the same underlying exposure for each bucket (e.g. three months, six months and nine months).

Synthetic positions should be deducted only provided that the settlement of those instruments is made on the basis of a physical delivery since:

a) a cash settlement cannot possibly give rise to a long direct position in capital instruments of a financial sector entity.

b) the only impact on the entities capital of a derivative whose underlying asset is an equity instrument and that is settled by difference/netting, is the consequence of the change in the market value of the said derivative. These movements are recognized daily in the P&L account, exactly as it is done with all derivatives with any other underlying.

c) a derivative "long in own equity instruments" settled by difference is equivalent to a derivative settled with physical delivery plus a forward sale of the same instruments, at the same maturity and for a price equal to the market value at the date. We understand that the application of article 45 would allow to offset long and short positions, resulting in a net nil position.

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 BSG advises applying those provisions to exposures in the banking-book, as it won't be conceivable in the case of indirect holdings to an intermediate entity classified in the trading-book.

The calculation of tranches according to Article 14 c (1) b) is not comprehensible. It is not clear, why the calculation of the different tranches has to be done separately. By that the complexity is high without any benefit. In addition an example for calculation should be inserted to explain the operating mode.

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

– No additions to the comments provided in the general section above.

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

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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?

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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?

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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)?

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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?

–Such sub-consolidation (regulatory or not) should be permitted where there are minority interests arising from a parent undertaking of regulated financial institution.

First, there is the case when the subsidiary is only subject to individual capital requirements, we think that in those cases a hypothetical sub-consolidation could serve for excess capital calculation purposes.

In the case of subsidiaries that are parents in a third country and are not subject to capital requirements ratio we consider that the CRR would allow the recognition of the minority interest when the subsidiary is subject to requirements that result in "de facto" minimum capital requirements equivalent to those resulting of the sub-consolidation (article 81.a.ii). This is the case when the subsidiary is not subject to minimum requirements but is required by law to be funded through common equity with no possibility to leverage through external funding nor from other companies of the same group, and whose only activity is to hold the stakes in the subsidiaries (no other intragroup operations are allowed).

In summary, we understand that if the subsidiary in question is not a regulated entity the calculation would be undertaken by looking at the immediate higher regulated parent entity level. In addition, we would emphasize the need that article 84 be interpreted as recognizing local prudential requirements when these are higher than the requirements at consolidated level. We think that article 84 should be read as that the only difference in the calculation between (i) and (ii) is the elimination of intragroup positions but the minimum ratio to apply should be the higher between the consolidated and the local.

3. Common Equity Tier 1 (CET1) deductions for Significant and Non-Significant Investments in Financial Sector entities

To address systemic risk and interconnectedness, CRR included rules relating to a bank's investment in capital instruments of financial sector entities which result in potential CET1 deductions.

CET1 deductions can result from:

- Significant investments in financial sector entities ('SI') – where a bank holds more than 10% of the common equity Tier-1 issued by that entity.

  Non-significant investments in financial sector entities ('NSI') – the total exposure to financial sector entities where a banks holds less than 10% of the common equity Tier-1 issued by that entity. CET1 (and possibly Additional Tier 1 / Tier 2) deductions are required if the total exposure is higher than 10% of an institution's CET1.

A major issue with these rules is that they are 'blunt' with very little risk sensitivity. In particular maturity restrictions for the recognition of short positions (provided for at Art 45 (a) of the CRR and the requirements to look-through index instruments have major impacts for trading book positions (especially equity derivatives) if they were to be included in the scope of this RTS . The level of exposure resulting from the rules can be many times the level of economic exposure if hedging short positions are not recognised.

As a consequence, the SI and NSI CET1 deductions could have material impacts on EU bank capital ratios. The impact is likely to be exacerbated by the focus on end point CET1 capital ratios (by certain central banks/regulators and key stakeholders), ignoring the phase-in period possible through transitional provisions.

The impact of SI and NSI on banks will be heavily dependent on the scope of exposures that are included in the SI and NSI exposure measure and the calculation methodology for the exposure. Although the general rules have been established in CRR, the scope and methodology are likely to be determined by the detailed rules included in the EBA's binding technical standards. As such, these detailed rules should be very carefully considered given their potential impact and possibly of significant adverse unintended consequences.

In addition, interpretation and implementation difficulties (both operational and practical) are likely to result from detailed and complicated calculation rules for SI and NSI exposure. These are not currently apparent as processes to determine SI and NSI exposures and associated CET1 deductions are not currently being operated by EU banks for current capital position calculations under CRD 3.

It is recognised that the EBA have little time to complete the technical standards given the timetable imposed by CRR. However, it is very concerning that there is no time available for QIS-type exercises for key rules introduced for the first time by CRR and impacted by technical standards - particularly for those rules which could have a material impact on bank's capital ratios, such as those covering SI and NSI. It is important to note that similar general issues around significance and interpretation/implementation difficulties also apply to Prudent Valuation Adjustments, which was the subject of a previous draft RTS from the EBA.

The merits of initially implementing principle-based regulatory technical standards in these areas, with subsequent consultation and QIS-type exercises to determine the detailed rules at a future date should be considered. Experience gained from initial bank implementation, and subsequent consultation and QIS of proposed detailed rules would help identity unintended consequences and allow the formulation of rules which would better meet regulatory objectives.