Response to Draft Regulatory Technical Standards On Own Funds under articles 33(2), 69a(6) and 79(3) on the draft Capital Requirements Regulation (CRR)-Part Three

Santander welcomes the opportunity to comment on the Draft RTS on Own Funds-Part Three that develops relevant aspects regarding the treatment of indirect and synthetic holdings and the treatment of minority interest.

We fully share the concerns expressed by the industry associations (EBF, AFME) with respect the treatment of indirect and synthetic holdings and fully support the comments they have made.

However, in this response we want to focus on the treatment of minority interest, particularly in Q12, an issue that has attracted relatively less attention in the industry responses but we deem very relevant for groups organised in subsidiaries, which policy is those subsidiaries to be listed. We consider that this model presents advantages from a financial stability perspective and thus should not be unduly penalised by the prudential framework.

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?

In our opinion, three situations must be distinguished:

1) Jurisdictions in which the subsidiary has to comply with requirements on an individual basis by virtue of national legislation.

2) Where there is no legal obligation neither for sub-consolidated group nor for the parent company in the third country to comply with capital requirements ratio but a set of prudential regulation imposes capital requirements for the financial entities and, in fact, the sub-consolidated group in the said country is subject to minimum capital requirements.

3) The parent company in the third country is not subject to capital ratio and there is no local prudential regulation that imposes minimum capital requirements for the sub-consolidated group in the said country.

Following we comment in detail these situations:

1. The recognition of minority interest when the subsidiary is not subject to sub-consolidated requirements but only to individual requirements.

1.1 Eligibility of minority interest
We consider that the fact that a subsidiary is not subject to requirements at sub-consolidated level should not preclude its minority interest to be recognised even if it is a parent undertaking of other institutions. We believe that the decision by a local regulator to forego supervision at a sub-consolidated level does not make the minority interests any less valid for capital purposes and this is recognized in the Capital Requirements Regulation (CRR). In this regard:

a) The conditions for the eligibility of the minority interest of a subsidiary are detailed in letters a) to c) of number 1, article 81 of the CRR and they do not include the condition that the subsidiary be subject to sub-consolidated requirements (at least, if it is an institution).

b) If the company is in the scope of article 81.1.a) and the conditions imposed by the letters b) and c) of the said article are fulfilled, the process to determine the amount of minority interest included in consolidated CET1, established in article 84, must be applied.

c) We consider that the similar wording of item (i) and item (ii) of article 84, 1, a) implies that in the calculation of the surplus of CET1 the same ratio should be utilized both for the Common Equity Tier 1 capital requirements of the subsidiary and for the amount of Common Equity Tier 1 required on a consolidated basis.

That is to say, when there is not any requirement imposed by the host supervisor at sub-consolidated level, the consolidated capital ratio ( “...sum of the requirement laid down in point (a) of article 92(1) etc...”) should be used for both calculations of paragraphs (i) and (ii) of article 84.1.a)\(^1\) and the only consequence of the nonexistence of a sub-consolidated capital ratio is that in the calculation of the eligible minority interest there could not be “any additional local supervisory regulation in third countries...” added to the CRR and CRD ratio requirements.

1.2 Conditions to apply in order to secure the calculation of eligible minority interest

First, we understand that although the subsidiary is only subject to individual capital requirements, its sub-consolidated risk weighted assets should be utilized in the calculation of eligible minority interest according to article 84.

As for the supervision of the said risk weighted assets, we believe that a sub-consolidated balance sheet, revised by an established audit firm, mandatory in most jurisdictions, it is indispensable for verification of the group estimated capital requirements of its subsidiary on a sub-consolidated basis. The detailed process of obtaining the risk weighted assets from the sub-consolidated balance sheet, considering the approved capital internal models and all the necessary additional information, should be at the disposal of the home supervisor.

In this regard, it is worth mentioning that irrespective of the subsidiary being subject to individual or consolidated capital requirements the home supervisor should verify the

\(^1\) The differences will stem from the existence of intragroup exposures that will make the subsidiaries contribution to the consolidated risk weighted assets different from the risk weighted assets at sub-consolidated level.
calculation of the amount of consolidated Common Equity Tier 1 that relates to that subsidiary and is required on a consolidated basis, following Article 84.1 a.ii. We believe that there should not be many differences between the evidence required to accomplish this obligation and to verify the capital requirements calculation of the subsidiary on a sub-consolidated basis, according to Article 84.1 a.i.

To enhance trustworthiness data and the comparability of financial statements enabling the review by the home supervisor of the company’s calculation, the following conditions, that we understand are satisfied by most institutions in third countries, are sufficient:

a) The subsidiary is subject by virtue of local law to minimum capital ratio at an individual level.

b) The existence in the third country of local regulation transposing the principles of the Basel capital Accord.

c) The fluent exchange of information between the host and home supervisor.

d) The obligation to audit the subsidiary subconsolidated balance sheet by an established firm.

In conclusion, we do not believe that any additional condition is required.

2. The recognition of minority interest when the subsidiary is a holding that is not subject to sub-consolidated capital requirements but is subject to requirements that achieve the same prudential goal

2.1 Eligibility of minority interest

Let us consider the following structure:

The parent of a financial subgroup in a third country (a subsidiary of the ultimate parent in the EU), is not subject to sub-consolidated capital requirements,

The financial entities of the subgroup are subject to said capital requirements and the local prudential regulation is as a whole equivalent of CRR/CRD in terms of the subgroup capital adequacy.

If the preceding conditions are fulfilled we understand that the parent holding should be considered an undertaking subject by virtue of applicable national law to requirements equivalent to the ones in the Capital Regulation and Directive (Article 81.1. a.ii) and the minority interest of that holding must be eligible.

This situation effectively occurs in some third countries where a holding structure is mandatory for a bank to provide both retail banking and investment services. Similar to the current Liikanen proposal in Europe there are jurisdictions that already require these activities be provided by separate subsidiaries. Under this framework the parent should be by law a holding funded mainly through common equity and whose only substantial activity is to hold the stakes in the subsidiaries (no other intragroup operations are allowed).
Thus, although the holding is not subject to a sub-consolidated capital ratio, the subgroup is “de facto” subject to a minimum capital requirement that results from the sum of the subsidiaries capital minimum requirements. As the intermediate holding must finance its stakes in the group’s subsidiaries, mainly with equity, the sum of the minimum level of capital of these companies determines the minimum level of equity in the holding. These subsidiaries are subject to capital requirements and, consequently, the requirements for the risk weighted assets of these financial entities are finally also required for the consolidated subgroup in the third country.

2.2 Calculation of eligible minority interest

When these conditions apply we understand that the “de facto” holding minimum capital requirement should be used for the calculation of the minority interest that can be included in the consolidated CET1 as established in Article 84 of the CRR. It should be noted that this method offers equivalent results\(^2\) if compared with estimating the amount of eligible minority interest based on the capital and requirements for the holding on a sub-consolidated basis\(^3\).

For illustration purposes, take as an example a financial group where the parent company is a Holding which participates in financial Subsidiary A ($100) and in financial Subsidiary B ($50) fully funded by equity (equivalent to CET1 under Basel III). Both subsidiaries are subject to minimum capital requirements of 10%. Subsidiary A has Risk Weighted Assets (RWA) by an amount of $600 and Subsidiary B of $500.

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\(^2\) The difference, if any, should be due to intragroup operations

\(^3\) if the ratios used for the estimation of the capital requirements both at an individual and at a sub-consolidated basis are the same
Thus, the minimum capital requirement for A is $60 and for B is $50, which implies that as minimum the Holding should finance the $110 capital needs required by regulation. The excess of capital in Subsidiary A results in a correspondent excess of capital at the Holding level in the same amount, $40. If there are minority interests equivalent to a 25% of the holding capital, at least the 25% of the $40, that represents the excess over the regulatory minimum, should be deducted from consolidated CET1 following Article 84.1, a) (i).

In summary, we understand that when the group in a third country is subject to the following conditions, minority interest issued by a holding should be recognised even if the holding company is not subject to legal capital requirements. The fulfillment of these conditions should be evaluated by the home authority:

1) The activity of the Holding is essentially restricted to the mere holding of participation in financial institutions, subjected to prudential capital requirements.

2) The funds for holding such participations are fundamentally common equity and the Holding cannot incur in debt except for a short period and with the previous authorization of the local supervisor.

3) The balance sheet of the Holding provides a full accounting consolidation for all subsidiaries and is subject to a full independent audit by an established firm.

4) The measures applied by the supervisor to the bank’s subsidiary shareholders (dividend restrictions), when the bank capital is below the required minimum, applies mutatis mutandis to the holding’s shareholders: thus, the holding cannot distribute dividends when the bank subsidiary is below the regulatory minimum capital.

5) An intragroup agreement must be signed between the holding company and each of the financial entities establishing the holding to be secondarily but unlimitedly liable with regards to the losses of the respective financial entity.

6) The Holding can only be dissolved once all the obligations of its financial subsidiaries have been satisfied.

3. The parent company in the third country is not subject to capital ratio and there is not local prudential regulation that imposes minimum capital requirements for the sub-consolidated group in the said country.

3.1 Eligibility of minority interest

In this situation the parent company/holding is not subject to capital requirements but does hold equity in a financial entity/subsidiary, that complies fully with the requirements established in article 81.1 of the CRR, that entitles the subsidiaries minority interest be recognized as CET1 for consolidated purposes.

The graphic and data below better illustrate the corresponding corporate structure:
Cost of acquisition of B by M: $750

Cost of acquisition of A by B: $150

Where M represents the consolidated Group, B the parent company/holding and A, the financial entity/subsidiary.

According to the definition in the CRR (article 4, 120) “minority interest” means “the amount of Common Equity Tier 1 capital of a subsidiary … that is attributable to natural or legal persons other than those included in the prudential scope of the consolidation …”.

The CRR does not elaborate further this concept and does not give guidance about the treatment of indirect holdings of CET1 capital in an institution (such as A in the diagram above) that might be attributable to minority shareholders through their stake in the parent company of the institution (B in the diagram).

This is a very sensitive topic if this intermediate company (B) does not fulfill the conditions imposed in article 81 and, although there is not a specific remission to the accounting framework on this point, we believe that the accounting standards must be used as an interpretative tool.

The relevant international financial standard (IFRS 10, appendix A) define the “non-controlling interest” (before also known as “minority interest”\(^4\)) as the “equity in a subsidiary not attributable, directly or indirectly, to a parent”, a definition very close to the prudential “minority interest” if we change the accounting concept (equity) for the prudential one (CET1).

This principle, that the indirect holdings should be included in the “non-controlling interest”, is recognized not only in the standard but also in its basis for conclusions\(^5\) and was necessary for the right attribution of eventual losses in the company with indirect non-controlling interest before the amendment to IAS 27 in 2005\(^6\).

Consequently, we believe that similar criterion should be applied in the attribution of minority interest to subsidiaries A and B for prudential purposes as it is shown below.

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\(^4\) IFRS 10, BCZ 155 “The 2008 amendment… change the term “minority interest” to “non-controlling interest”. The change… reflects the fact that the owner of a minority interest…might control…Non-controlling interest is a more accurate description of the owners who do not have a controlling interest in an entity”

\(^5\) IFRS 10, BCZ, 156 “…non-controlling interest was defined as the equity in a subsidiary not attributable, directly or indirectly, to a parent…”

\(^6\) The amount of non-controlling interest in subsidiary A, 37.5, was the limit of A losses that can be attributed to non-controlling interest, according to IFRS 10, BCZ 160 “IAS 27…stated that when losses attributed to the minority (non-controlling) interest exceed the minority’s interest in the subsidiary’s equity, the excess, and any further losses…is allocated against the majority interest…”
3.2 Calculation of eligible minority interest

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Note: where M represents the consolidated Group, B the parent company/holding and A, the financial entity/subsidiary.

In our opinion:

a) The minority interest attributed to B (212,5 M) could not be included in the consolidated CTE1 because neither the parent company/holding nor the subgroup in the third country are subject to any legal or “de facto” capital requirement, but

b) The minority (non-controlling) interest arising from A (37,5 M) are eligible if A fully complies with article 81.1 and, subsequently, the process in article 84.1 to determine the amount of eligible minority interest for the consolidated CTE1 at M should be applied.