AFME Briefing note

Free Flow of Capital and Liquidity - Issues for Cross-border Groups in the EU Prudential Framework

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Introduction

The free flow of capital and liquidity enables integrated, open, competitive and efficient financial markets and services. It allows European companies and sponsors of infrastructure projects of all sizes to raise money where it is cheapest, matches investors with investment opportunities and enables financial institutions to extend credit where it is most needed. Ultimately, efficient capital allocation provides a foundation for sustainable economic growth in the EU.

Greater integration of the European Union's single market and economic and monetary union has, over time, led to the increasing liberalisation of capital movements and the removal of barriers which previously prevented cross-border capital flows within the EU. In particular, the introduction of the Banking Union and a Single Supervisory Mechanism (SSM) in the Eurozone, alongside fundamental advances in financial stability through the European recovery and resolution framework, have further contributed to breaking down barriers to capital flows. The development of stronger capital markets to complement banks as a source of financing through the Capital Markets Union (CMU) further underscores the need to consider remaining barriers to the movement of capital, both within and beyond the EU. The present legislative process towards the adoption of revisions to the Capital Requirements Directive and Regulation (CRD/R) is an opportunity to build on these frameworks, to analyse and and remove remaining barriers to the efficient capital allocation of capital within cross-border banking businesses.

AFME's membership is largely comprised of cross-border banking groups, with either European or international headquarters, operating both within and outside the EU. Depending on their business model, these groups are typically organised into one of two organisational models, with either centralised or decentralised, structures. Centralised structures are typically managed from the top-level entity, with centralised funding and risk management functions, while decentralised groups operate autonomous individual entities with local funding and risk management functions. The two approaches can also be combined, with decentralised sub-groups operating in a centralised manner across certain jurisdictions.

Groups that centralise their funding and risk management functions can face obstacles to exchanges and flows between the different entities of the group through restrictions or limits placed on such intragroup transactions. Groups with decentralised structures can be affected by restrictions to the recognition of their interests in local entities. Finally, EU headquartered firms with a global footprint also face specific obstacles to their operations when they have entities operating in third countries that are not yet formally considered as being equivalent, even though they have implemented international prudential standards.

Whatever their organisational structure, these global firms all face some form of restrictions on the flow of capital and liquidity within their groups arising from the current EU prudential framework.

Purpose of this paper

This paper describes the types of restrictions and obstacles cross-border groups face in relation to the current EU prudential framework as set out in the existing Capital Requirements Regulation (CRR) and puts forward recommendations for how they could be addressed. It does not provide AFME's views on proposed changes to the prudential framework published by the European Commission on 23 November as we are in the process of analysing these with our members. We will communicate our views on the new proposals separately.

Some of the recommendations made in this paper may therefore be viewed as long term goals. It is nevertheless important to bear in mind the significant economic benefits of removing obstacles to the free flow of funds. Removing legislative barriers will enable more efficient internal capital allocation within banks, allowing resources to flow to where they are most in demand from European businesses and households. It will also help ensure continued funding of the real economy through cyclical downturns[1] and greater resiliency of the banking sector in general, which in turn will help unlock growth opportunities through a more efficient allocation of savings to investments.

The paper is structured as follows:

- Section 1 explains why it is appropriate to review the scope of the prudential framework for cross-border banks, or the treatment of their intragroup exposures in the shorter term

- Section 2 examines how the scope of the prudential framework could be adjusted across the areas of risk-based capital requirements, the leverage ratio and liquidity requirements

- Section 3 sets out the current treatment of intragroup exposures across all aspects of the framework and includes our recommendations for removing national dimensions and harmonisation

- Section 4 describes issues faced by EU groups with international activities that arise mainly as a result of inefficient processes for determining the equivalence of third country prudential frameworks

1. Concrete advances in financial stability safeguards need to be recognised in the scope of the EU prudential framework

Prudential regulation begins with the Basel Committee on Banking Supervision (BCBS), which defines rules for internationally active banks at the consolidated level. The EU however applies BCBS standards at both solo and consolidated levels to all credit institutions and full scope investment firms operating in the EU. Thus, in the EU, these standards also apply to exposures between two entities within the same group (referred to as "intragroup"). This application of prudential requirements to intragroup flows and exposures imposes additional costs on firms and can induce a reduction of the provision of financial services or give rise to additional costs for end-users of financial services and products.

[1] There is empirical evidence to suggest that cross-border intra-bank funding is less volatile than inter-bank funding; see for example Reinhart and Riddough (2014).

To reduce barriers to the free movement of capital within cross-border groups, the scope of application of BCBS standards as they are currently implemented in the EU should be revisited. In the short term however, if it is not possible to amend the scope of these standards in the EU, it is necessary to reconsider current waiver provisions and the treatment of intragroup exposures, extending their exemptions and streamlining the wide range of different types of discretions that currently exist for Competent Authorities and Member States so that the movement of funds within groups is not unduly hampered by regulatory restrictions. Absent a fundamental revision of the scope of the framework, the EU will have to deal with a combination of waivers to application of the various requirements at the individual entity level and exemptions for intragroup exposures, both of which must be substantially improved to reduce current barriers.

We understand that the present system is largely the result of legacy concerns of individual Member States. However, in a Single Market, and in particular in the context of the Banking Union, there is no longer any case for maintaining restrictions that seek to isolate capital along national lines. Over the past years, there have been significant regulatory developments and clear improvements in financial stability safeguards, including the creation of the Single Supervisory Mechanism together with a Single Resolution Board. These advances must be recognised. More broadly, the implementation of a European recovery and resolution framework since the crisis has also greatly contributed to rendering national arguments for limiting exemptions for intragroup transactions within the boundaries of single Member States untenable. Finally, if capital and liquidity are trapped in local jurisdictions through regulatory constraints, this can have counterproductive influences on the resilience of a banking group.

2. Scope of application of the EU prudential framework

The current CRR defines in its Articles 7 and 8 the conditions under which waivers can be obtained from the application of capital and liquidity requirements on an individual basis. However, in practice, few of these have been granted, even for intra-Banking Union entities.

Therefore, and as envisaged by the Commission[2], AFME considers that amendments should be made to the CRR to draw out the prudential consequences of the creation of the Banking Union, recognising the Banking Union as a single jurisdiction where banks are subject to supervision by the same authority (i.e. the SSM). To simplify the prudential framework, the scope of the CRR should be adjusted to accommodate these developments. However, if the current system of waivers is to stay in place, these need to be extended beyond individual Member State borders and their discretionary nature removed, without introducing any additional requirements.

Furthermore, when it can be demonstrated there are no impediments to the flow of resources, the same treatment should apply between all countries within the EU, as well as between jurisdictions outside the EU when they have equivalent prudential regimes in place.

Capital requirements

The CRR's current Article 7 provides for a derogation to the general application of capital requirements on an individual basis. Going forward, the CRR should be adapted to support the full implementation of the SSM by removing the current Member State dimension in this provision. This could be achieved by amending Article 7 of the CRR with a view to allowing banking groups to be granted cross-border capital waivers for their Banking Union subsidiaries.

[2] Report from the Commission to the European Parliament and the Council on legal obstacles to the free movement of funds between institutions within a single liquidity sub-group, 05.06.2014

As things currently stand, some institutions' subsidiaries are *de facto* covered by 3 or more different levels of capital requirements (and the associated regulatory reporting requirements): group consolidated level, sub-consolidated levels and individual level. The relevance, and the proportionality of this approach, more especially for subsidiaries located in Eurozone countries and hence all having the ECB as their Competent Authority within the SSM, is questionable.

Moreover, to further strengthen the relevance and proportionality of this approach, Article 22 should also be amended to allow for an extension of the exemption from the application of prudential requirements, currently only in place for entities supervised on an individual basis, to entities supervised on a sub-consolidated basis which are already subject to prudential supervision on a consolidated basis via their parent company in the same Member State.

While these waivers should apply to entities within the Banking Union as a matter of routine (i.e. without a discretionary component), we consider that similar waivers should also be made available (possibly on a discretionary basis) to banking groups operating across the European Union more generally in recognition of the EU Single Market.

Leverage ratio

The purpose of the leverage ratio is to restrict the build-up of leverage in the banking sector, and to reinforce risk-based requirements with a simple backstop measure. Given that leverage requirements will always apply at the consolidated level, it is not necessary to apply leverage requirements to individual entities to restrict the build-up of leverage in the banking sector as whole. Exposures within groups cannot contribute to the sector's aggregate leverage versus the real economy or other parts of the financial sector. Moreover, individual level requirements do not serve as a backstop to individual banking groups' leverage positions. Instead, because they in aggregate may exceed an individual group's consolidated leverage requirement, they have the potential to result in leverage requirements becoming the economically binding requirement even where they are not the binding requirement at consolidated level. This means that they do not serve as backstop.

Therefore, the leverage ratio requirements should not apply at the individual level. Similarly, any additional leverage ratio buffer for G-SIBs should only apply at the ultimate consolidated level to be consistent with the design, and calibration, of the Basel framework.

Liquidity requirements

Liquidity requirements should ideally be applied at an adequate level of consolidation, which will depend on the liquidity management model of the bank. For banks operating centralised liquidity/funding models, this would be at the highest level of group consolidation. In the case of the NSFR for example, in line with the Basel standard, consolidated application of the requirement is justified given that its objective is to limit the asset/liability mismatch on the consolidated level. Its implementation should not in itself lead to additional funding requirements at solo levels, however solo application of the NSFR can result in banks having to keep more long term funding. This results in suboptimal funding structure for the banks as a whole and is ultimately also to the detriment of banks' ability to support the real economy.

Against this background, the current focus of CRR Article 8 on a single liquidity sub-group (SLSG) could be modified to replace the concept of SLSG with a concept of consolidated application that is appropriate to the group structure. This would also bring the waiver for liquidity more in line with the capital waiver as currently captured by the CRR. We note again here that in practice, no cross-border liquidity sub-group has been authorised so far by the SSM. At a minimum, we therefore recommend that Article 8 (paragraphs 1, 2 and 3) of the CRR be framed in a way which recognises the Banking Union as a single jurisdiction where banks are submitted to the same supervision authority (SSM), leaving less discretion for potential measures restricting the free flow of liquidity.

As with capital waivers above, such liquidity waivers should apply to entities within the Banking Union as a matter of routine, but similar waivers should also apply to banking groups operating across the European Union more generally.

3. Intragroup transactions

Pending more fundamental adjustments to the scope of application of the requirements, the treatment of intragroup exposures needs to be revisited. This section sets out suggestions of how to achieve the necessary adjustments to avoid the prudential framework perpetuating unnecessary legal barriers to the free flow of funds within groups.

Intragroup exemptions in the risk-based framework

Under Article 113 (6) of the CRR, institutions can apply a 0% risk weight to their intragroup transactions subject to the approval of the Competent Authority and under a number of conditions. These conditions require the inclusion of the counterparty in the scope of prudential consolidation of the firm, for it to be subject to the same risk evaluation, measurement and control procedures as the institutions and for there to be no impediments to the transfer of funds. However, one of the conditions of these exemptions is that the group counterparty must be in the same Member State.

For cross-border banking groups, limiting such a provision to a single Member State places an unnecessary restriction on the flow of funds within a group, particularly in the context of the Banking Union. It is also questionable whether there is a need for such restrictions within the broader Single Market, and with respect to entities in third countries with equivalent prudential rules and they should also be reconsidered.

This being said, AFME is not arguing for the complete exemption of intragroup exposures across all jurisdictions if this is not appropriate due to real impediments to the transfer funds, or if the exposure is to an entity that is based in a jurisdiction that is not deemed to have a prudential regime equivalent to the CRR.

Instead, we are of the view that intragroup exposures should consistently be exempt regardless of jurisdictional considerations when the Competent Authority is satisfied that conditions a), b) c) and e) of CRR Article 113.6 are fulfilled. In other words, condition d) (i.e. that the group counterparty be located in the same Member State) should be broadened so that the counterparty can be physically located in any participating Member State of the Banking Union, the EU or in a third country jurisdiction with an equivalent prudential regime.

Intragroup transactions in the large exposure framework

As is the case with the rest of the international framework, the Basel large exposure framework is designed for application to internationally active banking groups at the consolidated level and as such does not specifically consider the treatment of intragroup exposures. The CRR however does apply large exposure limits to intragroup exposures but uses a relatively complicated, and inconsistently applied, system of discretion to allow for the possible exemption of intragroup exposures by Competent Authorities and/or Member States.

In summary, Article 400 §1 (f) allows for the complete exemption of intragroup exposures from the Large Exposure framework if they would be assigned a 0% risk weight under the risk-based framework. Article 400 §2 (c) gives Competent Authorities the discretion to go beyond the limited geographical scope of Article 400 1 (c), exempting cross-border intragroup exposures partially or fully. Finally, Article 493 §3 (c), gives Member States the discretion to over-ride the choice of the Competent Authority by fully or partially exempting cross-border intragroup exposures until 2029.

The inconsistent application that has occurred under the current legal framework therefore limits the ability of cross-border businesses to freely transfer funds between their legal entities. It also creates an unlevel playing field between these types of institutions depending on the type of choice made by their relevant Competent Authority and/or the Member State in question, with the two possibly contradicting each other. This approach creates significant obstacles for firms with centralised liquidity management as entities must be mindful of incurring large exposures to the parent entity which acts as the main funding entity. In this context, legislative change is required to remove the conflicting powers afforded to Member States and Competent Authorities, as well as to enhance the ability of the SSM to exercise its powers as the common supervisory authority of the Banking Union.

We therefore recommend that the discretion set out in Article 400(2)(c) of the CRR be moved to Article 400 (1) as (l)new so that, where a firm's intragroup counterparty is subject to the same conditions as those listed above (i.e. equivalent prudential requirements, included in the same consolidation with the same levels of risk and control and with no impediments to the transfer of funds), intragroup exposures must be fully and consistently excluded from large exposure limits if the Competent Authority is satisfied that these conditions are met. This change should also be accompanied with the removal of Article 493(3)(c) of the CRR to allow the SSM to exercise these powers without possible constraints stemming from national legislation.

It is also worthwhile recalling that another consequence of retaining the status quo is that any non-exempt intragroup transaction needs to be grouped together with all such transactions since large exposure requirements apply to so-called "groups of connected counterparties". This compounds the negative effects of the current system.

We note that most of the above issues have already been recognised for a number of years. Indeed, the CRR mandates (in Art 507) the European Commission to review whether it is appropriate for the exemptions set out in Article 400(2) to continue to be discretionary (or whether they should become mandatory exemptions). In particular, the Commission is required to take into account the efficiency of group risk management whilst ensuring appropriate financial stability safeguards are in place. Again, the regulatory developments and improvements in financial stability safeguards since the CRR introduced this mandate imply, in our view, that there are no longer any reasons to allow discretions (and therefore divergences) to remain in this area of the European framework. The present review of the CRD/R represents an opportunity to foster further harmonisation of the single rulebook in this area.

Finally, the introduction of internal TLAC/MREL requirements should not be constrained by intragroup large exposure limits. Any exposures resulting from internal MREL must be exempt from large exposure limits.

Intragroup transactions in the leverage ratio framework

Under the CRR's current approach to the leverage ratio (Delegated Act (DA) Article 429.7), intragroup exposures within a single EU Member State may be excluded from the leverage ratio at the discretion of the Competent Authority when a number of conditions are met[3]. However, any intragroup exposures between entities which are cross-border are not exempt and must be included in the leverage exposure measure. There is no justification for this approach which implies that intragroup transactions *within* a single Member State do not create leverage but that those *across* borders do. Clearly this rule increases the cost of cross-border financial intermediation without an underlying increase of leverage. Ideally, the leverage ratio would be applied only at a consolidated level, as otherwise the aggregate individual requirements can exceed those at consolidated level.

If however the leverage ratio is to be applied at solo level, we recommend therefore that the exemption for intragroup transactions is extended to remove geographical considerations, i.e. it should apply to group entities which are established in another Member State, whether of the Banking Union or the EU, or entities established in a jurisdiction which applies prudential supervision equivalent to the CRR. This is line with our recommendation above for the risk-based approach and maintains consistency between the two frameworks. Moreover, when the Competent Authority is satisfied that these conditions are fulfilled, the discretionary nature of the exemption should be removed (i.e. "may" should be replaced by "shall" in Article 429.7 of the CRR/DA)

Intragroup transactions in the Credit Valuation Adjustment (CVA) framework

CRR Article 382 (b) allows banks to remove intragroup transactions defined in Article 3 of the European Market Infrastructure Regulation (EMIR)[4] from the scope of the CVA risk charge.

The scope of this rule is similar to the exemptions discussed above, however, the conditions introduce another requirement – that the European Commission adopts an implementing act on equivalence of other jurisdictions under Article 13 (2). The additional analysis required under Article 13(2) primarily focuses on the clearing obligation in Article 4 of EMIR and the risk-mitigation techniques for OTC derivative contracts not cleared by a CCP in Article 11 of EMIR. This is because the rationale for an intragroup exemption in the CVA framework was to align with the scope of mandatory clearing requirements and margin requirements for bilateral non-cleared derivative transactions.

We believe there is no need for an *additional* Commission implementing act on equivalence under Article 13(2) when there is already an implementing act[5] on third country equivalence with the CRR and several implementing acts on the equivalence of derivatives regulations for central counterparties under EMIR.

Furthermore, Competent Authorities allow firms to exempt intragroup transactions from the mandatory clearing and bilateral margin requirements through a permission process. This produces a deviation of the scope of the CVA charge and the requirements on the clearing obligation and margin requirements that we believe was not the aim of the co-legislators.

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[3] These conditions are the same as those summarised above, i.e. those set out in CRR Article 113

[4] Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories

[5] Commission Implementing Decision (EU) 2016/230 amending Implementing Decision 2014/908/EU as regards the lists of third countries and territories whose supervisory and regulatory requirements are considered equivalent for the purposes of the treatment of exposures according to Regulation (EU) No 575/2013.

We recommend aligning the scope of the CVA exemption with a revised risk-based framework intragroup exemption as discussed above. Specifically, the adoption of a Commission implementing act under Article 13(2) of EMIR should be replaced with the condition that the counterparty is based in a jurisdiction that applies equivalent prudential regulation to the CRR. At a minimum, the scope of the CVA charge should be amended so that firms which have received permission to exempt intragroup transactions from the clearing obligation and margin requirements for non-cleared derivatives should also receive permission to remove the transactions from the CVA risk charge.

Intragroup flows under the NSFR

If the application of the NSFR remains at both the consolidated as well as at solo level, the treatment of intragroup exposures in this area of the prudential framework should also be revised and should not be discretionary or jurisdiction specific. We therefore recommend that intragroup funding and deposits be assigned symmetrical ASFs and RSFs as the group will operate in the interests of its subsidiary. At the very least, this should apply to entities located in the Banking Union but consideration should be given to extending this type of treatment to entities outside of the Banking Union too.

Intragroup flows under the LCR

We have equivalent concerns regarding the scope of the LCR as we do for the NSFR and the current conditions under the LCR Delegated Act (DA) to grant preferential treatment to intragroup exposures are also unsatisfactory for cross-border banking groups as once again they are discretionary and often limited to exposures in the same Member State. Ideally, intragroup flows should not be territorially constrained, either between entities located outside and within the EU, and a fortiori for entities located within the EU. At the very least, Articles 29 and 34 of the DA should be amended to recognise the Banking Union as a single jurisdiction where banks are supervised by the same authority (i.e. SSM). Moreover, the discretionary nature of the current provision should be removed so that when the relevant conditions are fulfilled the lower outflow/higher inflow percentages are granted as a matter of course.

Cross-border activity between Member States in the G-SII scoring methodology

There are other areas where Banking Union developments also need to be reflected, one of these being the determination of the extent of cross-border activity in the G-SII identification criteria.

Currently, among the 5 categories defined by EU legislation for the identification of G-SIIs, Article 131(2) of CRD 4 defines category (e) "Cross-jurisdictional activity" as "cross-border activity of the group, including cross-border activity between Member States and between a Member State and a third country". This implies intra-Banking Union activities (and *a fortiori* intra-EU exposures) are accounted for under the cross-border activity indicator, thereby artificially increasing the systemic relevance of Banking Union firms.

We recall that one of the underlying objectives of the cross-border indicator was to take into account the risk that the resolution of a multi-jurisdiction banking group would be technically more difficult in case of failure, and that an additional capital buffer was therefore warranted. According to the BCBS: *"The greater a bank's global reach, the more difficult it is to coordinate its resolution and the more widespread the spillover effects from its failure"*[6]. However, since the Banking Union is now a single supervised jurisdiction thanks to the SSM set up, this risk is no longer relevant for intra-Banking Union transactions. We note also that this was anticipated by the BCBS itself: "*As regards the structural changes in regional arrangements – in particular, the European*

[6] BCBS G-SIB methodology update July 2013 §21

Union – they will be reviewed as actual changes are made."[7] Intra-Banking Union activities should therefore no longer be taken into account in the measure of cross-border activity.

Ideally, the entire EU would be considered as a single jurisdiction but at the very least, we recommend that intra-Banking Union exposures be scoped out of the cross-border exposure measures through the present review of the CRD/R.

The G-SII methodology should be revisited more generally to reflect progress made in bank recovery and resolution. The methodology currently treats all assets and liabilities of such entities as cross-border relative to the jurisdiction of the holding company/group headquarters. The review of the methodology (foreseen for 2017) should take into account entities which have predominantly local assets and local liabilities and are capable of being separately resolved.

Internal MREL

To make bail-in truly effective, the write-down of external MREL needs to be matched with an internal process to allocate losses to the resolution entity. However, the need to have in place an arrangement that enables the reallocation of losses within the group does not imply that pre-funded resources are needed at each solo-level entity. Consideration will therefore need to be given to how this should work within the European Union and the Banking Union in light of the BRRD framework for group resolution planning, resolution colleges and automatic recognition of resolution actions.

4. Specific issues for EU headquartered institutions with a global footprint

The current CRD/R limits the inclusion of capital (qualifying capital or minority interests) issued by third country subsidiaries within group consolidated capital, despite those subsidiaries being fully included within the scope of group supervision and their risk weighted assets (RWAs) fully reflected in group RWAs. As a result, the subsidiary's contribution to capital resources at group level is not adequately taken into account, penalising European groups with extra-European activities and in particular those that run decentralised capital and funding models.

Recognition of capital issued by subsidiaries located in third countries

Additional Tier 1 (AT1) and Tier 2 (T2) instruments issued by subsidiaries in third countries must comply with requirements specified under the CRR (and its associated implementing regulations) to be eligible at the level of the group. However, third county requirements can differ slightly from the ones included within the CRR, even though their objectives are to all intents and purposes the same. This creates issues in the following instances:

i) Conversion triggers / write down clauses

The CRR requires that AT1 instruments must include a conversion trigger (CET1<5,125%) for such instruments to be eligible as capital. When such instruments are issued from subsidiaries in third countries, to be recognised at the consolidated level, the AT1 trigger, and write-down clauses, need to be calculated in accordance with the provisions of the CRR. However, in practice, conversion or write down triggers for AT1 issued in third countries are often based on CET1 ratios calculated in accordance with *local requirements* and not the CRR.

[7] BCBS G-SIB methodology update July 2013 §39

We recommend that when these local prudential requirements are in place (whether they are deemed to be *formally equivalent* through the equivalence process or *equivalent in practice* as the jurisdiction has been assessed to be Basel compliant), these instruments must be eligible for group consolidated capital. This is to ensure that entities' contribution to both group RWAs and consolidated own funds are reflected in a symmetric and equal manner, and to recognise that resources issued locally will be available to absorb losses incurred by the subsidiaries.

Additionally, the CRR eligibility criteria determines that AT1 instruments issued by subsidiaries must meet the same criteria as if issued directly by the EU parent to be included in the consolidated own funds of the group. This could be interpreted to mean a minimum 5.125% trigger calculated with respect of Group consolidated CET1 ratio. Furthermore, the EBA has given guidance requiring triggers to be set at each level within the group where the instruments are intended to be included. This implies that AT1 instruments issued by subsidiaries can only qualify at group level if they contain double triggers - for example, if a subsidiary issues an AT1 instrument solely with a trigger referenced to the subsidiary CET1 ratio, it would not be eligible at Group level as it would additionally need a CET1 trigger based on the Group CET1 ratio.

It is therefore necessary to clarify the CRR to give explicit recognition at the group level of AT1 instruments which include a trigger in reference to the subsidiary's individual CET1 ratio, calculated under local equivalent rules, rather than disqualifying the instrument altogether in the absence of either i) a trigger calculated with reference to the subsidiary CET1 capital calculated under the provisions of the CRR; or ii) an additional trigger referencing the Group CET1 ratio. This is to ensure that the CRR requirements do not incorrectly result in disincentives for subsidiaries to self-fund, and to ensure that contribution of subsidiaries to group capital resources is consistent with those subsidiaries contribution to group RWAs. In particular, it is necessary to recognise that losses arising at the subsidiary level will impact the group CET1 ratio and therefore any conversion at the local level will result in an improvement in the group consolidated capital ratio.

ii) Point of non-viability:

Even though this is not explicitly mentioned as a contractual requirement in the current CRR, it is expected that articles 52 and 63 of the CRR will be amended to require that both AT1 and T2 2 instruments be written down or converted to Common Equity Tier 1 instruments at the point of non- viability. In this regard, we would like to note that almost all jurisdictions have regulations that guarantee the absorption of losses of AT1 and T2 instruments when the entity is not viable. While some countries have not established a specific resolution framework for banks, the general liquidation regime allows for the absorption of losses from those instruments.

iii) Authorisation processes:

EBA regulatory technical standards define the process and data requirements that institutions must comply with for the application for permission from the Competent Authority to carry out a call, redemption, repayment or repurchase of own funds instruments. Third country authorities however have their own authorisation processes that can differ from the ones considered in Europe. This is an operational issue rather than a fundamental difference that we consider should not affect the inclusion at consolidated level of instruments issued by subsidiaries in these third countries.

Restrictions in recognising minority interests must be removed

As a general rule, the CRR allows minority interest to be included in own funds up to the level of the capital requirements. However, there are currently a number of unjustified restrictions in the types of entities from which minority interests arises that can be included within group consolidated capital.

Currently, minority interests in holding companies in third countries are excluded, even when these entities are located in jurisdictions subject to prudential regulation. It is our strong view that where such entities are subject to prudential requirements and supervision equivalent to the CRR, any minority interest or qualifying own funds issued from such entities should be eligible for inclusion in consolidated requirements.

Moreover, we note that as part of the EBA's feedback on its final draft RTS for Own Funds Part III, the EBA explicitly recognised this unequal treatment with respect to minority interests arising from holding companies and alluded to the need for flexibility within the CRR. Specifically, the EBA noted that it 'has some sympathy for arguments suggesting that minority interests arising from third country holdings should qualify for inclusion in consolidated CET1 but reads Article 81 (of the CRR) as preventing it. As this is a level 1 issue, it cannot be changed in the RTS.'

The CRR as currently drafted has caused a clear competitive disadvantage for entities with diversified businesses outside of the European Union. Therefore, we propose that minority interests and qualifying own funds arising in non-EU entities, which are subject to prudential regulation, should be permitted for inclusion in consolidated capital.

Further, a strict reading of CRD/R requirements is that only the recognition of minority interests in investment firms subject to EU MiFID requirements is allowed (whereas as those arising from a credit institution irrespective of location are allowed). This asymmetric treatment which does not explicitly include third country investment firms is not justified, as these investment firms can be subject to regulatory requirements considered as prudent as those contained within EU directives/regulations.

The ability to include regulatory capital instruments issued by non-banking entities in third country jurisdictions is increasingly important in the context of resolution planning. In particular, in accordance with final FSB requirements for Total Loss Absorbing Capacity (TLAC), G-SIB groups with more than one resolution group will likely issue external TLAC from subsidiaries that are deemed to be resolution entities. In practice, such resolution entities are likely to be intermediate holding companies. Therefore, banking groups should not be penalised from a CRR perspective, if resolution entities choose to meet TLAC requirements through regulatory capital instruments. Instead such capital issued by non-banking subsidiaries should be eligible for group consolidated capital purposes. Bifurcation in treatment is not appropriate given the common underlying rationale for both regimes; namely ensuring adequate loss absorbency.

Calculation of minority interests to be included in consolidated CET1 capital

The minority interest calculation set out under Articles 84 to 88 of the CRR lacks clarity and is subject to different interpretations. The text should be clarified and simplified to reach a better understanding of the provisions contained in those articles. Relevant issues to be considered in the revision include the following:

i) *Requirements at the subsidiary level*: the excess capital should be calculated on the basis of the regulatory and supervisory requirements and any supervisory expectation independently of its form (i.e. formal or informal requirement, Pillar 2 requirement or guidance, etc.). ICAAP and stress test exercises also form part of the supervisory expectations and they should be considered in the excess capital calculation. We therefore believe that it is appropriate that both P2R and P2G are included for the purposes of determining surplus capital in CRR Article 84 (1)(a), CRR Article 85 (1)(a) and CRR Article 87 (1)(a).

ii) *Minority Interests in CET1/AT1/T2:* when an entity fulfils requirements of AT1 and T2 capital (and TLAC in due course) with CET1, these requirements should be considered Common Equity Tier I requirements as of the excess calculation.

iii) *Treatment of Accumulated Other Comprehensive Income (AOCI):* Minority interests are defined as comprising "Common equity Tier 1 instruments, the share premium accounts related to those instruments, retained earnings and other reserves of a subsidiary". This definition does not explicitly include Accumulated Other Comprehensive Income. The EBA has published a Q&A stating that AOCI should not form part of minority interests However, this results in inconsistent treatment given the definition of CET1 capital under CRR Article 50 includes AOCI and furthermore the calculation of surplus minority interests references CET1 capital which also includes AOCI. It is therefore unclear why, in the opinion of the EBA, AOCI should be excluded from the minority interests of the subsidiary. It is vital therefore, that the CRR text explicitly provides for the inclusion of AOCI within MI.

Finally, improvements to the current system of equivalence decisions are required

In the CRR, equivalence assessments are used for instance for the purposes of treating exposures under credit risk requirements where counterparties are located in third Countries in the same way as those located in within the EU[8]. As mentioned above under the section on the recognition of capital issued by third country subsidiaries, we believe that acknowledgement of equivalent or Basel compliant third country prudential requirements should also be introduced for the purposes of calculating group capital resources.

As it stands today, the assessment of third country equivalence is an area of uncertainty which produces competitive disadvantages for the banking groups operating in countries outside the EU that have not yet been included in the equivalence list.

Currently, equivalence decisions are subject to the European Commission, based on work carried out by the European Banking Authority, adopting an Implementing Decision determining that a third country's prudential supervisory and regulatory requirements are at least equivalent to those applied in the European Union. This process represents a change to previous regulation where local Competent Authorities were responsible for assessing equivalence. It has been burdensome and slow with too few final assessments having been made. Resourcing has been a major issue for both the Commission and EBA, with national expertise not being made sufficiently available. At this stand, not even all previously compliant countries have been assessed in a first wave.

The methodology currently used to assess equivalence is also too rigid and does not take into account the reality of the countries under assessment. For example, the current approach of comparing national regulations and Basel III almost article by article is very narrow and may well end in the failure of all the countries being assessed. The EU itself is not fully Basel III compliant and this issue may affect other countries too, as regulation and supervision tend to adapt to the specificities of their own countries.

[8] Among these exposures are those to central governments and central bank denominated and funded in the domestic currency.

The approach should take into account other factors such as the overall quality of the regulation and supervisory bodies, the knowledge of their staff, the degree of development of local financial markets, as well as the health of the local financial system. Moreover, a country that has already been rejected should be reassessed as soon as the country commits to making changes in their legislation, in order to maintain the right incentives and to avoid that the process takes too long

Furthermore, it is essential for the Commission to accelerate the process of third country equivalence to issue decisions in a more timely and predictable manner, especially for those jurisdictions that were previously assessed as being equivalent by national Competent Authorities. Sufficient resource must therefore be dedicated to these activities. As an interim measure and pending the publication of a formal equivalence decision by the European Commission, Competent Authorities should permit the use of regulatory assessments conducted by the Basel Committee as a proxy.

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About AFME

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