AFME Position Paper

CRR2: Issues for EU headquartered institutions with a global footprint

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The CRR limits the inclusion of capital 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. The CRR also contains a number of unjustified restrictions on the recognition of minority interests in 3rd country non-banking entities which should be removed. This is becoming increasingly important in the context of resolution planning for groups with more than one resolution group which issue external TLAC from subsidiaries that are deemed to be resolution entities. In practice, such resolution entities are likely to be intermediate holding companies. Minority interests in such entities should be eligible for recognition when they are situated in 3rd countries.

This paper describes these issues in more detail, together with comments on the current equivalence process for 3rd country prudential regimes, and sets out AFME's recommendations for how these issues should be addressed in the CRR2.

1. 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 current 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 recognition of these instruments in group level capital

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.

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 through the RCAP or assessed by other international bodies such as for example the FSI), 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. If necessary, the CRR provisions on equivalence should be revised or extended to this effect (see section 3 below for further comments on equivalence issues for 3rd country prudential requirements).

Additionally, although strictly speaking not just an issue for 3rd country subsidiaries, there is also a broader concern 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. The CRR should also be amended so that it is clear that the absence of a trigger referencing the Group CET1 ratio does not disqualify the subsidiary’s instrument from inclusion in group capital resources.

The above clarifications to the text will ensure that the CRR requirements do not incorrectly result in disincentives for subsidiaries to self-fund, and that the contribution of subsidiaries to group capital resources is consistent with those subsidiaries contribution to group RWAs. This also recognises 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 (PONV)

Articles 52 and 63 of the proposed CRR2 require that both AT1 and T2 instruments be written down or converted to Common Equity Tier 1 instruments at the point of non- viability[1]. This implies that instruments issued by third-country subsidiaries of EU institutions can only be considered as Additional Tier 1 or as Tier 2 instruments by their EU parent entities if PONV clauses are included in the instruments’ contractual terms. Our main concern refers to the drafting of these new provisions as they refer directly to the EU law. In our experience, no third country authority accepts the introduction of references to the EU legal framework in issuance conditions. However almost all jurisdictions do have statutory frameworks or regulations that allow the absorption of losses of AT1 and T2 instruments when the entity is not viable. Therefore, in the case of banking groups with more than one resolution entity and resolution group, when the issuer is a resolution entity on which the local competent authority has taken decisions with regards to resolution or other write down or conversion powers, the decision set by the local competent authority should be considered as effective and enforceable for the purposes of Art 52 and Art 63 and therefore included within group capital resources.

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.

[1] We note more generally that CRR compliant issuances made prior to the proposed eligibility criteria under Art 52 and Art 63 must continue to be eligible, for example through transitional/grandfathering arrangements. We expand on this in our paper on the Resolution aspects of the Risk Reduction Measures Packaged - recommendations for effective implementation of TLAC, MREL and related reforms.

2. Unnecessary restrictions in recognising minority interests in third countries 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 unjustified restrictions on the minority interests that can be included within group consolidated capital depending on the types of entities from which minority interests arise[2].

Minority interests in 3rd country holding companies

Currently, minority interests arising in holding companies in third countries are excluded even where such entities might be subject to prudential regulation in their respective jurisdictions. 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.

We therefore welcome the CRR2 proposal to amend the current provisions with a view to allow minority interests in holding companies in third countries to be included if "*an intermediate financial holding company in a third country that is subject to the same rules as credit institutions of that third country and where the Commission has decided in accordance with Article 107(4) that those rules are at least equivalent to those of this Regulation*" (Art 81 amended). A further amendment is however required to extend the scope to mixed financial holding companies which are included within the scope of banking consolidated requirements but have not been referenced alongside financial holding companies in the amended Articles 81 and 82

Furthermore, in practice, intermediary holding companies are not likely to be subject to the *same* rules as credit institutions. We therefore suggest that where such entities are subject to prudential requirements and supervision *comparable or similar* to that of credit institutions, any minority interest or qualifying own funds issued from such entities should also be eligible for inclusion in consolidated requirements.

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. Banking groups should therefore 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.

Minority interests in third country investment firms

A strict reading of the current 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 all 3rd country credit institutions are allowed. This asymmetric treatment for investment firms and credit institutions is not justified, as investment firms can be subject to regulatory requirements as prudent as those contained within EU directives/regulations.

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[2] AFME also has a number of technical comments on the calculation of minority interests in CRR Articles 81 -84 which can be viewed here xxx.

3. Improvements to the current system of equivalence decisions

Notwithstanding a more general evaluation of EU equivalence decisions in financial services policy[3], equivalence assessments in the context of the CRD/R are essential for EU headquartered firms with subsidiaries in 3rd countries. They 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[4]. As mentioned above under the section on the recognition of capital issued by third country subsidiaries, equivalence in practice when 3rd country regulation is Basel compliant would also be very important 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 whether national regulations are equivalent to those applied in the EU almost article by article is very narrow and may lead to a failed assessment of the countries in scope.. 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.

The equivalence 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 and other international bodies like FSI as a proxy.

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[3] We note the publication of the Commission Staff Working Document on EU equivalence decisions (27 February 2017)
[4] Among these exposures are those to central governments and central bank denominated and funded in the domestic currency.

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About AFME

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