AFME Position Paper

CRD 5: Pillar 2 and MDA Clarifications

August 2016

Introduction

AFME is supportive of clarifications being made to the CRD in the context of the forthcoming CRD/R Review to ensure that the Pillar 2 framework and associated supervisory powers, in particular restrictions on distributions, are clarified and consistently applied throughout Europe. In particular, we welcome legislative change introducing Pillar 2 requirements and guidance and clarifying the stacking order of the various capital requirements and buffers required under the CRD and how these relate to the Maximum Distributable Amount (MDA) framework. We also think that legislative change is required to give preference to payments on AT1 instruments over CET1 instruments and variable remuneration or discretionary pension benefits as this will provide both European firms and the market with much needed certainty. However, where the EBA has published guidelines, particularly in respect of broader aspects of the Supervisory Review and Evaluation Process ('SREP'), we do not agree amendments should be made to the CRD/R to seek to also address these.

The paper below sets out our thoughts on how these changes can be achieved in the next round of change to the level 1 CRD text.

Moreover, beyond these discrete legislative changes and in light of ongoing developments at Basel level, we would also encourage the Commission to give consideration as to how the Pillar 2 framework might evolve going forward. In particular, we would welcome confirmation that, if more risks are captured within the Pillar 1 framework through changes to the RWA framework by the Basel committee, the Pillar 2 requirement will be reduced in due proportion.

Scope of the Level 1 Clarifications

AFME is supportive of legislative changes being made to the CRD in the context of the forthcoming CRD/R Review to reflect the EBA's recommendations as set out in its "Opinion on the interaction of Pillar 1, Pillar 2 and combined buffer requirements and restrictions on distributions". In particular, the EBA recommends that the stacking order of the various capital requirements and buffers and their interaction with the MDA framework be clarified, as well as that the conditions for AT1 distributions be reviewed in the level 1 text.

While we very much agree these clarifications are needed, we caution against changing any broader aspects of the Supervisory Review and Evaluation Process (SREP) through the level 1 text. We are supportive of increased supervisory harmonisation, but note that the EBA's SREP Guidelines have recently been consulted on and finalised. Any further change to SREP practices and methodologies beyond the specific clarifications noted above should be done through an update of the EBA Guidelines (subject to due consultation) and only if divergences are noted after a monitoring phase of implementation of new Guidelines.

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Supervisory Powers

In order to achieve the above clarifications, AFME is supportive of changing Art 104 of the CRD4 to list the powers of competent authorities, including their power to impose additional own funds through a so-called Pillar 2 requirement (P2R). The conditions for imposing additional own funds through P2R should be listed in a separate article (see below Additional Own Funds Requirement). Moreover, although capital guidance (P2G) is a non-binding supervisory power, our view is that it would also be reasonable to provide a legal basis for this instrument in the amended legal framework. We provide further comments on how this guidance should be defined below (see the section Own Funds Guidance).

We would also recommend that an addition be made to Article 104 setting out that the duty of the Competent Authority is to assess the **overall own funds level** of the supervised entity, taking into account, holistically, all risks and all prevailing capital requirements and buffers. Indeed, the design of the Supervisory Review and Evaluation Process (SREP) is not to merely define an add-on, but rather to determine the appropriate overall own fund level which aims at ensuring that the institution guarantees the sound management and coverage of all its risks. Moreover, the SREP should be based on the firm's own assessment of its overall capital adequacy demonstrated through its ICAAP, rather than being simply seen as an additional requirement to Pillar 1. A Pillar 2 add-on, if any, must only be inferred from this assessment of the overall own funds level, reflecting firm-specific risks not covered elsewhere[1]. We would view this as an improvement compared to the current situation where capital requirements and buffers add up under the responsibility of different regulatory and supervisory authorities without any holistic view of the entity's risk profile.

In this context, we feel it would also be useful to clarify the notions of requirements and buffers more generally. It should be noted that the initial BCBS framework (D189) refers to **capital buffers**, not capital buffer requirements. Further, the BCBS states explicitly that capital buffers are "usable": "The Committee is introducing a framework to promote the conservation of capital and the build-up of adequate buffers above the minimum that can be drawn down in periods of stress." Therefore, we recommend avoiding the use of the qualification of "capital buffer requirements". There should be only capital requirements (i.e. Pillar 1 and Pillar 2R) and buffers (i.e. the combined buffers and Pillar 2G) and this should be made explicit in level 1.

Lastly, we would welcome clarification of how items g), h) and i) of Art 104 (1) relate to the Pillar 2 framework.

Additional own funds requirements

The Commission should clarify in the level 1 text that Pillar 2 requirements can only apply where material risks are not covered by Pillar 1, and that these additional requirements cannot be used to reverse policy choices adopted in the level 1 text. This would include for instance not using P2R to override transitional or grandfathering arrangements, but also Pillar 1 exemptions and exposures subject to a 0% risk weight under the Pillar 1 framework.

[1] This would also be consistent with the EBA's Q&A number 2015_2302 which states that « Competent authorities should not set additional own funds requirements (or other capital measures) where the risk is already covered by the combined buffer requirements and/or additional macro-prudential requirements, e.g. macroeconomic and systemic risks".

A note on own funds requirements for IRRBB

With respect to defining the Pillar 2 requirement risk for Interest Rate Risk in the Banking Book, we would welcome the inclusion of specific wording on when such risk would be considered material: “interest rate risk arising from non-trading activities should only be considered material when the economic value of the institution declines by more than 20% of the institution's own funds as a result of a sudden and unexpected change in interest rates of 200 basis points”.

It is however important that it be clarified in the forthcoming CRD/R that additional requirements can only be imposed when the institution is exposed to risk or elements of risks that **lead to P&L losses.** Risks that create variability, but that do not lead to losses, should not be translated into own funds requirements (although they may create the need for Pillar 2 guidance). Moreover, we believe that the level 1 text should introduce the possibility to use the concepts of Economic Value of Equity and/or Net Interest Income to measure a firm’s IRRBB exposure, consistently with the indicator(s) used for management purposes. Lastly, as there may be the need to specify different interest rate shocks in the future to take into account macroeconomic developments, we recommend that a mandate be given to the EBA to update its IRRBB Guidelines accordingly.

Composition of capital required to meet additional own funds requirements

The current EBA SREP Guidelines requires the additional own funds requirements to be made up of *at least* 56% of CET1 and 75% of Tier 1. We agree this should be elevated into the level 1 text for purposes of legal certainty and harmonisation. However, in order to avoid divergences between institutions subject to different competent authorities, it would also be helpful to clarify in the CRD5 text that this flexibility is afforded to institutions (who can fulfill the requirement by holding more than the minimums specified) rather than to competent authorities (who would otherwise be able to impose requirements being made of for instance 100% CET1).

Development of a methodology for own funds requirements

We do not agree that the Commission should specify a more detailed methodology for P2R in the level 1 text, be it for determining the notion of materiality, how risks should be quantified or proportionality taken into account. This is because the EBA’s SREP Guidelines already cover the principles and methodologies that supervisors should use in this context. Moreover, the particular risks in question were previously not included in Pillar 1 as the determination of the related capital requirements in a uniform, non-institution focused way was deemed inappropriate. While further detail with a view to reaching further harmonisation of the Pillar 2 process may be helpful (for instance in the areas of approaches to materiality or proportionality), this should be done on the basis of the existing EBA Guidelines and be subject to public consultation, not through changes in the level 1 text.

Guidance on additional own funds

As already noted, we agree that the new CRD should define the notion of Pillar 2 guidance and the consequences of breaching it. The CRD should also reflect that, whilst requirements are to be met at all times, guidance is an additional amount of capital estimated necessary over and above the requirements and any breach should not trigger the same intensity of supervisory response to a breach of the requirements.

In this context, it should also be recognised that Pillar 2 guidance is not the only component of the capital framework to cover the results of stress tests (whether these are external or internal to the firm). Indeed, any extreme losses identified under adverse stress test scenarios can already be covered by the combined buffers. In order to avoid double counting, and in particular with the capital conservation buffer, it should be specified in the legislative text that **only when these losses exceed the combined buffers** should additional Pillar 2 guidance be applied.

Joint decisions on institution-specific prudential requirements

We recognise the need for co-operation between consolidating supervisor and supervisors responsible for subsidiaries and note that there is already an established process to arrive at joint decisions on Pillar 2 capital requirements. Bearing in mind potential differences in stress test methodologies between these authorities, we think that the existing process can be built on in the context of Pillar 2 guidance, whereby the consolidating supervisor should reflect on the individual guidance of other competent authorities, but should not be bound by this for the purpose of consolidated requirement, and be required to fully reassess capital guidance at the consolidated level so that risk diversification and mitigation at that level is fully reflected in any capital guidance.

Stacking order of capital layers

There is a need to distinguish between the layering of the various capital requirements and buffers (implying various triggers of supervisory response of different intensity) and the order of available funds allocated to the various layers, alongside the order of loss absorbency. We believe that more work is needed to articulate this into consistent and harmonized rules that reflect these different perspectives so as to provide the necessary clarity for investors.

A first part of this process could be achieved either by clearly describing the stacking order of the different capital requirements and buffers (i.e. as proposed – Pillar 1 – Pillar 2 requirements - combined buffers – Pillar 2 guidance in the capital framework), or by amending each CRDIV article dealing with capital buffers (Art. 129, 130, 131, 133) by including specific reference to Pillar 2 requirements.

Secondly, we would also welcome the specification that buffers "sit on top" of MREL/TLAC requirements[2], however, this should not result in any automatic distribution restrictions as described below.

Restrictions on distributions

The MDA mechanism was not designed with TLAC/MREL in mind and transposing it to fit in with the TLAC/MREL framework will effectively lead to a substantial increase in distribution thresholds that investors do not expect or understand.

Moreover, given that MREL is a gone concern requirement, we do not think that BRRD references should be introduced in the CRD5 MDA framework. We recognise that any breach of TLAC/MREL should be treated seriously, but it should be considered separately from the MDA process to allow flexibility in the remedies applied depending on its cause. For instance, there is a need to distinguish between whether a breach of TLAC/MREL is due to a shortfall in capital instruments (Tier 1) versus fixed term debt instruments, as these forms of breach may have very different causes and effects. Capital instruments are perpetual in nature, and a breach through reduction of Tier 1 capacity will, in most instances reflect the emergence of losses in a given bank, whereas debt instruments with fixed terms are subject to refinancing risk. Market conditions can and do fluctuate rapidly, following economic and/or regulatory stimuli, and it is perfectly feasible that a breach of MREL through the non-renewal of maturing debt may reflect market conditions rather than be a translation

[2] It should be noted that it will also be necessary, as recognised by the EBA in its July 2016 Interim Report on MREL, to lower the calibration of MREL levels to take into account the elimination of double-counting.

of under-performance from a given bank. Supervisory reaction to these differing circumstances must be differentiated.

For these reasons and as further explained in the AFME response to the EBA's interim report on the implementation and design of the MREL framework[3], AFME does not believe that capital buffers should operate in such a way that using part of a buffer to satisfy MREL should automatically trigger MDA restrictions. As such, it is not appropriate for Article 141 of the CRD to be amended to include MREL breaches.

In summary, the **automaticity** of distribution restrictions on dividends and AT1 coupons as a consequence of a breach of MREL/TLAC **is not proportionate and should not be retained**. We note that this has been identified by the EBA as an issue for further consideration in their July 2016 Interim Report on MREL (see page 44).

Preference to AT1 instruments

We would welcome the introduction of a form of preference to coupon distributions on AT1 instruments over dividends in recognition of their hybrid nature. It is necessary that this be introduced into the level 1 text to provide legal certainty. Moreover, the preference should be introduced in the description of the MDA framework, rather than by requiring an amendment of the legal characteristics of CET1 instruments (including those already issued). This is because the latter could indeed open the door to legal dead-ends as most CET1 instruments are common shares whose characteristics are predefined by national company laws.

One way of achieving this could be to specify in Article 141 of the level 1 text the cases where AT1 coupon payments **may be limited or prevented due to the triggering of the MDA restriction**, with the assumption that they are **otherwise always allowed by the competent authorities, including in situations where the institution does not have a current profit** but is able to draw on distributable reserves. This would be reflective of the creditor hierarchy, establishing that restrictions on distributions should impact CET1 instruments first, ahead of AT1 instruments. In other words, AT1 coupon payments should be restricted by the competent authorities only **as a last resort,** that is to say when the distribution threshold is reached and the competent authority is not satisfied that the institution's capital restoration plan will return the firm to the desired capital situation within a reasonable time frame and after all other sources of capital creation or reduction of capital needs have been taken into account in this context[4].

In this context, we also wish to highlight that the EBA recommended a revision of the condition in Article 141 which currently requires that no distributions can take place where no interim profits have been made. We support Art 141 being amended and consider that the approach set out above will achieve this.

[3] Our response can be consulted here

[4] The eligibility criteria set out in CRR Article 52 §1 (l) requiring AT1 distributions to be discretionary on the part of the issuing bank would of course continue to apply.

Disclosure requirements

We are supportive of the disclosure of the Pillar 2 requirement of the capital framework (but not of its constitutive components for each risk element) where an institution issues capital instruments to investors that are external to its corporate group. Such disclosure would in particular allow investors to make an assessment of the possibility of MDA restrictions being applied at future points. We note however that some local authorities (e.g. market authorities) may require the disclosure of Pillar 2 guidance which is likely to create disclosure pressure across the market leading to the same result of unsettled markets as witnessed recently. To avoid such market uncertainty reoccurring, there should be an explicit legal obligation for the types of firms mentioned above to **limit their disclosure to their Pillar 2 requirement**.

Additional comments

Minority interests

When reviewing the CRD/R, we also think that the Commission should provide clarity as to the incorporation of P2R and P2G in the determination of the level minority interests included in consolidated capital. We 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).

Considerations regarding AT1 instruments and the development of the AT1 market

In light of its policy objectives to support the recovery and resolution framework, the Commission should give further consideration to the consequences of the legislative proposals for investors in AT1 instruments. Introducing preferential payment treatment of AT1 instruments over CET1 instruments is a helpful step in the right direction as discussed above.

Other issues to consider which create a lack of transparency and comparability for investors in this market include the effects of the so called Available Distributable Items (ADIs) which rely on the profitability of the parent company expressed in terms of prevailing accounting standards, including national GAAP in some cases, with which investors may be less familiar than IFRS for instance (the reference to individual accounts in CRR Art 4.128 links coupon payments to the profits of the individual entity rather than the Group). Using local GAAP rather than IFRS (which is more widely understood) increases the lack of transparency and distorts competition globally.

Transparency and comparability could therefore be enhanced by basing the definition of distributable items in relation to coupon payments on debt instruments on IFRS Group accounts. This would be in line with Basel III, which does not require a link to individual level accounts.

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About AFME

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