

CRD IV

4 May 2012

Holdings of Own Shares and Shares of Other Financial Institutions

There are inconsistencies in CRD IV regarding the treatment of holdings of own shares as compared to holdings of shares in other financial institutions. There is no reason to treat own shares differently from shares of other financial institutions for the purpose of the deductions addressed by CRD IV Regulation (CRR). AFME is proposing that the “no counterparty risk” limitation is removed, that netting of direct positions in own shares with indirect positions taken through indices should be allowed, and that the maturity restriction for shares of other financial institutions be removed.

Holdings of Own Shares

CRR Article 39 which relates to own shares, should be aligned with Article 42, which relates to other financial shares. Equivalent changes should also be made for Articles 54 and 64, to align with Articles 56 and 66.

The first change proposed is to remove the restrictions that only allow netting of positions and looking through indices for trading book exposures. This restriction should be removed in order to align with Basel III, which explicitly allows netting of positions and looking through indices for the banking book also. AFME welcomes the changes made to give effect to this in the Danish Presidency text.

The second change proposed is to remove the ‘no counterparty risk’ requirement for short positions. The BCBS has already acknowledged that such limitation is unfounded: it repelled its original suggestion to restrict the netting of positions in financial institutions other than the issuer when the short positions involve counterparty risk. The Commission proposal itself authorises the netting of long and short positions in own shares when such positions are taken through indices, even when they include counterparty risk. Limiting the scope of netting for other positions in own shares would have no prudential basis and would result in the issuing bank computing artificially inflated net long positions, and hence deducting excessive amounts from its capital base to the detriment of client activities. Banks carry positions in own shares to service client demand; for example when they are part of a major stock index (e.g. Euro Stoxx 50, CAC 40, DAX 30, FTSE 100, etc.) and also sell capital protected investment products to retail or other risk adverse investors, or when they provide pension funds, insurers or other clients with risk-reducing solutions. The current wording would make European banks uncompetitive in these products.

No reason has been provided for not aligning treatment for own shares with treatment for shares of other financial institutions. In both cases there is no reason for disregarding short positions if they entail counterparty risk as such counterparty risk is already covered by existing regulation, and the Commission proposal contains provisions increasing capital required for this risk. Such provisions relate specifically to ‘wrong-way risk’, for situations where the probability of default of the counterparty is correlated with the exposure. Therefore, even in cases where the short exposure is provided to the issuing bank by another financial institution, which could be more likely to default in situations where the issuing bank would be under stress, counterparty risk is properly reflected under the Commission proposal.

The third change proposed is to allow netting of direct and indirect positions taken through indices. Netting direct positions in own shares with indirect positions taken through indices is necessary to allow consistent

risk management. As an example, an institution which has sold an investment product providing its clients with an exposure on a given stock index will typically hedge itself on the components of the index, including its own shares. In such a situation, the institution will have no net exposure on its own shares. This has always been the position of the BCBS, which reaffirmed it in the December 2011 Capital FAQ (BCBS 211, paragraphs 78 – 89, question 16, specifically referring to paragraphs 80-84). The current wording, however, could be interpreted as disallowing netting of indirect positions taken through indices against direct positions in own shares. Such a restriction would have no rationale and does not apply to shares of other financial institutions. There would be no ground to such a difference, which would also prevent European banks from providing standard hedging and investment solutions to their wholesale and retail clients. AFME welcomes positive changes to deal with this issue in Article 71(0) of the Danish Presidency text.

Holdings of Shares of Other Financial Institutions

CRR Article 42, which relates to holdings of other financial shares, should be amended to ensure that gross long equity positions are eligible for netting with short derivative positions and that there is no maturity restriction for short positions. Equivalent changes should also be made for Articles 56 and 66.

The first change proposed is to remove the restrictions that only allow netting of positions and looking through indices for trading book exposures. This restriction should be removed in order to align with Basel III, which explicitly allows netting of positions and looking through indices for the banking book also. AFME welcomes the changes made to give effect to this in the Danish Presidency text.

The second change proposed is to remove the restriction on netting requiring the maturity of the short position to match the maturity of the long position or have a residual maturity of at least one year. This is not practical as some exposures, such as cash equities, do not have a maturity. This requirement appears also to effectively disallow the hedging of a short derivative position with a long position in shares (again, since the latter will usually have no maturity). AFME welcomes positive changes in Article 70a of the Danish Presidency text, which go in the right direction and represent an improvement compared to the original Commission proposals.