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Association for Financial Markets in Europe

AFME Position Paper

CRR2 Own Funds: Minority Interests and Resolution

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Introduction

This paper sets out areas of the draft CRR2 amendments related to own funds which require attention, in particular:

- the need for clarity in the calculation of minority interests to be included in consolidated CET 1 capital;
- prudential filters for unrealised gains and losses; and
- own funds issues related to resolution aspects of the EU Risk Reduction Measures package.

Clarity will aid in consistent application of provisions in relation to minority interests, with our recommendations seeking to enhance the internal coherence of the relevant CRR articles.

Prudential filters for unrealised gains and losses should remain unchanged in the CRR to retain alignment with Basel standards.

In relation to resolution aspects of the own funds provisions, we regard it as essential that the EU legislators introduce as a matter of priority transitional grandfathering arrangements ensuring the continued eligibility of issuances made prior to the new eligibility criteria under articles 72b (MREL), 52 (Additional Tier 1) and 63 (Tier 2) CRR coming into force, and communicate this clearly to the public and the markets. This is necessary to provide clarity for banks on their current shortfall and enable them to continue issuance over the next months without uncertainty as to whether further issuances will ultimately be eligible.

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.). We therefore believe that it is appropriate that both P2R and P2G (or the equivalent in non-EU countries) 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):* It is our understanding that the modification to Article 81(1), which states that 'Minority interests shall comprise the sum of "Common Equity Tier 1 capital' is being made with a view to clarify that all positive items that are eligible to be included in the definition of 'Common Equity Tier 1 capital" are indeed also allowed to be included where relating to a subsidiary. Specifically minority interests should therefore no longer exclude AOCI as is currently the case, and as also confirmed by the EBA in its published Q&A. Whilst this is a welcome change, for the purposes of clarity, we believe a further technical amendment is needed to make reference to 'Common Equity Tier 1 items' for consistency with Article 26[1], so as to ensure that this is not misinterpreted as minority interests net of prudential filters and deductions as per the definition of Common Equity Tier 1 capital in Article 50.

iv) *Third Country Equivalence:* Instruments issued from third country subsidiaries should qualify as minority interests in cases where the third country applies prudential supervisory and regulatory requirements at least equivalent to those applied in the Union.

The Commission may adopt, by way of implementing acts, a decision as to whether a third country applies prudential supervisory and regulatory requirements at least equivalent to those applied in the Union. In the absence of such a decision, regulatory equivalence assessments already conducted by the Basel Committee, other international bodies (FSI) and national competent authorities should temporarily be accepted.

v) *Non-bank institutions in the EU:* Instruments issued from non-bank subsidiaries which meet certain criteria[2] within a banking consolidation group in the EU should qualify as minority interests. The loss absorbing capacity of such instruments is consistent with instruments issued out of banking subsidiaries of the same group with similar characteristics. As such, the instruments should be recognised on the same basis as instruments issued out of banking subsidiaries that qualify as minority interests.

Own funds issues related to Resolution aspects of the EU Risk Reduction Measures Package

The items noted below are own funds related issues that have implications from a resolution perspective which we believe require attention:

External MREL - Transitional arrangements

The proposals make significant changes to the eligibility criteria for eligible liabilities and also introduce new criteria for Additional Tier 1 and Tier 2 capital instruments[3]. It is essential that transitional arrangements are provided to grandfather issuances prior to the new legislation coming into force. A significant volume of liabilities has been issued over the past 12-18 months, with a view to meet the ambitious 1 January 2019 target. These existing liabilities do not comply with the proposed new criteria in their entirety (e.g. restrictions on acceleration, contractual recognition requirements and set-off arrangements) and absent transitional provisions MREL shortfalls would increase very significantly.

It is also essential that banks have clarity that planned issuances prior to the finalisation of the legislation will be eligible in order for them to proceed with issuances over the next year. The importance of a transitional period has been acknowledged by the EBA[4] and a number of European resolution authorities. The US has provided for grandfathering of liabilities issued prior

[1]Common Equity Tier 1 items constitute those items listed in Article 21(1), including the recognition of interim or year-end profits as part of retained earnings for the purposes of point (c) of Article 21(1), in line with the provisions set out in Article 21(2).

[2]Qualifying criteria for minority interests of a non-banking subsidiary to be recognised would be that it is subject to regulation and capital requirements.

[3]Articles 52(p), (q) and 63(o), (n) CRR

[4]See EBA Final Report on MREL, 14 December 2016, at p.22

to its Final Rule and the EU should also adopt this approach and signal clearly that there will be grandfathering for liabilities issued prior to entry into application of the new requirements.

In light of the short time frame to meet the minimum requirements by 1 January 2019 it is critical that banks have clarity on their shortfall and are able to proceed with issuances to increase their loss absorbing capacity prior to finalisation of the legislation. Early clarity on grandfathering is therefore necessary to support this objective.

External MREL - Eligibility criteria

It is important to note however, that transitional provisions would not resolve a number of important concerns with the proposals where we strongly believe changes are required. These include:

a) **Restrictions on acceleration rights:** the proposed restriction on acceleration rights[5] goes beyond the TLAC Standard and could unnecessarily hamper the market for debt which is eligible to satisfy MREL requirements, making it more difficult and more expensive for banks to issue such debt. Standard acceleration rights such as upon non-payment of principal and interest should be permitted. This is necessary to introduce a clear distinction between regulatory capital and eligible liabilities. Specifically, senior debt investors invest in securities with lower coupons than capital securities due to their relative position in the creditor hierarchy. However senior debt issued by banks offer no covenants to protect senior investors' rights. As a result, investors take comfort from the fact that they can accelerate payment under normal circumstances in the event that a bank withholds payment. If this acceleration right is withdrawn then the senior investors will be left with the same acceleration right as that enjoyed by investors in capital securities and it unclear whether they will accept lower coupons for similar risks.

   This is important for both external and internal MREL as in addition to the impact on the market, the proposal also increases the risk that debt instruments would be viewed as equity rather than debt for taxation purposes. This could impact the tax deductibility of interest payments and have a material impact on the cost of issuing both external and internal MREL. Should the co-legislators determine that acceleration rights should be restricted, we would strongly urge them to consider a rule which allows acceleration for non-payment subject to a 30-day cure period, in line with the approach taken in the final US TLAC rules.

   It is worth noting that powers under the BRRD allow the resolution authority to essentially over-ride the terms of existing liabilities if an entity enters resolution. The law therefore gives the resolving authority the power to over-ride the acceleration provisions noted above. The presence of such safeguards is also accepted by the FSB, as explicitly addressed in the FSB Key Attributes[6] which explicitly recognises that should contractual acceleration or early termination rights be exercisable, the resolution authority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers.

b) **Contractual recognition of bail-in**: the requirement to include contractual provisions for the recognition of bail-in[7] should be deleted or at the very least limited to liabilities

[5] Article 72b(2)(m) CRR
[6] See section 4 of FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions

[7] Article 72b(2)(o) CRR

governed by the law of a third country and aligned with the requirements of article 55 BRRD. There should be no such requirement for liabilities governed by EU law as this would be inconsistent with the statutory bail-in power already in place under the BRRD and could create confusion in the market and legal uncertainty as to whether the bail-in would be implemented under statute or contract. It would also create a substantial burden on firms to comply with no corresponding benefit.

It is important to note that the contractual requirement contrasts with the specified features included in the CRR2 for Additional Tier 1 and Tier 2 capital instruments, whereby statutory as well as contractual bail-in is envisaged, which would result in inconsistent provisions amongst the various instruments.

c) **Subordination requirements**: As drafted the proposals require instruments to be structurally subordinated as well as either contractually or statutorily. This appears to be contrary to the legislative intention and the TLAC Standard. It should be clarified that all three routes to subordination should be equally permissible and respected. The requirement under article 72b(2)(e) should be moved to a new 72b(2)(d)(iii) to correct this.

With the introduction of the concepts of resolution entity and resolution group, it is important that the legislation is neutral with regard to different methods of achieving subordination and it should be possible to make use of the 3.5% RWAs exemption from subordination for groups utilising structural subordination as well as those utilising contractual or statutory subordination to ensure a level playing field.

Internal MREL - Eligibility criteria

Several of the eligibility criteria in article 72b are inappropriate for internal MREL. Article 72b(2)(b) and (c) (restrictions on issuance within a resolution group) and the requirements in article 72b(3)-(5) should not apply to internal MREL. This might require separate eligibility criteria for "internal MREL" to be defined (under a separate article).

As discussed above, the restriction on acceleration rights[8] should be removed and should not apply to internal MREL due to the risk of recharacterization as equity for tax purposes which would impact the tax deductibility of interest payments on internal MREL and, in certain circumstances, the treatment of repayments of principal. This could negatively affect financial results and have a material impact on the cost of compliance, resulting in a material impact on the cost of issuing internal MREL. Standard acceleration rights, such as upon non-payment of principal and interest, should be permitted for internal MREL. These acceleration rights do not present a risk to the effectiveness of internal MREL passing losses from an operating entity to a resolution entity and do not present a risk to recapitalisation. Should an entity reach the point that it has triggered an acceleration clause due to non-payment, it is highly likely that it would be in distress and that its parent would need to recapitalise the entity in order the preserve the franchise value and to execute the resolution strategy.

The requirement for contractual recognition of bail-in under article 72b(2)(o) is also inappropriate for internal MREL for the same reasons as external MREL discussed above.

Should the co-legislators determine that acceleration rights should be restricted, we would strongly urge them to consider a rule which allows acceleration for non-payment subject to a 30-day cure period, in line with the approach taken in the final US TLAC rules.

[8] Article 72b(2)(l) CRR

Treatment of MREL holdings

We support the proposed approach to the deduction of TLAC holdings from Pillar 1 MREL which takes due account of the application of the MREL framework to all institutions. It should be clarified whether deductions are intended only to be applied to resolution entities of GSIIs.

We believe that a change to the proposal should be made by deleting article 72j(3) to permit trading book holdings which cease to meet the conditions set out in article 72j CRR to be included in the exceptions set out in articles 72h and 72i. There does not appear to be a good rationale for this restriction given such restrictions do not currently apply for holdings of regulatory capital instruments and, furthermore, this restriction may make the use of such exemption unusable in practice.

Additionally, we believe that additional clarity is needed as to how the deductions are to be made, namely:

a) what in practice is meant by 'gross long position';
b) how the 30-day holding is intended to work due to rolling trading book positions;
c) whether holdings in own instruments could benefit from the threshold under 72j;
d) how the corresponding deduction approach is to operate in practice given the deduction articles for own funds were not amended; and
e) consistency of netting rules for calculation of own funds and MREL liabilities.

In order for banks to be able to assess the level of holdings of other GSIIs' Pillar 1 MREL, they require clarity as to whether instruments they may be holding are eligible liabilities. The timing of the introduction of the deduction should therefore be linked with the timing of relevant disclosure requirements.

Redemption restrictions

We do not believe that it is necessary or proportionate for regulatory approval to be sought for every redemption of MREL-eligible instruments where the institution retains sufficient eligible liabilities to meet its requirements. We support the EBA's recommendation that a redemption approval regime should be introduced for eligible liabilities but should be limited to require approval where the proposed redemption would lead to a breach of its MREL requirement.[9] This approach is also consistent with the TLAC Standard. The proposed extension of the capital regime for supervisory permission to eligible liabilities in article 78 CRR should be amended to limit the requirement for permission to these circumstances.

As recommended by the EBA, this more limited supervisory permission requirement could be supported by providing resolution authorities with the express power to monitor the maturity profile of eligible liabilities and to request institutions to modify the maturity profile of its eligible liabilities where this constitutes an impediment to the resolvability of the institution.

This approach would provide banks with greater flexibility to manage their issuances and facilitate the ability of banks to be market-makers in their own eligible instruments, which is important to support a liquid market. It would also be more manageable for the authorities given the volumes involved, while ensuring that resolution authorities maintain oversight of the maturity profile of eligible liabilities.

[9] Recommendation 5, EBA Report on the Implementation and Design of the MREL Framework, 14 December 2016.

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