AFME Position Paper

CRD5: Pillar 2 and the MDA Framework

May 2018

Introduction

AFME is supportive of many of the proposed changes to the CRD to ensure that the Pillar 2 framework and associated supervisory powers are clarified and consistently applied throughout Europe.

In particular, we welcome:

- The distinction that has been made between Pillar 2 requirements on the one hand and Pillar 2 guidance on the other, and the associated clarification of the stacking order of the various capital requirements and buffers, as well as how these relate to the Maximum Distributable Amount (MDA) framework.
- The clarifications that Pillar 2 requirements must not address macro-prudential risks as this avoids duplication with the capital already required to be held for this purpose through other requirements of the prudential framework (such as the systemic risk and countercyclical buffer and macro-prudential tools). Moreover, the clarification that Pillar 2 shall not be used to address risks where the CRR has granted a transitional treatment or that are subject to grandfathering provisions is also welcome.
- The introduction of the preference for AT1 coupon payments over dividends and variable remuneration once the MDA framework is triggered as this will provide the market with much needed certainty on these instruments.

The rest of this paper therefore mainly focuses on issues we feel remain with the proposals for Pillar 2 as currently drafted. We provide suggestions for amendments to the text in these areas.

Pillar 2 Requirements (P2R)

P2R should not be used to override policy decisions made by the legislator

We agree that P2R must be firm specific. As already noted above, we also welcome the clarification that P2R addresses the micro-prudential perspective, whereas it shall not be used to address areas where transitional treatment or grandfathering provisions have been granted. We nevertheless feel that an additional clarification of Art 104a (2) is necessary to ensure that it is clear this principle equally prevails in other circumstances so that policy choices established by the co-legislators in Pillar 1, such as certain exposures that receive a 0% risk weight treatment or are that are explicitly exempted from Pillar 1 requirements, cannot be reversed by the imposition of an associated P2R.

Further clarification necessary to avoid double counting of risks in P2R

We agree with the approach taken that the design of the SREP should not necessarily be to result in an automatic P2R add-on if this is not warranted, but that it is rather to determine the appropriate overall level of own funds to ensure that the institution guarantees the sound management and coverage of all its risks. We think that this is well expressed in Art 104a §3 but are concerned that there is still potential for double counting some of the risks already covered by the combined buffers. We therefore recommend that it be clarified in Art 104a §3 that these risks should not be included in P2R.

Composition of P2R

P2R risks should be met with the same quality of capital as required to meet Pillar 1 risks and should therefore follow the minimum ratio requirements set under CRR Article 92 (for CET1, Tier 1 and Total Capital). The makeup of P2R capital should not vary upon discretion of individual competent authorities as this leads to an unlevel playing field. In this context, it would be helpful to clarify that institutions have the flexibility to hold more than the minima specified (as opposed to competent authorities being able impose requirements made up 100% CET1 for instance).

Harmonisation of the SREP methodology

Harmonisation of the SREP methodology throughout the EU is very much welcome, and we support further refinement of the EBA's SREP Guidelines as required. The Commission proposal for an EBA mandate to develop an RTS would however appear to be better suited to defining Pillar 1 requirements rather than a supervisory methodology resulting in institution-specific decisions. We therefore recommend that this mandate be removed from the text.

Disclosure of P2R

Where an institution issues capital instruments to investors that are external to its corporate group, we are supportive of the disclosure of the *total P2R* (i.e. not broken down into constitutive parts for each risk element). Indeed, disclosure of the total level of P2R allows investors to make an assessment of the possibility of MDA restrictions being applied at future points. We believe it is premature at this stage to mandate disclosure of the individual Pillar 2 requirement components given the Pillar 2 methodologies and practices amongst the supervisory community within the EU have not yet reached a stable status and are not yet fully transparent. Institutions' disclosures should also go hand-in-hand with supervisory disclosure on the Pillar 2 framework. We are however supportive of disclosing the composition of P2R in terms of the types of instruments (CET1, AT1, T2) held for this requirement. Article 438 of the CRR should be amended to ensure this is clear.

Pillar 2 Guidance (P2G)

The legal text needs to be clarified to appropriately reflect the risks covered by P2G

While we welcome the clarity provided in the explanatory memorandum that P2R does not cover macro prudential risks, Article 104b (new) describes own funds guidance as being capital that must be held above Pillar 1 + P2R i) to avoid cyclical economic fluctuations leading to a breach of these requirements and ii) to ensure that stress test losses can be absorbed without breaching Pillar 1 + P2R. We have two concerns with the this as we consider that as proposed the text will lead to the double counting of risk:

i) Given that extreme losses under adverse stress test scenarios are already covered at least in part by the combined buffers, the text should be clarified so that it is *only* when these stressed losses (whether based on internal or external stress tests) *exceed* the combined buffers that a P2G component should be applied.
ii) Macro-prudential risks such as "cyclical economic fluctuations" should not be included in P2G. They are already taken into account through other tools, such as the macro-prudential tools in CRR

Art 458. Moreover, maintaining this is contradictory to the general approach taken in the CRD5 proposal that that the SREP and Pillar 2 purely cover micro-prudential risks

Moreover, the current drafting of Article 104b §1 is confusing as it does not clearly distinguish between a firm's own assessment (and their internal stress test obligations) under the ICAAP on the one hand and the P2G component which is a result of the SREP on the other.

P2G should be clearly classified as not constituting an "Inside or Material Non-public Information" under the Market Abuse Regulation

As mentioned above we are supportive of disclosure of the total P2R. On the other hand, the P2G component is not relevant in determining the price of securities issued by firms and does not result in any automatic MDA trigger (which would indeed be market relevant information). While the CRD5 does not propose that this be disclosed, we are concerned that certain individual authorities might require its disclosure. This could create disclosure pressure across the market leading to the same result of unsettled markets as witnessed last year. Moreover, we consider it is important to maintain the level of the P2G component confidential between the institution and its competent authority as P2G is strictly linked only to those risks not covered elsewhere and is non-binding in nature.

To avoid future market uncertainty reoccurring, we suggest that the CRD5 clarify that P2G is not an "Inside or Material Non-public Information" as defined in Article 7 (1-4) of Regulation (EU) No 596/2014[1].

Consequential amendments to reflect the new approach to P2 are necessary, for instance to ensure that both P2R and P2G are reflected in minority interest calculations

The wording of CRR Article 84 1(a) should be clarified to ensure that both components of Pillar 2 are reflected in the surplus capital calculation for the amount of determining minority interests to be included in consolidated CET1 capital. Similar adjustments should be made to CRR Art 85 1(a) and CRR Art 87.

A note on interest rate risk in the banking book

Finally, we have some concerns on the Commission's proposals to implement the revised Basel IRRBB framework (CRD Art 84 & 98). In particular, we think that the approach adopted is too prescriptive in cases of breaches of the outlier test. The outlier test was designed to be a single metric by which to compare firms. However, this can only serve as a starting point for a more detailed supervisory assessment which must take firm specificities into account. Therefore, and in keeping with the philosophy of the Basel IRRBB standard, it should be made clear in the level 1 text that a breach of the outlier test does not lead to automatic capital consequences.

The MDA framework

Preference to AT1 coupon distributions

We are supportive of the introduction of the preference of AT1 coupon distributions over other types of distributions once the MDA framework has been triggered in Art 141 §3 as this appropriately reflects their

[1] An inside information is an information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial Instruments

hybrid nature and the creditor hierarchy. The provision will provide both banks and the market with much needed legal certainty on these instruments.

We nevertheless invite further reflection to ensure that this provision does not contradict with other provisions of the CRD/R framework, such as Articles 52 and 53 of the CRR, and to avoid any unintended impacts on current AT1 instruments or potential conflicts with 3rd country legal requirements.

Use of distributable reserves

We are also supportive of firms being able to make use of their reserves, in addition to current profit amounts (which could be zero), for the purpose of making payments once the MDA has been triggered within a limited number of conditions as set out below:

A note on the consequences of a TLAC/MREL breach and interaction with the MDA framework

A breach of TLAC/MREL should be taken seriously by the authorities. However, the response of the A breach of MREL should be taken seriously by the authorities. However, the response of the supervisory and resolution authorities should be tailored to address the cause of the breach in the circumstances. It would be inappropriate for Maximum Distributable Amount (MDA) restrictions to be automatically imposed by virtue of a bank using its combined buffer solely as a result of CET1 being used to meet a temporary MREL shortfall. This could occur, for example, due to a temporary debt refinancing issue rather than the bank facing any immediate solvency issues and would result in a substantially higher threshold at which MDA could apply, and – as importantly – generate considerable potentially destabilising uncertainty as to the threshold at which MDA will apply.

We believe that MDA restrictions should not be automatically triggered by a breach of the combined buffer which occurs only due to insufficient MREL. This approach of disconnecting MDA from MREL, which has been adopted by the Bank of England, is preferable to a grace period because it would still allow the regulator to require the necessary actions to be undertaken by banks whilst avoiding the triggering of the rigid MDA restrictions designed and calibrated for the 'going concern' solvency framework. Furthermore, the market would likely react immediately regardless of the grace period.

More information on views regarding TLAC/MREL and the MDA framework can be found here in AFME's "Recommendations for effective implementation of TLAC, MREL and related reforms".

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