AFME Position Paper

Level of application of the CRR capital & liquidity requirements and the treatment of intragroup exposures

May 2018

Objective of this paper

This paper provides AFME's views on the Commission's proposals to:

- extend the waiver to solo level application of the CRR's capital requirements beyond a single Member State through its proposals to modify **Article 7** of the CRR and
- modify the existing waiver for a liquidity sub-group spread across several Member States through its proposed changes to **Article 8**.

We also take this opportunity to set out our views on the treatment of intragroup exposures throughout the framework. Absent more fundamental changes to the level of application of the CRR requirements in the short term, the intragroup framework should be improved as a matter of priority to reduce unnecessary constraints on cross-border flows of capital and liquidity.

Introduction

AFME welcomes the Commission's proposals to amend Article 7 and 8 of the CRR as we understand them to have been made in the context of affording recognition to "substantially reinforced group supervision" thanks to the creation of the SSM[1], while simultaneously attempting to balance concerns of host Member States regarding the completion of Banking Union.

It is important to recall that there are significant, recognised economic benefits to removing obstacles to the free flow of funds. In particular, the efficient internal capital allocation within banks allows resources to flow to where they are most in demand from businesses and households. The free flow of capital and liquidity also enables integrated, open, competitive and efficient financial markets and services. It allows European companies and sponsors of infrastructure projects of all sizes to raise money where it is cheapest, matches investors with investment opportunities and enables financial institutions to extend credit where it is most needed. Ultimately, efficient capital allocation provides a foundation for sustainable economic growth in the EU and helps ensure continued funding of the real economy through cyclical downturns[2] thus contributing to the greater resiliency of the banking sector in general.

In AFME's view, there are substantial benefits to the EU economy for recognising in the EU prudential framework the clear improvements in financial stability safeguards that have been made, including the significant financial reform agenda designed to decrease the likelihood of bank failure, the creation of the Single Supervisory Mechanism together with a Single Resolution Board and the implementation of a European recovery and resolution framework. The latter ensures that if a bank does fail, its resolution will be orderly because it conveys extensive powers to Resolution Authorities. These wide-ranging tools at the disposal of Resolution Authorities are there to ensure notably that any losses in the case of failure will be borne by shareholders and creditors, rather than national taxpayers.

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[1] See explanatory memo of the CRR proposals

[2] There is empirical evidence to suggest that cross-border intra-bank funding is less volatile than inter-bank funding; see for example Reinhart and Riddough (2014).

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Taken together, the developments of the SSM, SRM, SRB and EU recovery and resolution framework have rendered national arguments for ring-fencing capital and liquidity much less persuasive than they were before and during the crisis. Finally, we note that the ECB supports the Commission's "proposal to grant capital waivers within a banking group on an EU cross-border basis, and not only locally, as is the case now. This will allow a more efficient management of capital across the EU. [They] are convinced that the banking union and progress made in financial integration allow the granting of these waivers inside the SSM without creating additional risk to financial stability."[3]

Our views and proposals below are aimed at reducing fragmentation and harmonising the capital and liquidity frameworks across the EU.

Amended Article 7

Under the current CRR capital waivers can be granted where a parent and subsidiary are located in the same Member State, subject to certain conditions being met. These are set out in Article 7(1) and include the requirement that that funds be adequately distributable between the parent and subsidiary, that the parent's risk evaluation, measurement and control procedures cover the subsidiary and that the parent guarantees the commitments entered into by the subsidiary (or that the risks of the subsidiary are of negligible interest) [4].

As proposed, the amendment to Article 7 has introduced the possibility of cross-border waivers and therefore no longer requiring solo application of the CRR requirements to subsidiaries that are part of group with a head office in a different Member State. However, the existing requirements for applying the waiver within the same Member State are reinforced by additional requirements that the subsidiary's own funds must be guaranteed by the parent, and that the guarantee must be collateralised for at least 50% of its amount when the waiver occurs in a cross-border situation. The cross-border waiver proposal is at the discretion of the relevant Competent Authority even if this condition is fulfilled.

AFME views

1) In the context of building a single rule book, if the conditions are fulfilled (to the satisfaction of the Competent Authority), the treatment should apply as a matter of course, particularly within the Banking Union. The discretionary regime results in more fragmentation across Member States and has been recognised as an issue by the European Parliament in their report on the Banking Union, where it is stated that "national options and discretions may hinder the creation of a level playing field between Member States."
2) While we welcome the fact that the conditions required to waive the CRR solo application are mostly the same as those applicable to subsidiaries incorporated in the same Member State as the head office, we do not understand why an additional collateral requirement applies when a subsidiary is located in a different Member State. The collateral requirement is counterintuitive as it may prevent the optimal allocation of funding within a group in the case of difficulties.

[3] Introductory statement of Danièle Nouy, Chair of the ECB Supervisory Board, ECON hearing, 25 April 2017

[4] As a reminder, the list of conditions is Art 7(1), is as follows:
(a) there is no current or expected material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities by the parent undertaking to the subsidiary;
(b) either the parent undertaking satisfies the competent authority regarding the prudent management of the subsidiary and has declared, with the permission of the competent authority, that it guarantees the commitments entered into by the subsidiary, or the risks in the subsidiary are of negligible interest;
(c) the risk evaluation, measurement and control procedures of the parent undertaking cover the subsidiary;
(d) the parent undertaking holds more than 50 % of the voting rights attached to shares in the capital of the subsidiary or has the right to appoint or remove a majority of the members of the management body of the subsidiary.

3) Furthermore, the collateral requirement is a static measure, whereas the capital requirement can be dynamic (i.e. can increase or decrease depending on whether the subsidiary is e.g. in a growth or restructuring phase). Hence the collateral could prove to be difficult to manage from an operational point of view and may well result in over-collateralisation in practice.
4) The collateralisation requirement may be extremely onerous given that the types of unencumbered assets required may not be readily available for this purpose; as such cross-border firms may be unlikely to be able to fulfil the requirement.
5) Finally, it is not clear what the expected collateral haircuts are (Art 7 para 2.b condition v)

Under the current CRR, where waivers have not been granted, some institutions' subsidiaries are *de facto* covered by 3 or more levels of capital requirements (and the associated regulatory reporting requirements): group consolidated level, sub-consolidated levels and individual level. The relevance, the proportionality of this approach, more especially for subsidiaries located in Eurozone countries and hence all having the ECB as their Competent Authority within the SSM, appears particularly unwarranted if all the conditions listed in Article 7(1) are fulfilled.

AFME recommendation 1

AFME's recommendation is that the CRR be adapted to support the full implementation of the SSM by removing the current Member State dimension in the existing CRR and without introducing the collateralisation requirements that are put forward in the CRR2 proposals.

This could be achieved by amending Article 7 of the CRR so that banking groups are granted cross-border capital waivers for their Banking Union subsidiaries if the current conditions provided in Article 7 are fulfilled.

While these waivers should apply to entities within the Banking Union as a matter of routine (i.e. without a discretionary component if the relevant conditions are fulfilled), we consider that similar waivers should also be made available (possibly on a discretionary basis) to banking groups operating across the European Union more generally in recognition of the EU Single Market.

Acknowledging that no amendments in relation to capital waivers have been tabled thus far however and that this should not hold up the present package, we recommend that the Parliament consider a fall-back solution of retaining the current CRR text of Article 7, with a mandate for the EBA to conduct an analysis of cross-border waivers within a short time frame, and on the basis of which the EC could present further legislative proposals in the future.

Note on the leverage ratio – application at consolidated level is most appropriate

The purpose of the leverage ratio is to restrict the build-up of leverage in the banking sector, and to reinforce risk-based requirements with a simple backstop measure. Given that leverage requirements will always apply at the consolidated level, it is not necessary to apply leverage requirements to individual entities to restrict the build-up of leverage in the banking sector as whole. Exposures within groups cannot contribute to the sector's aggregate leverage versus the real economy or other parts of the financial sector. Moreover, individual level requirements do not serve as a backstop to individual banking groups' leverage positions. Instead, because they in aggregate may exceed an individual group's consolidated leverage requirement, they have the potential to result in leverage requirements becoming the economically binding requirement even where they are not the binding requirement at consolidated level. This means that they do not serve as backstop.

The leverage ratio would therefore ideally apply only at the consolidated level. It is therefore important that the issue of the waivers provided for in Article 7 also be considered in terms of its implications for the leverage ratio and the extent to which is becomes the dominant binding constraint for the system.

Amended Article 8

Under the current CRR, waivers can be granted where the parent and the subsidiary are located in the same Member State, subject to certain conditions in Art 8(1) being met, thereby creating a liquidity sub-group. The liquidity requirements under Part Six of the CRR are then applied to the liquidity sub-group. The current CRR also allows for waivers of solo application and the supervision of institutions of a single liquidity sub-group authorised in several Member States following the procedure set out in Article 21 (joint decisions on the level of application of liquidity requirements).

We understand that the intention of the amended Article 8 is to provide greater flexibility to the SSM with respect to the application of liquidity requirements at the liquidity sub-group level across borders. As such, the Commission has introduced the possibility for the SSM to apply liquidity requirements at the level of the liquidity subgroup without having to follow the joint decision procedure set out in Article 21. However, this possibility is accompanied by the additional requirement that the parent undertaking must provide a full guarantee of the net liquidity outflows of the institution or group of institutions benefitting from the waiver, which must be fully collateralised for at least 50%.

As a reminder, net liquidity outflows are defined in the Liquidity Coverage Ratio (LCR) as the difference between the weighted liquidity outflows and weighted liquidity inflows. This is the denominator in the LCR calculation. High quality liquid assets, which are available to cover the net liquidity outflow, make up the numerator of the LCR.

AFME views

1) Similarly to our views on Article 7, liquidity waivers should be afforded on a non- discretionary basis if the relevant existing conditions are fulfilled.
2) Compared to the existing CRR, the proposal introduces a more stringent approach for firms operating within the Banking Union where a cross-border liquidity sub-group can be created without the need to provide a collateralised guaranteed. The proposal would also introduce stricter requirements within the Banking Union than under the proposed Art 8(2) which would apply outside the Banking Union without the collateralised guarantee requirement.
3) It is not clear why a 50% collateralisation level is proposed or why the collateralised guarantee applies to the net liquidity outflows rather than the actual liquidity shortfall, which would correspond to the net liquidity outflows that are not covered by high quality liquid assets. As currently drafted, the proposed collateralisation would represent a double counting of liquidity risk.
4) Assuming institutions are able to put the required collateralised guarantee in place, they are in practice likely to come up against other restrictions to cross-border flows created by the CRR, for instance in the form of limits to intragroup exposures.

AFME recommendation 2

As with the waivers in Article 7, groups meeting the requirements detailed in Article 8 should be granted a waiver on an automatic basis within the Banking Union. Ideally, this would apply to groups within the wider EU too and Competent Authorities should not be able to apply stricter requirements than those that already exist. In other words, the scope of the liquidity requirements (LCR and NSFR) should be on a consolidated basis within the Banking Union when the relevant conditions are fulfilled, with similar waivers being made available, possibly on a discretionary basis, to banking groups operating across the European Union.

The consolidated application of the NSFR (i.e. at group or Banking Union subgroup level) is particularly important for centralised groups because, contrary to short term liquidity requirements (which are subject to the LCR), medium to long term funding is issued and managed centrally.

Therefore, while we fundamentally think that both the LCR and NSFR should both be applied at consolidated level without additional conditions such as collateralised guarantees, if the collateralised guarantee requirement is to remain, it should only be considered in the context of the LCR. In order to function appropriately, the requirement should also be modified as follows:

- When calculating the guarantee amount, the amount of high quality liquid assets held by the entity benefitting from the guarantee should be deducted from the net liquidity outflow amount so that it is the liquidity shortfall that is covered by the guarantee. Entities should not be required to provide a guarantee to cover liquid assets which would be available in the event of a liquidity stress. This could dissuade entities from holding any additional liquid assets in an entity within the liquidity sub-group. The guarantee amount should be recalibrated periodically
- The high quality liquid assets which are used to collateralise the a guarantee should not be considered as encumbered for the consolidated liquidity sub-group calculations, as these are available to cover the net liquidity outflows of the subsidiary included in the consolidated calculation.

Moreover, we note that guarantees are also considered in the context of the proposals for internal MREL under the BRRD, in addition to guarantees for the liquidity waivers. Collateral held against these guarantees should be fungible when held for the same entity, as these would likely be triggered at the same point, that is when an entity is unable to pay its debts.

However, noting that there is limited appetite amongst the Council or Parliament for granting waivers on an automatic basis within the Banking Union, as a fall back, we propose that the approach under the current CRR that allows for cross-border liquidity sub-groups when a number of strict conditions are fulfilled and when a joint decision is taken (under CRR Article 21) by all the relevant competent authorities be retained. It should be noted however, that a number of technical amendments are required to clarify that waivers between (mixed) financial holding companies and their subsidiaries (institutions) should be allowed and that Art 8 should be adjusted to recognise the specific SSM situation where joint decisions through Art 22 are no longer required.

Finally, in addition to the above concerns in relation to Article 8, it would be of primary importance to also remove legal constraints currently impeding the free flow of liquidity within a banking group, *in primis* in relation to the large exposure rule. We expand on the challenges these rules pose and the changes that would be required to remove this impediment to cross-border flows in the following section.

Intragroup exposures

Prudential regulation begins with the Basel Committee on Banking Supervision (BCBS), which defines rules for internationally active banks at the consolidated level. The EU however applies BCBS standards at both solo and consolidated levels to all credit institutions and full scope investment firms operating in the EU. Thus, in the EU, these standards also apply to exposures between two entities within the same group (referred to as "intragroup"). This application of prudential requirements to intragroup flows and exposures imposes additional costs on firms and can induce a reduction of the provision of financial services or give rise to additional costs for end-users of financial services and products. Should the cross-border waivers discussed above not be available or practicable, it would be beneficial to revise the treatment of intragroup exposures in the CRR in the near term.

Intragroup exemptions in the risk-based and leverage frameworks are currently only allowed on a discretionary basis and within a single Member State. For cross-border banking groups, limiting such a provision to a single Member State places an unnecessary restriction on the flow of funds and centralised risk management within a group, particularly in the context of the progress already made towards completing the

Banking Union. It is also questionable whether there is a need for such restrictions within the broader Single Market and with respect to entities in third countries with equivalent prudential rules.

AFME recommendation 3

When competent authorities are satisfied the relevant conditions (as set out in CRR Article 113(6) a, b, c and e relating to the absence of impediments to the transfer of funds) are fulfilled, these exemptions should apply automatically and should be broadened to include intragroup counterparties that may be physically located in the Banking Union, another EU Member State or in a third country jurisdiction with an equivalent prudential regime.

AFME recommendation 4

In the absence of waivers for the solo application of the LCR and NSFR requirements, the treatment of intragroup liquidity flows (lower outflow/higher inflow percentages for ingroup flows under Articles 29 and 34 of the LCR Delegated Act and symmetrical ASF and RSFs for intragroup funding and deposits under the NSFR) should also be revised so that they are neither discretionary nor jurisdiction specific. At the very least, this should apply to entities located in the Banking Union but consideration should be given to extending this type of treatment to entities outside of the Banking Union too.

Intragroup exposures in the large exposure framework

The so called "Large Exposure Regime", applied throughout Europe along with specific national laws, creates significant constraints to the free circulation of funds within a cross-border banking group and should be addressed as a matter of priority.

Under the current CRR, the Large Exposure Regime limits interbank exposures to a maximum of 25% of regulatory capital. This rule also applies to intragroup exposures, with the current CRR using a relatively complicated, and inconsistently applied, system of discretion to allow for the possible exemption (full or partial) of intragroup exposures by Competent Authorities and/or Member States

The current system can be summarised as follows: Article 400 §1 (f) allows for the complete exemption of intragroup exposures from the Large Exposure framework if they would be assigned a 0% risk weight under the risk-based framework, that is when they are in the same Member State. Article 400 §2 (c) gives Competent Authorities the discretion to go beyond the limited geographical scope of Article 400 §1 (c), exempting cross-border intragroup exposures, partially or fully. Finally, Article 493 §3 (c), gives Member States the discretion to over-ride the choice of the Competent Authority by fully or partially exempting cross-border intragroup exposures until 2029. Some national legislators have however adopted even stricter limits to the large exposure rule, often setting a percentage lower than 25% of the bank's eligible capital, or the equivalent of a predefined fixed amount.

The inconsistent application that has occurred under the current legal framework therefore limits the ability of cross-border businesses to freely transfer funds between their legal entities. It also creates an unlevel playing field between these types of institutions depending on the type of choice made by their relevant Competent Authority and/or the Member State in question, with the two possibly contradicting each other. This approach creates significant obstacles for firms with centralised liquidity and risk management as entities must be mindful of incurring large exposures to the parent entity, which acts as the main funding entity, or to an affiliate acting as the group's centralised risk management entity. In this context, legislative change is required to remove the conflicting powers afforded to Member States and Competent Authorities, as well as to enhance the ability of the SSM to exercise its powers as the common supervisory authority of the Banking Union.

It is also worthwhile recalling that another consequence of retaining the status quo is that any non-exempt intragroup transaction needs to be grouped together with all such transactions since large exposure requirements apply to so-called "groups of connected counterparties", compounding the negative effects of the current system.

Finally, we note that most of the above issues have already been recognised for a number of years. Indeed, the current CRR mandates (in Art 507) the European Commission to review whether it is appropriate for the exemptions set out in Article 400(2) to continue to be discretionary (or whether they should become mandatory exemptions). In particular, the Commission is required to take into account the efficiency of group risk management whilst ensuring appropriate financial stability safeguards are in place. Again, the regulatory developments and improvements in financial stability safeguards since the CRR introduced this mandate imply, in our view, that there are no longer any reasons to allow discretions (and therefore divergences) to remain in this area of the European framework. The present review of the CRD/R represents an opportunity to foster further harmonisation of the single rulebook in this area.

AFME recommendation 5

We therefore recommend that the provision currently set out in Article 400(2)(c) of the CRR be moved to Article 400 (1) as (l)new so that, where a firm's intragroup counterparty is subject to the relevant conditions (i.e. equivalent prudential requirements, included in the same consolidation with the same levels of risk and control and with no impediments to the transfer of funds), intragroup exposures must be fully and consistently excluded from large exposure limits if the Competent Authority is satisfied that these conditions are met. If this change is made, it should also be accompanied with the removal of Article 493(3)(c) of the CRR to allow the SSM to exercise these powers without possible constraints stemming from national legislation.

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