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AFME views on priority areas in the trilogue negotiations on the Risk Reduction Measures package (RRM)

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Contents

Summary ... 3

Introduction ... 11

Supporting growth through well-functioning capital markets ... 13
Reducing risks, via private risk sharing and stronger Banking Union ... 13
Resolution priority issues ... 13
Other priority areas ... 13

1 Supporting EU growth and financial stability by promoting the development of well-functioning capital markets ... 14

1.1 NSFR – Impact on repo markets ... 14
1.2 NSFR - Investors' access to equity markets ... 15
1.3 Implementation of the Fundamental Review of the Trading Book (FRTB) in the EU ... 15
1.4 Additional significant issues: SA-CCR; derivatives in NSFR ... 16

2 Reducing risks by removing cross border fragmentation and strengthening the Banking Union ... 17

2.1 Cross-border waivers ... 17
2.2 Intra-group flows and exposures ... 18
2.3 SIIs methodology ... 19

3 Resolution priority issues: External MREL, Internal MREL, Eligibility Criteria and Grandfathering, Moratorium tools, Article 55 ... 20

3.1 External MREL ... 20
3.2 Internal MREL ... 20
3.3 Eligibility Criteria & Grandfathering ... 21
3.4 Moratorium tools ... 23
3.5 Article 55 – Contractual recognition of bail-in ... 23

4 Other key priority areas ... 25

4.1 Intermediate Parent Undertaking ... 25
4.2 Treatment of software ... 25
4.3 Grandfathering of AT1 and T2 instruments ... 26
4.4 Leverage Ratio ... 26
4.5 Large exposures ... 26
4.6 Remuneration ... 27
4.7 Trade finance ... 27
4.8 NPLs ... 27
4.9 Pillar 2 (CRD) ... 27
4.10 Equity Investments in Funds ... 28

5 Additional topics and recommendations ... 29

European Parliament – Consolidated Text ... 29
European Council – General Approach ... 30

Summary

The tables on the follow page provides a concise overview of AFME's views on a number of priority topics which will be discussed during the final stage of the negotiations on the Risk Reduction Measures (RRM). The following chapters will expand on these issues and provide references to more detailed AFME material.

Supporting EU growth and financial stability by developing well-functioning capital markets		
Issue:	**Key concerns:**	**AFME recommendations:**
NSFR – Impact on repo markets	Repo markets play a key role in facilitating the flow of cash and securities around the financial system and in supporting liquidity in other markets. Moreover, repo transactions are key in delivering banks' role as market-makers. The NSFR standard introduces stable funding requirements for reverse repos. This would restrict the ability of banks to provide market liquidity for sovereign and other securities.	AFME strongly supports the EP position and believes that the application of a 0% Required Stable Funding (RSF) to reverse repos which are collateralised by high quality liquid assets (HQLA Level 1 assets; e.g. high-quality government bonds) [Article 428r CRR] is a justified and prudent approach which would not only preserve the viability of repo markets but also avoid unintended consequences on government bonds markets and on the many end-users who rely on well-functioning and liquid repo markets.
NSFR – Investors' access to equity markets	Equity swaps are a very common and efficient way for institutional investors to gain exposure to assets without holding underlying cash securities. This solution is more efficient and less expensive for investors, in a context of fragmented markets. The NSFR currently imposes disproportionate RSF factors (50% to 85%) for equity securities held by a bank to hedge an equity swap.	AFME welcomes the fact that the EP acknowledges the validity of the concerns above. At the same time, the review clause proposed by the EP [Article 510(7a), (7b) CRR] should also be complemented by a lower calibration of the RSF factor during the period leading to the review. This is necessary to avoid significant impacts on equity markets during that period, in line with CMU objectives. Moreover, the review should be undertaken as early as possible.
NSFR - Derivatives	The additional funding requirement for gross derivatives liabilities, if set at the initially proposed level, would have been disproportionate.	We welcome the decision to apply the 5% RSF level, in line with the recent revised Basel rules [Article 428s CRR].
EU implementation of the FRTB	The Basel review of the FRTB, currently under way, will be crucially important in avoiding disproportionate increases in capital requirements for certain trading activities which would undermine the CMU project, reduce liquidity and depth in capital markets, increase volatility, systemic risk and costs for end-users.	AFME recommends that any approach to FRTB implementation [Article 325 CRR]: Avoids disproportionate implementation challenges for banks and for regulators, by dispensing with any costly and unnecessary preparatory work on rules which will be replaced by planned EU legislation; Ensures that implementation is globally aligned in all key jurisdictions so to avoid operational obstacles and level playing field issues.
SA-CCR	SA-CCR has several shortcomings (calibration; lack of recognition of margining and netting) which result in significantly overstated exposures. It is important that the shortcomings be remedied, as well as a full impact study is performed before it is implemented through the CRR. The impact of SA-CCR in the Large Exposure framework accounts for a significant portion of the undue impacts.	Both the EP and the Council include a review of SA-CCR [Article 514 CRR]; however, that review will come very late. It is very important that the review is undertaken earlier (i.e. 1 year after entry into force instead of 4). The use of IMM in the LE framework should be retained until Basel has performed its review of SA-CCR and addressed the flaws. This is in line with the EBA recommendation and with what other jurisdictions are doing.

Reducing risks by removing barriers to cross border flows of capital and liquidity and strengthening the Banking Union		
Issue:	**Key concerns:**	**AFME recommendations:**
Cross-border waivers	Cross-border capital and liquidity waivers can strengthen resilience by reducing fragmentation by facilitating private risk-sharing. They are necessary for the efficient allocation of resources across the EU economy and will facilitate private risk-sharing.	AFME believes that in case meaningful and workable waivers, granted on an automatic basis within the Banking Union, cannot be achieved at this stage, the following fall-back incremental steps should be adopted. If the current CRR approach is retained, the EBA and the EC should conduct an analysis and review of cross-border waivers within a short time frame. On liquidity, a number of amendments are recommended to take into account the SSM and for FHCs, and the NSFR should always be applied at group consolidated level or (sub)-consolidated level within the Banking Union.
Intra-group flows and exposures	The application of prudential requirements (designed at Basel level for application at consolidated level) to intragroup flows and exposures creates fragmentation and fragility.	Co-legislators should revise the treatment of intragroup exposures in the CRR in the near term. Intragroup exemptions in the risk-based and leverage frameworks should be allowed on a non-discretionary basis [Article 113(6) CRR]. Particularly urgent is the consideration of intragroup exposures, which must be excluded from large exposure limits, if the competent authority is satisfied that the necessary conditions are met.
SIIs methodology	The cross-border activity indicator overstates the systemic importance of activities within the Banking Union.	AFME supports the recognition of the Banking Union as a single jurisdiction within the cross-border indicator of the G-SII and O-SII score [Article 131 CRD].

Resolution priority issues: External and Internal MREL, Moratorium tools, Eligibility Criteria, Grandfathering, Article 55		
Issue:	**Key concerns:**	**AFME recommendations:**
External MREL calibration [Art. 92a CRR, Art. 45c BRRD]	It is essential that MREL is calibrated to implement the TLAC standard for GSIBs and provide an appropriate calibration to support resolvability under the group resolution plan. Excessive requirements beyond this should be avoided.	AFME supports the Pillar 1 calibration of external MREL in line with TLAC standards, and the proposed calibration of Pillar 2 external MREL based on the concepts of loss absorption and recapitalisation. We are concerned that the proposed introduction of a mandatory Markey Confidence Buffer is unnecessary, and may result in excessive calibration, especially as the size of the bank post-resolution is likely to be smaller than before and a very conservative set of assumptions is already in place when calibrating MREL. TLAC Redemptions [CRR 77, 78, 78a]: AFME supports a general permission approach as a workable solution for reasonable levels of redemptions that do not, in any event, lead to a breach of MREL.
External MREL subordination [Art. 45b BRRD]	It is important for resolution authorities to assess the degree of subordination required to support the relevant resolution strategy and reduce "no-creditor worse off" concerns. We are concerned that the Council proposals set an overly conservative, inflexible approach to subordination which goes significantly beyond what is likely to be necessary to achieve this. The Council has presented a highly complex method setting a cap at a significantly higher level than expected, and considerable discretion for resolution authorities, which could lead to diverging application both within the Union and compared to third countries. The high level of subordination foreseen will also make the roll-over of this debt harder or more expensive, particularly if funding conditions are strained.	We do not agree with the Council proposals for a minimum level of subordination by reference to 8% TLOF. We believe the Commission and Parliament approaches provide sufficient flexibility for resolution authorities to set MREL subordination requirements at an adequate level. We maintain that subordination requirements in the BRRD should be set by resolution authorities to a level that ensures the "No-Creditor-Worse-Off" principle holds, but not a level beyond what is necessary for this. It is also important to take into account the capacity of the markets for these amounts of subordinated debt and the impact on bank profitability. The framework should be simple enough to support firms' planning and help market participants understand what is required of firms. Clear framing of the amount of subordination required is vital to ensure that this is not excessive and to avoid an unlevel playing field between the Member States and internationally, thus AFME supports the Parliament proposal. Moreover, the possibility to obtain an exemption of 2,5% - 3,5% to the subordination requirement allowed by the TLAC standard should be preserved.

Internal MREL [Art. 92b CRR, Art. 45g BRRD]	An appropriate calibration of internal MREL in line with the FSB TLAC Term-Sheet would reduce cross-border fragmentation and provide for the necessary flexibility to use resources where they are needed in the group. We only see this approach being taken in the Parliament position. This would support the development of the Banking Union and could also unlock the discussion with U.S. authorities for a lower internal TLAC calibration for EU banks in the U.S., as per recent statements by the Federal Reserve. The ability of firms to have flexibility in their issuance strategies for internal MREL is also vital. Waivers for internal MREL in the Banking Union would reduce fragmentation risks.	AFME strongly supports the EP proposal to allow scaling (75%-90% range) starting from the lower end, as this would guarantee the necessary flexibility for an efficient allocation of resources. It would also provide incentives to authorities for stronger cross-border cooperation and to banks for improving their own resolvability. It is vital that flexibility in issuance strategies is maintained, such that issuance indirectly to the resolution entity through entities in the same resolution group is permitted. AFME supports waivers for subsidiaries when the latter and resolution entities are both within the Banking Union, and strongly support the inclusion of collateralised guarantees as a possible form of internal MREL.
Eligibility Criteria [Art. 72 (a-c) CRR, Art. 45b BRRD]	Key provisions in the MREL eligibility criteria go above and beyond the eligibility criteria in the TLAC Standard. The proposal makes significant changes to the criteria for eligible liabilities and also introduces new criteria for Additional Tier 1 and Tier 2 capital instruments. There is also a need for clarity within the texts on specific issues, e.g. neither texts deal explicitly with liabilities that include an issuer call, but do not include an incentive to redeem. To the extent that this case is not dealt with, it should be clarified that the maturity date for MREL eligibility remains the contractual maturity. Additional criteria have been put forward by the European Parliament with regard to retail client holdings of MREL. Whilst the intention is clear and understandable we have concerns with the suggestions put forward from a practicable perspective. Further to this the issue is a matter for consumer protection law and therefore should not be addressed through prudential legislation.	Some eligibility criteria put forward in the Commission's proposals are not necessary and in some cases are duplicative of existing requirements elsewhere (i.e. contractual recognition of bail-in power). AFME recommends these are removed. Where clarity is required, e.g. with regard to liabilities that include an issuer call, but do not include an incentive to redeem, the text needs to be clear, e.g. that callable instruments with no incentive to redeem are eligible until contractual maturity. AFME does not support the Parliamentary position on restrictions for retail clients (up to 10% of client's portfolio). Issuers cannot monitor the entirety of (retail) buyers' investment portfolio, and have no control over secondary markets' transactions. Securities legislation or consumer protection legislation is best placed to introduce retail holders' safeguards, not prudential requirement legislation. In line with EBA and ESMA's recently released paper, retail holdings of banks' debt is not a European-wide issue, but where it becomes disproportionate to a bank's balance sheet/business model, this should be assessed on a case-by-case basis in the context of institution's resolvability assessment. AFME therefore supports the Council General Approach in the BRRD (as per Recital 9a).

Grandfathering [Art. 494a CRR, Art. 45b BRRD]	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 two years, and absent transitional provisions MREL shortfalls would increase very significantly.	AFME considers that a permanent grandfathering provision for all issuances prior (i.e. all liabilities, AT1 and T2 instruments, including issuances under UK law) to the revised CRR coming into effect is necessary to provide clarity for banks on their current shortfall and enable them to continue issuance over the next months. Should such grandfathering not be an option, AFME supports the Council approach to grandfathering but believes that the 6-year time frame provided for AT1 and T2 instruments should be extended to at least 10 years.
Moratorium tools [Art. 33a BRRD]	The new moratorium powers could have far reaching consequences and run counter to the objective of ensuring financial stability and of achieving an orderly resolution.	AFME believes that if co-legislators continue to pursue the introduction of a new moratorium tool, the Council position best addresses the many concerns. Both EP and Council move in the right direction, e.g. limiting their duration to a maximum of 2 days, however importantly only the Council restricts the use of additional stay powers. Attention should also be given to the scope of the tools.
Art. 55	AFME welcomes the acknowledgment of practical challenges in implementation of article 55 of the BRRD, which mandates the inclusion of a bail-in recognition clause in a wide range of contracts. AFME is concerned by the EP proposal for a cap on the waiver at an arbitrary level, which could significantly reduce trade finance activities, without enhancing resolvability.	The scope of Art. 55 should be limited to liabilities eligible for MREL and any additional liabilities as identified by the authorities. However, if the waiver approach is taken forward, we support the Council's position as it provides for an exemption for cases of impracticability. The Council has proposed sufficient safeguards against any abuse of the waiver, which could be enhanced by an annual report on its use submitted by the bank.

Other priority areas	
Issue:	**AFME recommendations:**
IPU	AFME welcomes, both in the Council and in the EP positions, the possibility to have a second IPU in case of conflicts with mandatory separation requirements; investment firms (currently) authorised under MIFID II should be able to fulfil the second IPU as clarified in the Council text. The EP's position also recognises that should be possible in cases where a single IPU would render resolvability less efficient. Firms will also need sufficient time to implement these proposals and we welcome the EP's proposal with respect to implementation of the requirement. Before finalising the CRD5 IPU, the trialogues should nevertheless consider the interactions between this requirement and the Commission's Investment Firm Review (IFR) proposal.
Pillar 2	AFME supports the EP proposal to introduce a new recital aimed at clarifying that Pillar 2 measures should not conflict with the specific treatments set out in CRR, including those aimed at avoiding unintended impacts on end-users and on the European economy. In respect of P2G, AFME opposes the introduction of a 'floor' and recommends that it be clarified that the determination of P2G is to ensure that institution's own funds can absorb the maximum stressed loss, taking into account credible management actions. It should also be made clear that it can offset the capital conservations buffer and countercyclical buffer in certain circumstances.
Treatment of software	Software is a strategic asset for banks and should be generally recognised as a tangible asset for prudential purposes. We welcome the EP proposal to exclude software from intangible assets that need to be deducted from CET1 and to require EBA to develop a RTS to specify, by 6 months after entry into force, the capital treatment of software.
Grandfathering AT1 and T2	While both EP and Council recognised the importance of continued eligibility of issuances made prior to the new eligibility criteria, we are concerned the EP position does not include in CRR grandfathering for AT1 and T2 instruments. It will be very important that this is addressed during the trilogues.
Leverage Ratio	AFME welcomes the approach adopted by the EP and Council, which is consistent with the Basel standard. In this respect, we seek further alignment by the EP in maintaining that G-SIB buffer as a 'buffer' to be used in stress, and not as a minimum 'requirement' which must be met at all times. We support the EP proposal to allow the exclusion of the central bank deposits from the exposure measure, though we believe this should not be limited to in 'exceptional circumstances'. In addition, cash and Level 1 HQLA variation margin should be allowed as collateral for purposes of calculating LR's replacement cost, an issue which has not been addressed in either the EP or Council text.
Large Exposures	AFME stresses the importance of allowing firms to use validated internal models for calculating exposures in the LE framework. In the area of derivative exposures, it is particularly important that the use of internal models is maintained until a review of the calibration of SA-CCR is complete and its impact in the LE framework understood.
Trade Finance	AFME welcomes the EP's treatment of factoring as trade finance and lowering of RSF factors, which in our view should however not be maturity-based and should be brought below 5%.
NPLs	AFME supports the introduction by the EP of the concept of "massive disposals" and the possibility for institutions to adjust their LGD estimates following such sales.

Remuneration	Ensuring that a significant portion of variable remuneration is deferred over a period of time and can be clawed back is an important objective. However, 'material risk takers' is a broad category, that also captures junior staff for whom the imposition of a longer (5 years) deferral (which might be appropriate only for certain very senior individuals) would have a significant impact on their overall remuneration and specifically their cash flow and would not be commensurate to their profiles and risks. A lower de minimis exemption – compared with what proposed by the EC - would further exacerbate this issue.
Equity Investments in Funds	AFME supports the Council's approach which brings all AIFs i.e. 3rd country and EU based AIFs, within the scope of the definition of a CIU, but recommends that this is extended to UCITs equivalent funds, which are less complex by nature (than AIFs). Both 3rd country AIFs and UCITs equivalent funds were previously within the definition of a CIU and a de-recognition will detract investment in these funds which may themselves invest in the EU.

Introduction

The Association for Financial Markets in Europe (AFME) welcomes the progress achieved towards the finalisation of the Risk Reduction Measures (RRM) Package with the adoption of a position by the European Parliament and by the Council of the EU.

The RRM package will further strengthen the resilience of the financial system, building on the very important regulatory reforms and industry efforts introduced in the wake of the financial crisis. It is also an important opportunity to provide stronger foundations to EU's objectives of boosting growth and investment, channel capital to the real economy, reduce fragmentation and barriers in the internal market and contribute to the completion of the EU Banking Union.

This AFME paper provides views on the ongoing negotiations and recommendations aimed at achieving the above-mentioned objectives, in light of the positions adopted by the two co-legislators (ECOFIN general approach of 25 May; EP/ECON Committee position adopted on 19 June).

Box 1 - Objectives for the final stages of the RRM negotiations:

Financial stability

Financial stability is a key objective; potential effects on stability - coming from various factors including the impact on market liquidity or on the (already low) profitability of banks - need to be carefully considered.

EU Growth agenda

Consistency with the EU growth agenda: consistency with EU objectives around Corporates, SMEs and investors access to finance and end-user's ability to manage risks.

Capital Markets Union

In the context of the efforts towards the creation of the CMU, prudential regulation needs to consider the possible unintended effects on capital markets. This is particularly important for key aspects of the NSFR, FRTB, SA-CCR.

Removing fragmentation

Removing fragmentation and unjustified barriers is a pre-condition for the Banking Union. It is also crucial within the internal market. In this context, coordination with other jurisdictions and global level playing field is very important.

This paper is divided into the following sections:

Chapter 1 - Supporting EU growth and financial stability by promoting the development of well-functioning capital markets

Well-developed and appropriately regulated capital markets are essential to channel resources and key services to the real economy. The RRM package is extremely significant for key capital markets[1]. Particularly important are those proposals which directly or indirectly impact on the supply and/or pricing of key services to all market users. More specifically there should be a focus on potential unintended repercussions on market-making activities and market liquidity; on government bonds markets; equity markets; and derivative markets. These unintended or excessive effects may result from an inappropriate calibration of some specific aspects of the **Net Stable Funding Ratio (NSFR)**. Particularly crucial here are the provisions on the treatment of repos, derivatives and transactions facilitating investors' equity investments. Similar calibration concerns apply to aspects of the **Fundamental Review of the Trading Book (FRTB)**, and **other components** (e.g. the Leverage Ratio, or the Standardised Approach for Counterparty Credit Risk, SA-CCR). The extent to which calibration beyond that which is necessary to manage the identified risks negatively impacts on the availability of services is particularly important given the very significant shrinkage in banks' capital markets activities over the last decade. A recent AFME-PwC Report[2] demonstrated that regulation has been the largest single explained driver of these changes.

Chapter 2 - Reducing risks by removing barriers to cross border flows of capital and liquidity and strengthening the Banking Union

Financial markets' fragmentation within the EU, and particularly within the Banking Union, is a source of fragility and runs counter the objective of reducing risks and at the same time leads to inefficiencies in the allocation of resources and specifically capital and liquidity. As strongly emphasized by academics and regulators (particularly the ECB) shocks both in financial markets and in the real economy can be mitigated or avoided *ex ante* by stronger integration of, and cross-border activities in, banking markets. This is a form of private risk sharing, which leads to significant risk reduction[3]. However, despite the progress made in the establishment of Banking Union, and the very significant post crisis improvements to financial stability intra-euro cross border integration has significantly decreased since 2008[4]. The RRM package, by improving the treatment of cross border activities can contribute to reversing this negative trend and, by allowing a more efficient flow of capital and liquidity, to strengthening the resilience of European banks. Such improved treatment can be achieved in key areas of the RRM package: **waivers**; **intra-group exposures**; **SIIs methodology**; **internal MREL**. While private risk-sharing cannot be a substitute for further developing the EMU, the benefits brought about in terms of diversification would greatly enhance the resilience of the euro area.

Chapter 3 – Resolution priority issues: External and Internal MREL, Moratorium tools, Article 55

AFME has been very supportive of the development of an effective recovery and resolution framework in Europe and closely involved in the implementation of the BRRD, development of TLAC and related issues. We support the principle that **external MREL** should be based on loss absorption and recapitalisation, but we caution against the inclusion of a mandatory Market Confidence Buffer (MCB) as we believe MREL should take account of the likely size of the firm post-resolution. We additionally think that the level of **subordinated MREL** that can be required under the BRRD should be set on an institution-specific basis to ensure compliance with the No-Creditor-Worse-Off (NCWO) principle. The level of MREL required, including the proportion that may be subordinated, should be easily foreseeable in order to allow banks to plan ahead. Going beyond what is needed would excessively constrain banks' balance sheets and would have serious negative and detrimental

[1] This is explained in detail – through several case studies - in AFME's recent publication on "*The links between the Risk Reduction package and the development of Europe's capital markets*", December 2017
[2] AFME-PwC, *Impact of Regulation on Banks' Capital Markets Activities. An ex-post assessment*, April 2018
[3] On this point, see Mario Draghi speech on *Risk-reducing and risk-sharing in our Monetary Union*, held at the European University Institute, Florence, 11 May 2018. With integrated capital markets, people could smooth their consumption thanks to the returns received on assets held in better performing areas of the EU, while cross-border banks could offset losses made in regions hit by a recession thanks to gains in another.
[4] European Central Bank, Financial Integration in Europe, May 2018

impact on European banks' profitability and the European economy. It is worth recalling that the TLAC calibration for G-SIBs at FSB level was assessed as a prudent compromise following a thorough analysis of historical losses and recapitalisation needs for selected systemically important financial institutions that failed or received official support. This analysis assessed that all historical cases considered, with only one exception, showed losses and recapitalizations lower than the TLAC calibration. Therefore, in our opinion it is unreasonable to interpret this calibration as a floor.

An appropriate calibration of **internal MREL**, including scaling in line with the FSB TLAC Term-Sheet, would reduce cross-border fragmentation and thus improve a group's overall resilience. It is vital that policymakers allow **grandfathering** of instruments that have already been issued with the purpose of meeting MREL, in order not to undermine the extensive efforts already made. The proposed new **moratorium powers** would have far reaching consequences and run counter to the objective of ensuring financial stability and of achieving an orderly resolution; if not fully removed, any compromise tools shall be strictly time limited (i.e. to no more than 48 hours) and no further stays should be available following their utilisation. Regarding changes to **Article 55**, it is important to recognise the safeguards already proposed, and as such acknowledge that no cap on the use of the proposed waiver is necessary.

Chapter 4 - Other priority areas where improvements can be made to avoid unintended consequences

Several aspects of the RRM package can have significant implications. The fourth section touches upon other areas where improvements to the current framework are warranted. These include IPU requirements, the Leverage Ratio, Large Exposures, the Pillar 2 framework, the capital treatment of software and remuneration.

Chapter 5 – Additional topics and recommendations
In addition to the priority areas mentioned above, this final section of this document considers aspects of the Parliament's and of the Council's positions which would positively address issues in other areas of the prudential framework.

For more detailed AFME views on the prudential aspects in the RRM package, our individual position papers can be found on our website[5].

Box 2 – Trilogue priority topics discussed in this paper:

Supporting growth through well-functioning capital markets	Reducing risks, via private risk sharing and stronger Banking Union	Resolution priority issues	Other priority areas
• NSFR: Repos; derivatives; equity markets • FRTB • SA-CCR	• Intragroup exemptions • Waivers • GSII methodology • Internal MREL	• External MREL • Internal MREL • Eligibility criteria and grandfathering • Moratorium tools • Art. 55	• Software • Pillar 2 • Grandfathering • IPU • Leverage Ratio • Trade finance • NPLs • Remuneration

[5] https://www.afme.eu/en/divisions-and-committees/regulation/crd5-and-crr2/

1 Supporting EU growth and financial stability by promoting the development of well-functioning capital markets

Europe remains heavily reliant on bank loans to finance its economy. This is one of the key reasons why developing additional market-based funding options - which can act as a 'spare tyre' when bank lending is constrained - has rightly become a major objective of the EU and of its Capital Markets Union project. Banks and markets both play essential, and complementary, roles in financing the real economy: banks help companies and governments to raise finance through capital markets; banks facilitate equity and debt issuance by helping end-users to access capital markets; they also support the provision of credit to the real economy through securitisation activities. Banks also have a central role in the provision of market liquidity: by acting as market-makers, they help corporates, governments and investors access funding and investment opportunities at fair, accurate and transparent market prices. Through their role as market intermediaries and principals, banks additionally help companies manage their risks from exposure to interest rate, exchange rate and commodity price fluctuations. By limiting the volatility of earnings, they contribute to sound economic growth. Elsewhere their role in managing risk enables the provision of products such as fixed rate mortgages to consumers.

Therefore, reforms that will disproportionately impact how banks operate clearly have the potential to affect capital markets, the end-users of financial services and the wider economy.

While AFME supports the RRM, we believe some specific elements require careful consideration as they could affect market liquidity or make it more difficult or expensive for real economy end-users to access the financial products and markets they need. To ensure the important objective of global consistency, we would also support these amendments to the legislative proposals being adopted into international standards.

In this respect, particularly careful consideration needs to be given to the following aspects[6]:

1. Impact on repo markets (NSFR);
2. Investors' access to equity markets (NSFR);
3. Implementation of FRTB in the EU;
4. Additional signifiant issues : SA-CCR ; derivatives in NSFR.

1.1 NSFR – Impact on repo markets

Repos (and reverse repo) transactions provide both relatively inexpensive funding and safe short-term investment opportunities (to banks, financial institutions and corporates), as they are collateralised by high quality securities, normally sovereign bonds[7]. As such, repo transactions play a crucial role in underpinning the liquidity of government bonds and therefore lower their risks and governments' cost of funding. Also, repo transactions are key in delivering banks' role as market-makers: banks fund the inventory of securities needed to perform their market-maker role through repo transactions.

A key issue the co-legislators will have to decide is whether to require, as suggested in the initial EC proposal, that whenever a bank provides short-term lending to financial institutions through a reverse repo, that loan needs to be backed by long-term stable funding (e.g. 5% to 10% RSF for reverse repos, as opposed to 0% ASF for repos).

The European Parliament is in favour of not requiring long-term stable funding, when the collateral for reverse repo is of very high quality. The Council agrees with the EC proposal.

AFME strongly supports the EP position and believes that the application of a 0% Required Stable Funding (RSF) to reverse repos which are collateralised by high quality liquid assets (HQLA Level 1 assets; e.g. high-quality government bonds) is a justified and prudent approach which would not only preserve the viability of repo markets but also avoid unintended consequences on government bonds markets and on the many end-users who rely on well-functioning and liquid repo markets.

[6] To be clear, all these components are necessary and supported by AFME; however, some specific aspects (e.g. calibration or timing; safeguards for globally consistent implementation) will need in depth attention during the trilogues
[7] 80% of EU-originated repos use government bonds as collateral

Additional AFME material:

- AFME publication on "*The links between the Risk Reduction package and the development of Europe's capital markets*".

1.2 NSFR - Investors' access to equity markets

Equity markets offer a large pool of potential capital that is currently untapped in Europe. Deep and liquid equity markets are key to EU long-term growth, to develop the Capital Markets Union, and for financial stability.

Banks perform several critical functions to support EU equity markets, ranging from underwriting to market-making. Also, banks offer institutional investors a common and cost-efficient way to gain exposure to equities without holding underlying securities: equity swaps. Equity exposure via equity swaps is the dominant form of equity financing in Europe.

When offering an equity swap, the bank hedges its market risk by purchasing the reference asset (or assets) and holding it for the life of the generally short-dated transaction. The NSFR currently imports LCR stress haircuts for equity securities held on balance sheet, namely 50% for non-financial shares and 85% for financials. Given the more structural (and not stressed) nature of the NSFR, a lower RSF for equity securities held as hedges would be justified.

Co-legislators should consider whether the unintended effects of the very punitive treatment of equity swaps on equity markets and on investors' ability to access a broader set of investment opportunities as well as its consistency with the CMU objectives.

The European Parliament, in its position, calls on the EBA and the EC to undertake an analysis to assess the impact on investors - in the context of the CMU - and the opportunity to apply lower stable funding requirements, for instance, to securities that are held to hedge derivatives which are funded by initial margin, either wholly or in part.

AFME welcomes the fact that the European Parliament acknowledges the validity of the concerns above. At the same time, we believe the review clause proposed by the EP, during the period leading to the review, should also be complemented during the trilogues by a lower calibration of the RSF for equity securities held as hedges in specific situations where this is justified (particularly when the initial margin provided by the client funds the equity instrument; or when the equity instrument is liquid). This is necessary to avoid significant impacts on equity markets during the period preceding the review clause.

Additional AFME material:

- AFME concise flyer on NSFR impact on equity markets;
- AFME publication on "*The links between the Risk Reduction package and the development of Europe's capital markets*".

1.3 Implementation of the Fundamental Review of the Trading Book (FRTB) in the EU

Bank trading activities are fundamental for European capital markets, as they support: Capital formation; Market-making; Hedging solutions. Given the strong economies of scale and scope in these activities, the role of larger and globally active banks is central. The Basel review of the FRTB, currently under way, will be crucially important in avoiding disproportionate increases in capital requirements for certain trading activities which would undermine the CMU project, reduce liquidity and depth in capital markets, increase volatility, systemic risk and costs for end-users.

The co-legislators will have to ensure the essential coordination between the EU and Basel process. The EU should not front run implementation before the finalisation of the standard in Basel which is expected later this year and needs to undertake a comprehensive impact analysis (as has been recognised in the Commission's recent call for advice on the impact of the final Basel III and market risk proposals). At the same time, given the global nature of the business, it is important that global level playing field and consistency is promoted.

Both the Council and EP position acknowledge the need to consider – and reflect in due course - the ongoing work of the Basel Committee through future legislative initiatives. They also agree that such initiatives should take the form of Level 1 proposals, which they expect to be presented by mid-2020. Furthermore, they have pushed for a clear commitment from the EC about a timely implementation of the FRTB. The differences between the Council and the EP pertain to what happens before such new Level 1 proposals (and their adoption): on the one hand the Council adopts an approach based on reporting requirements introduced through CRR2 and a subsequent EC delegated act; on the other hand, the EP already adopts a (soon outdated) form of FRTB, with a phasing-in period starting in 2022.

AFME recommends that – given the clear challenges of coordinating with the unfinished Basel work – any approach to FRTB implementation is focused on achieving the following objectives:

- Avoiding disproportionate implementation challenges for banks and for regulators, by dispensing with any costly and unnecessary preparatory work on rules which will be replaced by planned EU legislation;
- Ensuring that implementation is globally aligned in all key jurisdictions so to avoid operational obstacles and level playing field issues.

Additional AFME material:

- AFME flyer on FRTB.

1.4 Additional significant issues: SA-CCR; derivatives in NSFR

Standardised approach for counterparty credit risk exposures - SA-CCR has several shortcomings (calibration; lack of recognition of margining and netting) which result in significantly overstated exposures. It is therefore crucial that the shortcomings of SA-CCR be remedied, as well as a full impact study on its calibration and its aggregate impact performed before it is implemented through the CRR. Basel should review such shortcomings in the coming months. We note in the meantime that, for these reasons, other jurisdictions [8]are putting on hold SA-CCR implementation.

Both the EP and the Council include a review of SA-CCR; however, that review will come very late: only four years after entry into force of CRR2.

It is very important that the review is undertaken earlier (i.e. 1 year after entry into force). Also, the impact of SA-CCR in the Large Exposure (LE) framework accounts for a significant portion of the undue impacts. Consistent with some other jurisdictions, the use of IMM in the LE framework should be retained until Basel has performed its review of SA-CCR calibration and addressed. This is in line with the EBA recommendation and with what other key jurisdictions are doing.

Treatment of derivatives in the NSFR - The additional funding requirement for gross derivatives liabilities, if set at the initially proposed level of 20%, would lead to disproportionate funding requirements. Acknowledging the validity of these concerns, the Basel Committee has decided to allow a lower RSF, subject to a 5% floor.

Both European Parliament and Council have accepted the lower RSF calibration (5%).

We welcome the decision to apply the 5% RSF level, which we believe will also be adopted globally.

Additional AFME material:

- AFME concise flyer on SA-CCR

[8] For instance, during June 2018 US authorities have clarified that banks will not have to use SA-CCR – and can continue to use their approved models – in the context of the large exposures rules, which is an area where the excessive impact of SA-CCR is particularly important

2 Reducing risks by removing cross border fragmentation and strengthening the Banking Union

Building a fully integrated cross-border banking market, by removing obstacles to the flow of capital and liquidity within banks, would allow resources to be allocated more efficiently. This is essential for achieving a resilient and well-functioning Banking Union.

Importantly, from a risk reduction perspective, the perpetuation of the current fragmented situation is a source of fragility. As many academics, policy-makers, regulators and market experts have highlighted, removing the current penalising treatment of cross-border activities – even within the Banking Union – would create *ex ante* private risk sharing and reduce risks:

- Banks could diversify more, and offset losses made in regions hit by a recession with gains from regions in a more favourable cycle;
- Banks could better allocate resources where they are more needed allowing all market participants to smoothen their investments or consumption;
- The false sense of security coming from national ring fencing approaches [9]would be dispelled: when they become pervasive, eventually, all jurisdictions become worse off and the system becomes more fragile.

Despite the very significant policy and regulatory developments (SSM, SRB, EU prudential and recovery & resolution framework) intra euro-area cross border activities have significantly decreased since 2008, as noted in the ECB's most recent financial integration report. Both financial stability and EU growth objectives require this trend to be reversed as a matter of priority.

Private risk-sharing cannot be a substitute for further developing the EMU. However, the current emphasis on crisis tools (resolution mechanisms, including the SRF backstop; EU deposit insurance) should not come at the detriment of the equally important crisis prevention elements, which can be greatly strengthened by the above mentioned private *ex ante* risk-sharing (and shock-absorbing) mechanisms.

In this respect, particularly careful consideration needs to be given to the following aspects:

1. Cross-border waivers for capital and liquidity (see section 2.1) and internal MREL (see sec. 3.2);
2. Intragroup flows and exposures (see section 2.2);
3. SIIs methodology (see section 2.3).

2.1 Cross-border waivers

As explained in the introductory section, the removal of the current penalisation of cross-border activities – particularly within the banking union – is a precondition for achieving meaningful risk reduction and a more efficient allocation of resources across the European economy. The amendments to Articles 7 and 8 proposed by the EC aim at introducing the possibility of cross-border capital and liquidity waivers. At the same time this possibility is heavily constrained by additional requirements (guarantees and collateralisations) and remains discretionary even when all strict conditions are met. While we support the intention of the proposals, these limitations are likely to make them unworkable in practice.

The co-legislators will have to consider a workable design of waivers. Should that prove difficult at this stage, alternative targeted incremental steps aimed at recognising the big progress in building the Banking Union and the benefits of greater integration of banking activities should be considered.

The Council has opposed the waivers proposed by the EC and has proposed to keep the rules currently in force; instead they propose a future review of the waiver requirements, deferred to 'upon completion of the Banking Union'. The EP supports capital and liquidity waivers which are broadly in line with the restrictive

[9] This is explained in a recent paper from W. Ervin: https://www.brookings.edu/research/understanding-ring-fencing-and-how-it-could-make-banking-riskier/. At first, ring-fencing seems to work. There is a big advantage for a single ring-fencer if other jurisdictions do not match that move. However, trapping capital for local entities reduces the resources for others and their risks increase. If other countries adopt countervailing ring-fencing, then the benefit of a pooled 'central reserve' is lost

EC proposals; however, waivers would be limited to max 25% of the minimum own funds requirements and cannot apply to significant subsidiaries; they would be implemented 3 years after entry into force.

AFME believes that in case meaningful and workable waivers, granted on an automatic basis within the Banking Union, cannot be achieved at this stage, the following fall-back incremental steps should be adopted. If the current CRR approach is retained, the EBA and the EC should conduct an analysis and review of cross-border waivers within a short time frame. On liquidity, a number of amendments are recommended: the procedure in Art. 21 CRR is redundant when the SSM is the sole CA and should therefore be removed; waivers between (mixed) financial holding companies and their subsidiaries (institutions) should be allowed. Importantly, the NSFR should always apply at group consolidated level or at least at a (sub)-consolidated level within Banking Union as long-term funding is typically managed at this level; this would also avoid that the introduction of the NSFR results in additional elements of fragmentation.

Additional AFME material:

- Case study 4 in AFME publication on "*The links between the Risk Reduction package and the development of Europe's capital markets*".

2.2 Intra-group flows and exposures

The application of prudential requirements (designed at Basel level for application at consolidated level) to intragroup flows and exposures creates fragmentation and fragility.

The co-legislators should consider the effects of the current treatment of intragroup exposures in the CRR in the near term and how to address some of the obvious and unnecessary barriers they create.

The EP proposes an EC review of the obstacles in and to the Banking Union, to be carried out by January 2020. The issue is not addressed in the Council position.

In case cross-border waivers discussed above remain not available or practicable, it would be important that the co-legislators revise the treatment of intragroup exposures in the CRR in the near term. Intragroup exemptions in the risk-based and leverage frameworks should be allowed on a non-discretionary basis. Particularly urgent is the consideration of exposures which must be excluded from large exposure limits in the context of a limited extension of cross-border liquidity waivers under Article 8, if the competent authority is satisfied that the necessary conditions are met (and the SSM needs to be able to exercise these powers without constraints stemming from national legislation).

2.3 SIIs methodology

The cross-border activity indicator overstates the systemic importance of activities within the Banking Union; indeed, intra-Eurozone banking activities (including the local activities of subsidiaries and local central bank deposits) are accounted for in the same way as cross-border activities conducted outside the Eurozone.

During the trilogues the co-legislators will have to consider how to appropriately recognise the Banking Union as a single jurisdiction in the SII score methodology and is such a way so as to ensure a level playing field.

The Council position includes a G-SIIs methodology, which allows for an alternative calculation of the cross-border activity indicator, such that member states within the single supervisory mechanism are recognised as a single jurisdiction. Based on this alternative methodology, national designated authorities can move a G-SII to a lower bucket, with the constraint that no institution can be removed from the G-SIIs list as a result of this.

AFME supports recognition of the banking union as a single jurisdiction in measuring the level of cross-border activities in the G-SIIs methodology. A more adapted calculation which would take into account what has already been achieved in the banking union would free up banks' capacity to lend and support European economic growth. Any alternative methodology formulated to achieve this should be applied consistently and without constraint; where this cannot be achieved in the current package, any future review of the methodology should consider removing these constraints as potential obstacles to the completion of the Banking Union. This methodology should also be available for O-SIIs, as an institution's designation as a G-SII or O-SII should have no bearing on the recognition of the banking union as a single jurisdiction.

3 Resolution priority issues: External MREL, Internal MREL, Eligibility Criteria and Grandfathering, Moratorium tools, Article 55

We strongly support the objectives of the proposals to implement TLAC in the EU for GSIIs, review MREL to increase alignment with TLAC and address certain practical challenges such as achieving subordination and the application of article 55 BRRD. Our overarching perspective when addressing the proposals is to:

- Ensure that an effective MREL framework is introduced in which there can be confidence in the credibility and feasibility of resolution strategies;
- Facilitate the establishment of a deep and liquid market in MREL in the European Union to enable banks to achieve the necessary requirements for loss absorbing capacity and enhance market discipline while maintaining financial stability; and
- Ensure a consistent and transparent framework to establish a level playing field across the EU and internationally.

3.1 External MREL

The framework for MREL (Minimum Requirements for Own Funds and Eligible Liabilities) is being revised in the EU to accommodate the implementation of the global TLAC standard agreed by the Financial Stability Board. AFME supports the Pillar 1 calibration of external MREL in line with TLAC standards, and the proposed calibration of Pillar 2 external MREL based on the concepts of loss absorption and recapitalisation. We do not believe that a binding Market Confidence Buffer (MCB) is necessary, especially as the size of the bank post-resolution is likely to be smaller than before. It is important that the post-resolution entity is the basis for determining the recapitalisation amount, therefore it should not be possible for the resolution authority to adjust upwards such amount. A very conservative set of assumptions is already in place when calibrating MREL, such as the assumption that all loss-absorbing resources are exhausted prior to resolution taking place, and the disregard for non-eligible MREL liabilities due to them having a remaining maturity of less than one year.

We maintain that subordination requirements in the BRRD should be set by resolution authorities to a level that provides confidence that the "No-Creditor-Worse-Off" principle holds, but not a level beyond what is necessary to achieve this. The TLAC level has been tested and analysed as a level at which losses would be absorbed and recapitalisations needs met without the need for public support. Generally speaking, we think that the framework should be simple enough so as to support firms' planning, whilst also ensuring that market participants can understand what is required of firms to provide for adequate and proper market discipline.

Key issues that co-legislators will have to consider include the calibration of MREL requirements and the subordination of MREL liabilities, as well as the necessary amount of framing that should be set out to ensure a level playing field in the determination and application of such requirements by resolution authorities. In comparison with the European Commission's proposal, both the Parliament and Council deleted the concept of MREL guidance and inserted a binding Market Confidence Buffer. The co-legislators' position on subordination of MREL, however, is highly divergent with stricter requirements in the Council text.

AFME believes that Pillar 2 MREL requirements should be set in line with a clear set of criteria to justify and explain the determination of the requirement reached; this should also apply to the determination of the level of subordination deemed necessary. We think subordination should only be set at the level necessary to support a credible resolution strategy and in any case should not be set at such a level to create significant level playing field issues compared to institutions outside the EU.

3.2 Internal MREL

The requirement to hold internal MREL for both G-SIIs (in the CRR) and all other banks (in the BRRD) should acknowledge the work that has taken place at the FSB level on intra-group requirements, which sets out the need for internal TLAC at only material sub-group and at a scaled level (i.e. with the range of 75%-90%).

The objective of internal MREL is to enhance cross-border cooperation where this is necessary to support the preferred resolution strategy for the group. This objective should be recognised, and co-legislators should provide for sufficient flexibility, thus acknowledging that calibration of internal MREL should be part of the

resolution strategy being agreed between home and host authorities in the context of Crisis Management Groups or resolution colleges.

An appropriate calibration of internal MREL in line with the FSB TLAC Term-Sheet is vital to reduce cross-border fragmentation and provide for the necessary flexibility to use resources where they are needed in the group, thus improving its overall resilience. Moreover, waivers for internal MREL where the resolution entity and its subsidiary are both part of Banking Union would be consistent with the single resolution framework already in place and support efforts to continue to develop the Banking Union.

A key issue for co-legislators' consideration during the trilogue stage will be the calibration of internal MREL requirements and particularly whether appropriate scaling is prioivided in line with the TLAC Standard. Further to this, co-legislators will need to clarify the application of internal MREL requirements to third-country banks and the flexibility of issuance strategies.

The Parliament's approach to setting internal MREL provides for scaling in the 75%-90% range, in line with the FSB TLAC Term-Sheet, in both the BRRD and CRR. The Commission and Council instead set internal MREL at 90% of external MREL requirements for subsidiaries of third-country G-SIIs in the CRR and provide for no scaling in the BRRD. Both the Parliament and Council provide for greater flexibility in the issuance strategy, but this should also be available under the CRR.

AFME strongly supports the position of the European Parliament to scale internal MREL at 75-90% in line with the internationally agreed principles. The absence of such scaling is likely to increase fragmentation, increase overall requirements and reduce the resources available to support the resolution strategy. Moreover, AFME believes that waivers should be permitted for subsidiaries when the latter and resolution entities are both within the Banking Union, an approach strongly supported by the ECB and the EP. Flexibility to issue internal MREL to the resolution entity both directly, and indirectly, through other entities in the resolution group should be permitted.

Additional AFME material:

- AFME position paper on internal MREL[10]

3.3 Eligibility Criteria & Grandfathering

There are some key provisions in the MREL eligibility criteria which go above and beyond the eligibility criteria in the TLAC Standard. The proposal makes significant changes to the eligibility criteria for eligible liabilities and introduces new criteria for Additional Tier 1 and Tier 2 capital instruments. 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 two years based on the expectation that the European criteria would follow the international TLAC Standard, and absent transitional provisions MREL shortfalls would increase very significantly.

The key issues that will need to be considered in trilogues include the exact eligibility criteria that will need to apply to new MREL eligible liabilities, as well as the level of grandfathering that needs to be provided for. Clarifications will also be needed with regard to the interaction of certain elements with the eligibility of MREL instruments, e.g. the presence of issuer call options and how they might reduce the duration of eligibility even if not exercised. Moreover, a decision will need to be taken as to the opportunity to ban the sale of MREL liabilities to retail clients when it exceeds certain limits.

The question of the eligibility of debt issued under English law also needs to be considered very carefully in light of Brexit. To this end, we consider necessary a specific provision granting grandfathering to all liabilities (including AT1 and T2 instruments) issued under UK law, in order to safeguard the eligibility for MREL of such debt after the Brexit date.

The Council and European Parliament have both amended the eligibility criteria for MREL instruments in the CRR (art. 72) and BRRD (art 45b), but not in the same way in every case. Some additional language is added in the Parliament text with regard to restrictions on the issuance of MREL to retail clients namely that MREL instruments are not to be held by retail clients unless their investment does not exceed 10% of their financial instrument portfolio and their investment is at least €10,000. Preliminary considerations show that this will

[10] See here

be difficult to implement, particularly referring to the monitoring of external networks, and secondary markets. Whilst the intention of this additional language is clear and understandable, we do not believe consumer protection measures should be addressed in prudential requirement legislation and the Council position – if any – should be preferred.

Separately, it should be clarified within the relevant text that the presence of issuer call options should not result in the maturity of the instrument being reduced to a year before the earliest date of that option being exercisable. It is also vital that grandfathering be provided for all existing issuances of otherwise MREL eligible instruments, including for AT1 and T2 instruments, and foreseeing a derogation of the subordination requirement for the purpose of meeting BRRD MREL requirements.

AFME supports the changes the Council have made to the eligibility criteria for MREL instruments. We believe that restrictions of issuances to retail clients should not be addressed in prudential regulation as suggested by the Council text. We also encourage further clarity on the interaction between issuer call options and MREL eligibility.

AFME considers that a permanent grandfathering provision for all issuances (i.e. all liabilities, AT1 and T2 instruments, including UK issuances) prior to the revised CRR coming into effect is necessary. Should this not be possible, we support the Council approach to grandfathering, but with the caveat that a 10-year time frame for AT1 and T2 instruments would be more adequate than the proposed 6 years.

Additional AFME material:

- AFME position paper on eligibility criteria and grandfathering[11]

[11] AFME position paper on eligibility criteria and grandfathering

3.4 Moratorium tools

AFME does not believe that the introduction of the new moratorium powers is necessary or appropriate. They would have far reaching consequences and run counter to the objective of ensuring financial stability and of achieving an orderly resolution. In particular, they would create contagion and systemic risk; also, they would result in significant capital and margin increases for institutions and their counterparties and undermine the competitiveness of European banks. Counterparties and depositors would be incentivised to run at an earlier stage, at the first sign of stress for fear of a lengthy stay, further damaging the liquidity position of the institution. Moreover, the proposed moratoria would deviate from the international consensus regarding stays in respect of netting agreements and financial contracts, and thus threaten the effective recognition of resolution actions on a cross-border basis. Finally, the stay powers would create adverse consequences for a range of end users who rely on access to their operational deposits at EU custodian banks; clearing, payment and settlement systems would be disrupted as a result.

The key issue to be considered by co-legislators is – in case AFME's preferred option of full deletion is not taken forward - the shape of a possible compromise able to minimise the impacts set out above. Key elements of such compromise are: the duration of the new moratorium tool and its interaction with existing stay power under the current BRRD text (art. 69, 70, 71). In this respect, alignment with the FSB Key Attributes of Effective Resolution, which limit stays to 48 hours, should be ensured.

The Council and European Parliament limit the duration of the new moratorium tool, which would be applied only after the determination has been made that an institution is failing or likely to fail. However, only the Council considers the interaction with existing stays.

AFME believes that if co-legislators pursue the introduction of new moratorium tools, the Council position best addresses the concern above. Both EP and Council move in the right direction, e.g. limiting their duration to a maximum of 2 days, however only the Council General Approach adequately restricts the use of additional stay powers, i.e. those under Articles 69, 70 and 71 of the BRRD. We also recommend that attention should be given to the scope of the powers to avoid unintended impacts on financial stability: covered deposits, operational deposits, all financial contracts, custody services and third country financial market infrastructures should be out of scope.

Additional AFME material:

- AFME position paper on moratorium tools[12]
- AFME briefing note and Joint AFME - EBF letter[13].

3.5 Article 55 – Contractual recognition of bail-in

AFME welcomes the acknowledgment of practical challenges in implementation of article 55 of the BRRD, which mandates the inclusion of a bail-in recognition clause in a wide range of contracts. Two categories of contracts, currently in scope, present challenges. The first are contracts where inserting the relevant provision is unrealistic, which is the case for instance for trade finance products and membership of financial market infrastructure. A second category is represented by those contracts where the local regulatory authority resists any change in terms, e.g. uninsured deposits of bank branches outside the EEA. In addition to the practical implementation challenges, it is unclear that e.g. bailing-in trade finance products would bring a significant improvement to the recapitalisation of a bank.

Co-legislators will have to decide on the use of waivers under art. 55, notably the range of liabilities for which they are available and whether a cap should be placed on their use.

[12] See here
[13] See here

Both the Council and Parliament position provide for an exemption from the art. 55 requirement when "legally or otherwise" impracticable, but the Parliament places a cap on exemptions, set at 15% of total liabilities that would need such a clause if issued under third country law, and furthermore generally precludes from the waiver the very broad category of unsecured 'debt instruments', which under the BRRD could be any instrument acknowledging a debt.

AFME's preferred solution is to limit the scope of Art. 55 to liabilities eligible for MREL and any additional liabilities as identified by the authorities for the resolvability of the group. However, if the waiver approach is taken forward, we support the Council's position as it provides for an exemption for cases of impracticability and does not place a cap for such waivers, nor does it generally preclude unsecured debt instruments for such waivers. We believe neither a cap nor preclusion of unsecured debt instruments form the waiver are necessary as there are already important safeguards in the text regarding both MREL eligibility and resolvability.

Additional AFME material:

- AFME briefing note on Article 55 requirements[14]

[14] See here

4 Other key priority areas

A number of additional priority areas deserve further consideration during the trilogue stage.

4.1 Intermediate Parent Undertaking

It is important that the IPU requirement is implemented in a way which does not create unnecessary fragmentation of capital markets. Financial firms headquartered outside the EU provide an important contribution to financing the European economy.

The ECON's compromise introduces more time, as well as greater recognition of the need to ensure that that a single IPU should also not conflict with a group's global recovery and resolution plan. We are therefore supportive of this approach but recommend that the co-legislators also clarify as per the Council text that investment firms (currently) authorised under MIFID II are equally able to fulfil the 2nd IPU role when this permitted for the reasons mentioned.

Interaction with IFR proposal: It is not clear how the CRD5 IPU provision and Commission's IFR proposals will ultimately interact, as of course these are both subject to negotiations and are at different stages of this process. Nevertheless, as proposed, there are a number of links between the two that could affect the scope of the IPU provision and that the co-legislators need to consider side by side. We strongly recommend that the CRD5/CRR2 trilogues take this into account. As a reminder, the IFR proposes to expand the definition of a credit institution to include so-called class 1 investment firms. This implies that, going forward, i) the CRR use of the term "institutions" will only mean credit institutions and ii) only class 2 and 3 investment firms will be authorised under MiFID II and will be excluded from the IPU (class 1 investment firms will be authorised under the CRD/R as an additional type of credit institution).

For AFME members, it is important that i) such changes in definitions and the links with the scope of the IPU do not create any new conflicts with structural separation requirements (which should not be the case if it is clear that class 1 investment firms re-classified as credit institutions are not required to take deposits) and ii) the CA which will ultimately have oversight for any IPU or other entities belonging to third country groups is clarified as soon as possible.

AFME welcomes the above-mentioned flexibility and the acknowledgement by the co-legislators that firms should be given sufficient time to implement the new IPU requirement. We support the ECON's compromise where it introduces more time, as well as greater recognition of the need to ensure that a single IPU would also not conflict with a group's global recovery and resolution plan. It will also be important to fully consider the potential interaction between the IPU requirement and the Investment Firms review.

4.2 Treatment of software

Software is a strategic asset for banks, enabling them to serve clients where and when needed, to develop cyber security measures, and to deliver digital services competitively. Given the increasing push towards digitalisation and the investments being made by banks in this area, software should be generally treated as a tangible asset for prudential purposes.

AFME welcomes the EP proposal to exclude software from intangible assets that need to be deducted from CET1 and to require the EBA to develop a RTS to specify, by 6 months after entry into force, the capital treatment of software.

4.3 Grandfathering of AT1 and T2 instruments

Clarity on the continued eligibility of issuances made prior to the new eligibility criteria is necessary for banks to identify their current shortfall and enable them to continue issuance over the next months.

While both EP and Council recognised the importance of this point, we are concerned the EP position does not include in CRR grandfathering for AT1 and T2 instruments. It will be very important that this is addressed during the trilogues.

4.4 Leverage Ratio

AFME supports implementing the LR in line with the global standard. Additionally, Central bank deposits should be excluded from the exposure measure to avoid unnecessarily trapping capital that could be deployed to financing the economy and as there is no direct benefit to allocating capital towards them. The Basel Committee has recently supported this proposal.

AFME welcomes the approach adopted by the EP and Council, which is consistent with the Basel standard. In this respect, we seek further alignment by the EP in maintaining the G-SIB buffer as a 'buffer' to be used in stress, and not as a minimum 'requirement' which must be met at all times. We welcome the EP proposal to allow the exclusion of the central bank deposits from the exposure measure, and we believe this should not be limited to in 'exceptional circumstances'. In addition, cash and Level 1 HQLA variation margin should be allowed as collateral for the purposes of calculating LR's replacement cost, an issue which has not been addressed in either the EP or Council text.

4.5 Large exposures

It is important that firms retain the ability to use validated internal models for calculating exposures in the LE framework.

For secured financing transactions, AFME welcomes the approach adopted by the EP and Council, which allows for the use of own estimates to calculate the effect of financial collateral. However, it is equally important to allow firms to continue using internal models to measure derivative exposures in the large exposures framework until the calibration of SA-CCR at Basel and EU level has been completed and it is adopted in other major jurisdictions for use in the LE framework. The need for an impact study before implementation is in line with EBA recommendations and continued use of internal models for calculating derivative exposures in the LE framework is consistent with the approach adopted in other jurisdictions (e.g. recently the U.S. adopted this approach in their version of the large exposures framework - SCCL).

AFME stresses the importance of allowing firms to use validated internal models for calculating exposures in the LE framework. In the area of derivative exposures, it is particularly important that the use of internal models is maintained until a review of the calibration of SA-CCR is complete and its impact in the LE framework understood.

4.6 Remuneration

Ensuring that a significant portion of variable remuneration is deferred over a period of time and can be clawed back is an important objective. However, 'Material risk takers' is a broad category, that also captures junior staff (for example, a middle manager who reports to the Head of Internal Audit or a junior trader), for whom the imposition of a longer (5 years) deferral would not be commensurate to their profiles and risks.

As the EBA concluded when consulting on their Guidelines in 2015, we recognise that for senior management whose activities may have a greater impact on the risk profile of the firm, a longer deferral period (e.g. 5 years) may be justified. However, for more junior staff, a 5-year deferral would have a significant impact on their overall remuneration and specifically their cash flow, which is not commensurate with their profile and risks they might pose and/or manage. This position was reflected in the final EBA Guidelines which only require 5-year deferral periods for senior management in significant firms. * Reducing the *de minimis* exemption proposed by the EC would further exacerbate this issue.

(* See paragraphs 239-240 of EBA/GL/2015/22)

4.7 Trade finance

Trade finance products are essential for European corporates and the proposed liquidity requirements under the NSFR would significantly increase costs for end-users.

AFME welcomes the EP's treatment of factoring as trade finance and lowering of RSF factors, which in our view should however not be maturity-based and should be brought below 5%.

4.8 NPLs

Linked to the interaction of new requirements with legacy assets, we welcome the provisions proposed by the EP on massive disposals of NPLs: supervisors are putting pressure on banks to significantly reduce their NPLs, yet LGD estimates as a consequence would be overestimated and impact long term capital requirements.

AFME supports the EP introduction of the concept of "massive disposals" and the flexibility provided for institutions to consequently adjust their LDG estimated upon notification to the CA.

4.9 Pillar 2 (CRD)

While we support the revisions being made to the SREP framework, we are worried that competent authorities' powers are not adequately framed and could potentially lead to overturning policy choices made by the legislators in Level 1 legislation.

Pillar 2G:

Overall, we welcome the distinction between P2R and P2G introduced in CRDV. However, as drafted in the EP report, Article 104b(1)(a) introduces text which would allow competent authorities to set a potentially arbitrary, undefined minimum P2G own funds requirement (or P2G "floor" in addition to the CRR own funds requirements n.b. the text states banks could not breach either in the context of the supervisory stress test – see Article 104b (3)).

Art 104b(4a) in the EP text should be deleted as in essence it is akin to increasing the 'capital conservation buffer', which is requiring multiplying the amount of capital held for the same risks. Moreover, this could well lead to Competent Authorities divergent approaches across the EU, which would be contradictory to the intention to create a harmonised approach to P2G. Finally, as it would de facto introduce a requirement, which is contradictory to the concept of guidance in the first place.

With respect to the Council's General Approach, macro-prudential risks such as "cyclical economic fluctuations" should not be included in P2G. This is because they are already taken into account through other tools, such as the macro-prudential tools in CRR Art 458. We therefore do not support the maintenance of Art 104b (1)(a) in the Council text. Ideally 104b(1)(a) should be removed from the text altogether.

AFME supports the EP proposal to introduce a new recital aimed at clarifying that Pillar 2 measures should not conflict with the specific treatments set out in CRR, including those aimed at avoiding unintended impacts on end-users and on the European economy.

In respect of P2G, AFME opposes the introduction of a 'floor' and recommends that it be clarified that the determination of P2G is to ensure that institutions' own funds can absorb the maximum stressed loss, taking into account credible management actions. It should also be made clear that it can offset the capital conservation buffer and countercyclical buffer in certain circumstances.

4.10 Equity Investments in Funds

As per the draft CRR explanatory text in the Commission's November 2016 proposal, the draft CRR amendments related to equity investments in funds implement the Basel Committee on Banking Supervision's (BCBS) standard published in December 2013 (BCBS 2661). The industry believes however that the draft CRR text diverges from the BCBS standard by restricting the look-through approach to UCITs and AIFs marketed in the EU (together 'collective investment undertakings' or 'CIUs') and requires additional attention.

The EP's consolidated text does not address this issue and therefore these funds, which are currently within the definition of CIU per Article 4(1) of the CRR, will fall out of scope and default to the high-risk category, detracting investments in these funds which may themselves invest in the EU.

The Council text has partially addressed the issue through amending the definition of a CIU in Article 132(3) to include 3rd country AIFs and EU AIFs marketed by non-EU AIFMs. UCITs equivalent funds remain out of scope however and therefore default to the high-risk category, with a perverse outcome of UCITs equivalent funds potentially attracting higher risk weights than AIFs, despite being less complex by nature.

AFME supports the Council's approach which brings all AIFs i.e. 3rd country and EU based AIFs, within the scope of the definition of a CIU, but recommends that this is extended to UCITs equivalent funds, which are less complex by nature (than AIFs). Both 3rd country AIFs and UCITs equivalent funds were previously within the definition of a CIU and a de-recognition will detract investment in these funds which may themselves invest in the EU.

5 Additional topics and recommendations

In addition to the priority areas that we have detailed in this paper that deserve consideration, we list below aspects of the Parliament's consolidated text and elements of the Council's General Approach which have positively addressed issues in other areas of the prudential framework.

European Parliament – Consolidated Text

Subject	Article	Description
Pillar 3	[Article 438(i)] [Article 439 subpara 2] [Article 448(1)(e)(ii)]	• Removal of disclosure of requirements related to hypothetical risk weighted amounts. • A firm may be exempted from the requirement to disclose collateral received and posted where it is in receipt of central bank liquidity assistance. This is to avoid creating a market reaction that results in systemic stress due to the disclosure. • Risks from potential changes to interest rates need be assessed under two rather than six supervisory shock scenarios.
Large Exposures	[Article 399(1)] & [Article 401(4)] & [Article 403(1)] [Article 507] [Recital 67a (new) CRR = Recital 17a (new) CRD] & [Article 513a (new)]	• Additional wording provides clarity that risk substitution should only be mandatory where credit risk mitigation has been recognised to calculate capital requirements in the risk-based capital framework (in line with Basel). The Basel alignment is not complete, however, as the exposure value for non-FSEs should be the CCR value, rather than the exposure value by which the original counterparty was reduced. • Removes exemptions under Article 400(1) and Article 400(2) from the scope of scope of the EBA's review of the impact of removal of exemptions, limiting the review to exemptions per Article 390(6). This is because intragroup exemptions will be reviewed more holistically by 1 Jan 2020 as part of a review of whether the current rules are creating obstacles to completion of the Banking Union.
Equity Investments in Funds	[Article 132(7)] [Article 132(4)]	• Provides the option for an alternative calculation methodology for institutions applying the look-through approach, subject to certain conditions. • The requirement to multiply risk weighted exposure amounts by a factor of 1.2 if an institution relies on third-party calculations is qualified, such that it only applies whether an institution does not have the necessary data or information to replicate the calculation.

NSFR	Article 428b (2) Article 428h (1)	• This provision specifies that institutions shall maintain a net stable funding ratio of at least 100%. This is positive in comparison to the Council's proposal, which introduces an additional requirement for this ratio to be observed in the reporting currency, irrespective of the actual currency denomination. The Council's proposals would result in additional management buffers needed to manage the currency requirement, potentially increasing the de facto requirement significantly. This represents an area of super-equivalence in relation to Basel standards and its impact has not been assessed. • The provision specifies that competent authorities 'shall consider', rather than 'may', preferential treatment within a group in respect of higher ASF / lower RSF where certain conditions are fulfilled.
Infrastructure Finance	[Article 501a(1)(a), (b), (c), (d), (g)(i) & (j)]	• Amendments to extend scope of article to more infra projects. Note, we do not support amendment 501a (1) (ba) on sustainability, which would significantly reduce the scope fo application of the article.

European Council – General Approach

Subject	**Article**	**Description**
Pillar 3	[Article 466] [Article 99(7)] [Article 430a(4)(a)]	• Limiting disclosure to qualitative information and removing quantitative disclosure requirements for the Operational Risk. • New EBA mandate to assess cost-benefit of reporting requirements and their proportionality by 31/12/2019. • Increased threshold for what is defined as a 'small institution' for disclosure purposes to €5bn from €1.5bn, with an ability for competent authorities to increase this up to €10bn.
Large Exposures	[Article 400(1)(l)] [Article 394(1)(d) sub-para 3]	• Subsidiaries of resolution entities are brought into the exemption of holdings of internal MREL, which would enable internal MREL to be distributed effectively throughout the group. • €300m reporting threshold to be applied at the consolidated level only.

Equity Investments in Funds	[Article 132a (3)] & [Article 152(3)]	• Correction of calculation of CVA – formula aligned to Basel, formula previously incorrectly increased CVA RWAs by 50% of the exposure value, rather than 50% of the own funds requirement in the first step of the calculation.
CCP Exposures	[Article 497(1)(b)] [Article 497(3)]	• A technical amendment has been introduced such that the transitional provisions also apply to CCPs that have applied for recognition as QCCPs prior to entry into force of the regulation. This means that every CCP seeking to be a QCCP will have at least a 2-year transitional period to be recognised as a QCCP. • Re-introduces an ability for the COM to extend these transitional provisions, which the COM had deleted in its original proposals. The ability to extend transitional provisions has been limited to 'once' in exceptional circumstances. There is no such limitation in the current CRR and this should be removed to avoid market disruption.

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