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Dear Sirs

Reference **EBA/CP/2013/17**
EBA Consultation Paper on Draft Regulatory Technical Standards on Own Funds (Part III)
Published 23 May 2013

We welcome the enhancement of regulatory harmonisation in Europe and are appreciative of the opportunity presented at the open hearing on 24 June to understand better the EBA thinking behind this consultation paper.

We are concerned however about the unintended consequences of drilling through to any part of the financial sector when determining the capital position of an individual bank. Our main concerns are in regard to where the draft RTS appears to extend the text of the directive.

RBS has contributed to the responses from the trade bodies, BBA and AFME. Our more detailed comments on the questions in the consultation paper are contained in the following annex. We would be happy to elaborate further on any of the points made in this response and look forward to engaging with the EBA in this area. In the first instance, please address any enquiries to myself.

Yours faithfully

Rajan Kapoor
Group Chief Accountant

Principal comments

1. Calculation of sub consolidations and the treatment of minority interests

The stated objective regarding minority interests ('MI') is to harmonise the calculation of minority interests to be included in regulatory capital

We note that there are a number of areas where the detailed rules as proposed will have unintended consequences. In particular, we consider it important that there is clarity that the non-EEA Basel 3 implementation is equivalent to the CRD in jurisdictions which have or are in the process of implementing Basel 3.

In practical terms, the structural reforms currently being discussed or brought in through the Dodd-Frank Act in the US and Liikanen proposals mean that the treatment of foreign holding companies for institutions will require some additional direction to enable the MI from subsidiary institutions domiciled overseas to continue to be eligible within a multi-national banking group.

Allied to the above, the text would benefit from simple explanation to determine at what level a sub-consolidation should be performed (either for institutions domiciled within or outwith other EU countries). We would appreciate clarification on the treatment of subsidiaries which are not institutions. Reserves may be held in subsidiaries throughout the Group and these entities may not be institutions.

As a separate but related point, we would welcome clarification on the approach to take, where the bank has a participating interest in a holding company, by definition a financial institution, but where the underlying group is not engaged in financial activities. There are differing views from EEA regulators as to whether the whole group, including the holding company, can be treated as non-financial, or whether the holding company must be treated independently of the sub group.

2. Deductions from Capital – Financial Sector

The objectives of the draft RTS regarding deduction of indirect and synthetic holdings are stated as being to achieve greater harmonisation as well as increased conservatism in the way the deductions of investments in financial sector entities as well as own capital instruments are applied.

We consider that the determination of "Significant" should only include holdings which a bank can influence to the extent of exercising a vote, so indirect, synthetic & index calculated share equivalents should be excluded for this purpose. Holdings in the Trading Book should also be excluded because these are not held in the medium or long term to extend or benefit the group's franchise.

The RTS could be read to require a bank to look through a holding in a mixed activity holding company to an underlying institution for example a supermarket chain which owns a bank. Furthermore, to look through to a retail operation, and attempt to consolidate it would be beyond stated intentions of the Basel framework and be operationally complex. Determination of the financial proportion would be very difficult, and operationally very onerous. In each case, the investment of the bank is in the net resources of the overall (principally non-financial) group. For practical purposes, the investing bank would not have access to sufficient information regarding the subsidiary bank on a timely basis. The accounting policies applied by the investee subsidiary my not be the same as those of the investing bank, thus adding to the burden.

Separately, holding companies listed on the FTSE 100 would fall within the financial sector entity definition as financial institutions. On this basis, we would have to include most constituents of the index as financial sector entities. Simply because the holding company is

listed but the operating companies are not, and thus to capture, say, a chemical business would seem to be excessive.

RBS would be happy to engage with the EBA to assist in the determination of a practical approach which could be applied within Europe, in a timely fashion.

Similarly, to look through to the pension fund for a bank's employees would seem to go against the spirit of legislation put in place to keep these funds separate from the control of the employer. Under IFRS the employer recognises the net surplus or deficit of the pension fund on its balance sheet but not individual assets or liabilities. In the UK the assets of a pension fund are managed by independent trustees who have legal duties to protect the interests of the members of the fund. The employer does not have access or title to these assets. The bank already takes a deduction from capital for any current obligation to fund any shortfall.

RBS considers that the Trading Book and Non Trading Book position should be clarified for both Significant and Non Significant Investment deductions. The Trading Book contains positions which are not expected to be held for long term, and the market risk on such positions is calculated according to the current equivalent exposure to a company, offsetting long and short positions which may mature at different future dates. Risk management practices, including hedging of open positions on the Trading Book, also need to be taken into account. Such hedges may have differing maturity dates and meet the Trading Book rules but appear to create a long position for these purposes.

Additionally, the current draft text would require nominal positions to be used instead of delta or share equivalent positions. This would increase the impact of the RTS considerably, whilst the actual economic risk is better measured through equivalent positions.

We note that the Directive text on the matter does not specify the methodology to be used, and in particular if the Trading Book is permitted to use the market risk rules, which enables netting without maturity restrictions, then this would provide a more appropriate and proportionate view of the financial sector holdings. The current proposal could make it less beneficial for a bank to hedge an existing short position, if that bank had capacity for a higher market risk charge, to avoid triggering the threshold limit.

Annex - Questions for consultation:

Q01: Are the provisions of Article 14a sufficiently clear? Are there issues which need to be elaborated further?

Article 14a - Indirect and synthetic holdings for the purposes of Article 33(1) (f),(h) and (i) of Regulation

RBS considers that the wording of these provisions, whilst intended to expand on the articles referenced, appears to widen the scope. The text is sufficiently broad that it could be considered indirect level 1 rather than level 2.

We note that the Basel FAQ 15 which refers to an "investment" in an intermediate entity, differentiated from a concept of "exposure" as used in the CRR Art. 4 definitions;

> (114) 'indirect holding' means any exposure to an intermediate entity that has an exposure to capital instruments issued by a financial sector entity where, in the event the capital instruments issued by the financial sector entity were permanently written off, the loss that the institution would incur as a result would not be materially different from the loss the institution would incur from a direct holding of those capital instruments issued by the financial sector entity;
>
> (126) 'synthetic holding' means an investment by an institution in a financial instrument the value of which is directly linked to the value of the capital instruments issued by a financial sector entity;

We consider "exposure" is open to interpretation and the application of a consistent definition would be helpful. We would be happy to work with EBA to provide further definition and explanation.

Q02: Provisions included in paragraph 1of the following Article 14a refer in particular to pension funds. These provisions have to be read in conjunction with the deductions referred to in Article 33(e) of the CRR. Would you see any cases where there might be an overlap between the two types of deductions? Please describe precisely these situations and the nature of the problem.

RBS understands that the rationale for the deduction under Article 33(e) (Article 36, 1.(e) in the final text) is to recognise the legal separation of the bank and it's pension fund. In the UK, under IFRS, the employer includes the net surplus or deficit on the balance sheet. If there is a surplus on the pension fund, the employer cannot access that to meet its obligations to depositors and other creditors, without significant legal and tax restrictions, but may reduce future funding obligations.

Where a bank has recognised a deficit on the pension fund, it will already have reduced its reserves to the extent of the liability recognised.

The bank will be indirectly exposed to the overall impact of market movements on the investments held by the pension fund to meet the obligations of that pension fund. The bank would not suffer a loss equivalent to the nominal amount of the investments the funds may have in financial sector entities.

Q03: Please provide also some input on the potential impact? What would be the size of the deduction of defined benefit pension funds under the treatment proposed in the following Article? Would the treatment cause a change in the investment policy of the pension fund with regard to such holdings, or have any other consequences for the operation of the defined benefit pension scheme?

We would expect the impact would be significant, but we are not in a position to quantify that impact.

Pension funds typically hold a variety of investments which may include the financial sector. There is usually an offset to the losses on one section of the portfolio depending on other market movements and other changes to the fund obligations.

The employer would typically agree on an investment approach with the fund trustees, and any limitation to, say, exclude investments in financial sector entities could lead to sub-optimal results, not in the long term interests of the pension fund, the bank and the employees.

We are concerned that where such a look through was made, there might be a reasonable expectation of the bank to request changes to the investment strategy of the Pension fund. Any ability to request such changes would run counter to legislation brought in specifically to police the boundary between a corporate and its' pension scheme.

Q04: Do you agree with the examples of synthetic holdings provided in paragraph 2 of the following Article 14a? Should other examples be added to this list?

These are reasonable examples, being a reproduction of the answer to the Basel FAQs. RBS would rather see a full list defined or a set of principles stated, in preference to a list which gives examples but is not comprehensive.

Q05: Are the provisions contained regarding synthetic holdings in paragraph 2 of the following Article 14a and in Article 14e sufficiently clear? Do you agree that the amount to be deducted shall be the notional amount? Would you see any situations where another amount shall be used?

The RTS does not explain how each example would calculate the deduction to be made, whether a long or short position – the CRR text states that the value is directly linked to that of a financial sector entity. We consider that the notional amount is not necessarily an appropriate measure for positions held in the Trading Book.

Additionally, the EBA is guided by the Basel text, but the impact of not separating out the Trading Book net positions runs counter to the requirement to manage the Trading Book as noted in Article 103. In particular, Article 104 2 c) ii) requires a bank to hedge all material risks. Risk management practices, including hedging of open positions on the Trading Book, also need to be taken into account. Such hedges may have differing maturity dates and meet the Trading Book rules but appear to create a long position for the purposes of Article 14.

Q06: Are the provisions relating to the deduction of serial or parallel holdings through intermediate entities sufficiently clear? Do you see any unexpected consequences? Are there issues which need to be elaborated further?

Many large corporates have significant treasury operations, frequently set up as subsidiaries, which participate in markets. Clarity is requested on whether these are considered to be "intermediate entities". In the UK, a number of authorised institutions are owned by retailers. In each case the listed company would seem to meet the definition in Article 4;

> 22) 'mixed activity holding company' means a parent undertaking, other than a financial holding company or an institution or a mixed financial holding company, the subsidiaries of which include at least one institution;

As stated in the response above, information is neither transparent nor available promptly to enable apply the look through approach in most situations. Under Art14(b)(b), the phrase "operationally burdensome" is used to clarify approaches in Arts(c-d). More detail on what firms should regard as operationally burdensome would be helpful, and the alternative measures proposed could provide a significant over-estimate.

Q07: Are the provisions of Article 14d relating to a structure-based approach sufficiently clear? Are there issues which need to be elaborated further?

We do not consider that Article 14d - Structure-based approach for the calculation of indirect holdings – is operationally feasible, but we consider that to apply the provisions of (6) & (7), using the maximum amount of financial sector entity exposure which could be held through this indirect approach, is excessive.

Q08: Are the provisions of Article 24b sufficiently clear? Are there issues which need to be elaborated further?

The current version is clear but we anticipate amendments when the final rate & index setting process has been agreed.

Q09: What in your view is the best means for ensuring that the benchmark rate is not materially affected by the credit standing of an individual participating institution? The criterion of minimum number of contributors or that of minimum representativeness of the market or both?

See response to Q08

Q10: What would be the minimum number of contributors to ensure this absence of correlation? If a minimum representativeness of the market was chosen as an alternative route, how to ensure and calculate this representativeness? Would the percentage of 60% be sufficient?

See response to Q08

Q11: How would you treat minority interests arising from an institution permitted, under Article 8 of the CRR, to incorporate a subsidiary in the calculation of its solo requirement (individual consolidation method)?

We are of the view that minority interests within subsidiaries should be eligible regardless of how these are supervised.

Q12: How would you treat minority interests arising from a subsidiary not subject to supervision on a sub-consolidated basis although it is the parent undertaking of other institutions? If the subsidiary would be allowed to undertake the calculation referred to in Article 79(1) on the basis of its sub-consolidated situation, some conditions would have to apply in order to secure this calculation in the absence of a supervision on a sub-consolidated basis. What would you propose as conditions?

Minority interests within those subsidiaries should be eligible regardless of whether they are supervised on a sub-consolidated basis. In particular, it would be helpful to understand that reserves of non institutions may be explicitly included in the sub consolidation.

We note that the examples are stylised and do not mirror the complexity of actual banking groups.