HSBC

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EBA/CP/2013/17 – Draft Regulatory Technical Standards (RTS)

Own Funds under Articles 33(2), 69a(6) and 79(3) of the draft Capital Requirements Regulation (CRR) - Part Three

HSBC welcomes the approach the EBA has taken to release a consultation on this Regulatory Technical Standard (RTS). However, as currently drafted, we believe the EBA has gone far beyond its mandate of specifying *"the application of the deductions"* for indirect and synthetic holdings.

Instead, the consultation appears to want to capture all possible interconnectivity within the financial system, to cover the risk of failure of financial sector entities. While this is a laudable aim, it would be impossible and inappropriate to achieve through the proposals of an RTS alone and would require a significant revision of the overall prudential framework via Level 1 text.

Furthermore, as currently drafted, the RTS requires banks to hold additional capital for risks where this is already addressed. This results in duplicative, overly punitive and untenable levels of capital deduction. Consequently, we believe that such an approach should be addressed by the Basel Committee on Banking Supervision as European banks are likely to be faced with far more penal capital rules than their US counterparts.

As currently written, there are also aspects of these proposals that are both unclear and subject to far-reaching, unintended consequences. We welcomed the EBA's acknowledgement, at its recent Public Hearing in London, that there are areas of this RTS regarding the deduction of indirect and synthetic holdings that will be subject to further consideration and development. However, we note that the deadline to submit draft regulatory standards to the European Commission is 28 July 2013, which we strongly believe provides insufficient time for the EBA to consider and act on the responses it receives. We fear that the time pressure to submit the RTS to the Commission has increased the risk of adoption of a hasty and ill-considered technical standard, lacking sufficient due diligence, with ramifications for the equity capital markets and lending to the real economy.

The consultation has also created major areas of uncertainty which are not addressed by either the text or the questions posed. These require urgent clarification to ensure a consistent application of the CRR across jurisdictions. These issues are set out in Appendix 2 to this letter.

We believe that many of the shortcomings of this RTS can be resolved through a Quantitative Impact Study and further consultation. The shortcomings are acknowledged in your own Draft Cost-Benefit Analysis / Impact Assessment, Annex 1, paragraph 15, which admits for indirect and synthetic holdings *"the aggregate outcome on capital requirements cannot be inferred given the lack of sufficiently detailed data"* and for minority interests, paragraph 23, *"Data is not available, however, to estimate the potential aggregate fall in available eligible capital"*.

We note there are three independent objectives within the RTS, namely:

1) deduction of indirect and synthetic holdings;
2) broad market indices; and
3) minority interests.

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We have included high level views on each section below and provided detailed responses to the questions listed in the RTS in Appendix 1.

High level comments

1) *RTS objective regarding deduction of indirect and synthetic holdings: 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.*

General

- The overall specific regulatory objectives of the RTS rules are unclear. Without clear articulation of the perceived risks that the consultation aims to address, it is difficult to achieve consistent application of rules, prevent unintended consequences and double-counting of requirements and deductions from capital of an unfeasible magnitude.
- Given the degree of departure from the level 1 CRR text, implementation of such proposals without first conducting a Quantitative Impact Study would risk major adverse implications for the industry and threatens the rigour of regulatory policy making.
- Although this RTS states that the CRR provides rules for direct holdings, those rules alone are insufficiently precise. This has a direct bearing on both the interpretation of the RTS and the intended interaction of indirect and synthetic holdings with direct holdings.
- A more detailed explanatory section or preamble in the RTS, defining its scope, perhaps similar in style to those in the US rules, would help the EBA meet its objective of harmonising the application of regulation.

Intermediate entity definition

- The concept of chains of intermediate entities is introduced without considering the complexity or length of the chains.
- The definition is too vague and would capture all entities except credit institutions and investment firms that hold instruments issued by financial sector entities. It would include, among others, mixed activity holding companies, insurance entities and non-financial corporates that have invested in financial sector entities, thus acerbating the capital impact.
- Defined benefit pension funds are specifically included along with insurance companies and other investments already subject to capital deduction, and this would result in a sizeable double counting of deductions.

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Relevant amount

- "Exposure" to the intermediate entity is not properly defined and contradicts other parts of the RTS where concepts such as "funding" or "investment" are used. When combined with the vague definition of "intermediate entity" highlighted above, it will lead to a significant array of loans, derivatives and credit facilities to a huge number of counterparties being captured and untenable levels of capital deduction.
- There is no reference to collateral, short positions or any form of mitigation of exposures being allowed in the calculations. It is the net exposure that should be relevant for the quantification of the amount to be deducted.
- The use of notional values for long synthetic holdings in all cases is not consistent with the EBA's intention to assess loss in the case of failure of a financial sector entity, or with the index security proposals, and does not recognise the genuine differences between trading book and non-trading book approaches.

2) *RTS objective regarding broad market indices: to put forward criteria for broad market indices so as to avoid that the interest rate/dividend paid by institutions on floating rate capital instruments increase when the credit standing of the institution decreases (credit sensitive dividend features).*

- The RTS sections in respect of indices are clear and lay out a logical path for approving indices that could be used in determining the returns available on capital securities.

3) *RTS objective regarding minority interest: to harmonise the calculation of minority interests to be included in regulatory capital.*

- The RTS has not achieved its objectives. In particular, it fails to provide a proposal for the treatment of minority interests on a sub-consolidated level for an unregulated parent company in a group structure. This scenario is raised as a question and banks are not provided with the opportunity to respond to a proposal in this respect.
- While we welcome the further explanation provided of the CRR rules for eligible minority interests, we request further clarity of the details of the calculation to be performed, so as to ensure consistent interpretation of the rules by banks. In particular, both the technical standard and the CRR itself contain insufficient clarity regarding the treatment of banking groups with minority interests in subsidiaries outside the EU.
- We would welcome the inclusion of a general principle that minority interests pertaining to subsidiaries included in the regulatory consolidation should be considered as eligible capital capable of absorbing losses and request that the technical standard is extended to take account of where this arises outside Europe.

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We attach our specific responses to the individual questions posed by the consultation. We have also written separately to provide an illustration of the potential capital impact on HSBC of the current proposals which we consider should provoke sufficient concern to prompt their substantial revision.

Given our interest in and apprehension regarding these recommendations, we have copied this letter to our lead regulator, the Prudential Regulation Authority, the European Commission and other parties who we believe should share our concern over its implications.

In conclusion, we request the EBA to engage further with the industry before finalising its technical standard and we offer our assistance to work with you to refine the proposals.

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APPENDIX 1

SPECIFIC RESPONSES TO THE INDIVIDUAL QUESTIONS POSED BY THE CONSULTATION PAPER

Deduction of Indirect and Synthetic holdings

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

We do not believe the provisions are sufficiently clear. It is not always obvious how to calculate the potential deductions, and where it does appear to be clear the results are inconsistent with the Level 1 text.

1.1 Definition of Intermediate Entity

1.1.1 Article 14a (1) contains the text: "Intermediate entities shall be entities other than institutions ... and shall **include**:". It is unclear whether the list of intermediate entities which follows is intended to be an exhaustive list or to be examples only. (We note that 14a (2) contains the additional text "...but are not limited to", which clearly indicates a non-exhaustive list.) It would be helpful if the list in 14a (1) *were* exhaustive, in which case perhaps the text could be redrafted thus: "Intermediate entities shall be entities other than institutions ... and shall **be any of the following**:".

1.1.2 If the list of types of intermediate entities is intended *not* to be exhaustive, that leaves firms with the enormous challenge that, seemingly, they will be required to analyse *all* entities (including non-financial ones) to which they have *any* type of exposure (whether by way of loan, equity or other exposure type), to determine whether that entity happens to have an exposure to a financial sector entity (which itself is too broadly defined in the CRR text itself - see below); and then attempt to determine whether a collapse in the stock of that financial sector entity would result in a corresponding loss to the firm. We assume this is the intention. If it is, the EBA should provide considerably more guidance on look-through.

1.1.3 **Mixed activity holding companies** and **mixed-activity insurance holding companies** are treated as financial sector entities under CRR (OJ version) article 4(1)(27). Such groups include **major retailing and auto manufacturing groups**. So, as CRR is currently drafted, direct holdings in such entities appear to contribute to the assessment of deductions. We believe this was not intended and needs to be amended in the Level 1 text itself as it goes far beyond Basel intentions. However, if they are "financial sector entities" and, in addition, they are to be considered within the scope of "intermediate entities" (because they are not covered by the "institutions" exclusion), it would seem an unintended consequence that guarantees, lending, facilities, derivatives exposures and all non-capital exposures to such entities would contribute to the assessment of deductions as well. As

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they would default if their own capital instruments had no value, the RTS could have the entire exposure against them assessed as being lost. As noted above, this classification includes many large "real-economy" entities worldwide and exposures are usually not just to the exempt institution within that group. Thus the impact of including these entities as intermediate entities will be substantial. We therefore suggest that **mixed activity holding companies should also be excluded from consideration as intermediate entities.**

1.1.4 There are a number of other types of entity we believe are inadvertently captured by the RTS with potentially adverse consequences. For example, non-financial corporate entities would not usually purchase financial sector entity equity, but they could. If they did so, it is unlikely such holdings would be disclosed to a lending institution. Further, while the requirement to deduct capital for all loan exposures because the capacity to invest might be within those intermediate entities' "mandate", this would seem to be an unintended outcome.

1.1.5 We support the proposal to exclude "institutions" (defined as credit institutions and investment firms, wherever incorporated) from the scope of "intermediate entity" as such entities are already subject to prudential regulation. We would also support the exclusion of regulated insurance companies or indeed any entity subject to prudential regulation.

1.1.6 Defined benefit pension schemes holdings are discussed later in this response, and their inclusion also creates a number of undesirable outcomes.

1.1.7 Given the above, we believe the scope of intermediate entities is unclear and potentially far too broad. **Extending the scope of "intermediate entities" beyond investment funds introduces unintended consequences and immense complexity. In the interest of international harmonisation, we suggest that intermediate entities be restricted to investment funds.** This approach would be in line with the US Final Rule preamble which says *"In order to limit the potential difficulties in determining whether an unconsolidated entity in fact holds the banking organization's own capital or the capital of unconsolidated financial institutions, the final rule also provides that the indirect exposure requirements only apply when the banking organization holds an investment in an investment fund, as defined in the rule. Accordingly, a banking organization invested in, for example, a commercial company is not required to determine whether the commercial company has any holdings of the banking organization's own capital or the capital instruments of financial institutions."*

1.1.8 Two further areas where additional clarification is required are as follows:

- In Article 14a (1) (c) (i), it is not clear what criteria would be used in the definitions of *"indirectly under the control or under significant influence"*. These terms should be specified precisely in the RTS or should be explicitly delegated as being in the determination of the financial institution or the relevant competent authority.

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- It is not clear what Article 14a (1) (c) (ii) is adding to Article 14a (1) (a). Article 14a (1) (a) includes within the scope of "intermediate entities" Special Purpose Entities (SPE) which hold capital instruments of financial sector entities. Article 14a (1) (c) (ii) includes within the scope of "intermediate entities" SPEs which hold capital instruments of financial sector entities and which are not consolidated. We believe therefore that (c)(ii) is redundant. If this is not the case it would be helpful if the EBA could clarify how the SPE in (c)(ii) differs from the SPE in (a).

1.2 Definition of Exposure

1.2.1 It is not clear what "exposure" means as used in CRR (OJ Version) Article 4 (1)(114). If assigned the meaning elsewhere in CRR, it would include senior debt as the Article 14(a) states, though this seems to go beyond the Basel FAQ approach which refers only to "investments". The RTS only provides an example of CET1, and it would be helpful to have a worked example of how look-through operates in respect of senior debt or derivative exposures.

1.2.2 More generally, the terms "exposure", "funding" and "investment" are used interchangeably throughout the RTS, although they do not have the same meaning. **The RTS needs to be more consistent in its use of the terms exposure, funding and investment, to facilitate harmonised application.**

1.2.3 For example, article 14c(1) refers *to "exposures of all investors"* which seems to imply that having an exposure means having an investment, but this need not be the case; in the same section *"the institution's exposure ... together with all other funding provided"* implies that exposures are necessarily funding; again Article 14b(b) refers only to *"investments"* and not at all to exposures; and Article 14d(7) does not mention exposures, but only considers funding in the computation of holdings.

1.2.4 To avoid any conflict between the Basel "investment" approach, with its implication of current outstanding obligation, and the use of "exposure" in CRR which may include a future increase or contingent element, **the RTS should clarify any limitations on the type of exposures captured**. This could be achieved by qualifying the wording *"any exposure"* in Article 14a(1), or by clarifying the meaning of *"loss that the institution would incur" where there is an exposure but no investment or funding.*

1.2.5 There are a number of exposures (whether exposures ***to*** an intermediate entity, or exposures ***of*** an intermediate entity to further intermediate or financial sector entities) which may or may not constitute either investment or funding, consideration of which might help inform a more precise definition of *"loss the institution would incur"*. Some examples include:

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1. If exposure includes **secured lending,** it is often the case that mitigation is taken through LGD, rather than the exposure value itself, which could distort the potential for loss. This should be a key EBA consideration.

   For such cases, the RTS should clarify that the indirect exposure would be offset by any type of credit mitigation, because on the failure of the intermediate entity, the credit mitigation would reduce the loss arising from the failure of the financial sector entity.

2. In the case of **securities financing transactions** the intermediate entity may be providing financing to the financial sector entity against, say, equity collateral, which could give rise to an exposure. However, the funding or investment will be from the intermediate entity to the institution.

3. In the case of **derivatives**, such as interest rate swaps, the mark to market may be zero or even significantly in favour of the intermediate entity, but the potential for future movements means there would be an exposure. Here, there is no funding or investment. It would be helpful if the EBA could indicate whether derivatives are intended to be included in the scope of "exposures" for the purposes of CRR (OJ Version) Art 4 (1)(114) and, if so, what exposure measure should be used.

4. If **general facilities, guarantees and other off-balance sheet exposures** not directly linked to financial sector entities are included, it is not clear whether they should be reduced by the usual regulatory percentages, or not included until drawn when funding and investment arises.

We believe it was not the intention of the Level 1 text to include all the above examples in the definition of exposure for the purposes of CRR (OJ Version) Article 36(1) (f), (h) and (i). If the intention is to include such items, it is critical to have clear guidance as to the circumstances in which they should be included and the exposure measure to be used.

1.3 Large Exposures

1.3.1 CRR recital (88) extends existing Large Exposure exemptions until at least 31 December 2015, and recital (89) requires the EBA to oversee the appropriateness of such exemptions. Many of these exemptions relate to intragroup exposures. It would be helpful to know if the treatment of exposures under Article 14a(1)(c)(i) is intended to reflect this considered review, or has unintentionally undermined it.

1.3.2 In the UK, there are 'Core UK Group' large exposure rules (BIPRU10.8A.8) which exempt exposures between Core UK Group members and, in turn, exempt the exposures between these bodies from capital requirements. The impact of the RTS on these rules is unclear.

1.4 Holdings offsets

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1.4.1 **We would expect that offsets would be permitted between holdings, whether arising directly, indirectly or synthetically.** It is critical that the intended offsets between the direct, indirect and synthetic holdings are clear and we urge the EBA to provide clarification as part of this RTS.

1.4.2 The Article 14d 'structure-based approach' appears to merge all indirect holdings (which are not own capital instruments) by tier, but it is not clear whether this holding would then be permitted to be disaggregated for the purposes of the overall computation by financial sector entity and capital tier, or whether the aggregate is intended to be treated as a single financial sector entity (or even an index). If a new single financial sector entity was intended, the precision of division of offsets by entity for direct holdings seems misplaced, and the model for parallel holdings would seem not to work for the structure-based approach.

Q02: Provisions included in paragraph 1 of 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.

2.1 There will be overlap in all cases where there is a defined benefit asset and where a deduction under Article 14a would be applied for assets held by that pension scheme.

2.2 For example, a pension scheme is in surplus and is shown in the sponsor balance sheet as a defined benefit asset of 100. The scheme owns CET1 instruments issued by a financial sector entity and valued at 50. Under the RTS, all 50 is to be deducted from sponsor regulatory capital. In this case the total deduction is 150. If the CET1 instrument value falls to zero, there would still be a defined benefit asset of 50. The effective capital deduction that applies if the scheme invests in these CET1 instruments is 200% of their value.

2.3 The nature of the problem is that the deduction under CRR (OJ Version) Article 36(1)(e) is made on the presumption that a defined benefit asset is not available to the sponsor. Depending on local law and regulations, it may indeed not be available in the form of a capital transfer that could be used directly by the sponsor. However, those assets are available to support investment risk being run within the scheme.

2.4 For pension schemes sponsored by the bank it would normally be possible to look through to the underlying positions. The Trustees can request this data from their investment managers and are likely to be sympathetic to the Sponsor's reasonable request to disclose it. Therefore, it may be possible to perform the full calculation and not fall back to the structure-based approach.

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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?

3.1 Size of the deduction of defined benefit pension funds

3.1.1 We are not able to provide an indication of the size of the potential impact for the reasons articulated elsewhere in our response to this consultation paper. However, the potential magnitude of the proposed deductions could be prohibitive to the current structure of pension funds and these elements should therefore be part of an EBA impact assessment.

3.2 Supporting the investment risk

3.2.1 The conditions required to be "supporting the investment risk" are unclear. This has two implications:

- there is insufficient clarity as to the extent that exposures to a defined benefit fund will be included; and
- there is a risk that "supporting the investment risk" will be interpreted differently by EU countries.

3.3 Impact on investment policy

3.3.1 It is highly likely there would be changes to the investment policy of schemes sponsored by financial institutions. The response, which is likely to be extreme to avoid the risk of deductions occurring under the structure-based approach, could lead to disposal of such holdings and effectively prevent future investments in instruments that would be treated as a potential deduction.

3.3.2 On a bank industry wide basis, approximately 15% of defined benefit pension scheme assets are comprised of holdings in the Banking, Finance and Insurance sector, excluding Mixed Activity Holding Companies. The reduction in demand for the affected instruments could have further consequences, as other investors may choose to avoid them too.

3.3.3 The exclusion of a significant sector of the market in which a pension fund could invest, decreases risk diversification and potentially increases the volatility of asset values in the pension fund.

3.3.4 The maximum investment mandate capacity approach is problematic for institutions providing financial services, such as inflation hedges, to pension schemes they do not sponsor, and could encourage such funds to use non-EU providers, or in the event of adverse pricing, to disinvest from financial sector capital instruments.

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3.3.5 Regulators continue to insist that the financial sector needs to raise additional capital, so it is inopportune to create conditions which encourage selling and / or reduce the potential providers of such capital.

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?

4.1 Examples can be helpful, but as the list is not comprehensive and the intention of the examples is unclear, little is gained from adding more of them. However, providing the discussion of synthetic instruments highlights the lack of clarity of the CRR text in respect of index and other holdings.

4.2 In addition to the examples of synthetic holdings in the draft, it would be helpful to have a more explicit, general statement about what is intended to be covered.

4.3 The text only lists long positions. It would be helpful if the EBA could insert a comment to the effect that "short positions shall be construed accordingly".

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?

5.1 We do not think the provisions in those articles are clear and we do not agree with the approach of using a notional amount as that would generate inappropriate levels of deduction that are not representative of the potential loss. The notional amount is not appropriate for anything other than the most straightforward linear equity swap or total return swap type synthetic positions.

5.2 The examples in the RTS demonstrate the inappropriateness of using the notional amount: a long call option can lose no more than the premium so, except in the case of a zero strike call (where the premium equals the notional in any case), the measure is unrelated to the risk and would usually be a fraction of the notional. For completeness we note that "notional" is not an appropriate term for equity-related products without further definition as equity products are defined with reference to a number of shares and prices, and for more complex instruments there is no commonly accepted definition of "notional".

5.3 The list of examples is not very helpful, because, while it gives an indication of the breadth of types of synthetic exposure, it separates elements which might normally be treated holistically. For example, it is not clear whether, by giving separate examples for long calls and short puts, it is intended that decomposition to simple products is always required: for

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example, whether strangles or collars have to be decomposed (giving a vastly different result from their impact as a structure), or what approach should be taken for instruments such as digital options which do not have a coherent representation as the combination of simple products.

5.4 Alternatives do exist. It is reasonable to treat trading books from non-trading books differently. For a dynamically changing trading book, the delta of positions would give the best representation of the exposure, because as the move to zero value occurs, either additional regulatory capital is required, or positions are reduced. The institution will be under daily constraints so concerns that its capital would not be reassessed sufficiently regularly to avoid additional capital inadequacy are unfounded.

5.5 The text does not recognise that positions held in trading and non-trading books are likely to have completely different loss profiles. For example, many total return swaps over financial sector capital instruments ("equity swaps") can be terminated without notice. Further, no account is taken of the provision of collateral, which is usually replenished daily for such instruments.

5.6 It is unclear whether short synthetic positions should be assessed as notional. In our view this would be equally wrong but necessary if the long positions were treated in this fashion. The treatment of short positions should be clarified in the RTS.

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?

6.1 The computation and cap appear unworkable and are not readily comprehensible. Also, the example is based on a simplistic case and would be extremely difficult to apply in real life circumstances, where multiple layers of participation exist through various types of "funding" instruments not ranking *pari passu* and where information is not transparent in the way envisaged. We would encourage the EBA to provide further examples to ensure consistent application of the RTS in more realistic circumstances.

6.2 Look through depth and coverage

6.2.1 It is not clear how many levels of intermediate entity are contemplated. CRR Article 4 (1)(114) seems to envisage only one level, an exposure to an intermediate entity: "'Indirect holding' means any exposure to an intermediate entity that has an exposure to capital instruments issued by a financial sector entity". Notwithstanding this text, the EBA explanatory note and RTS indicates chains and parallel connections of more than one level which seems both contrary and superequivalent to the CRR. Further explanation is needed

of where the boundaries are to be drawn and how many levels of connection are required. Alternatively it should be made explicit who is to make this judgement and on what basis.

6.2.2 It is not clear what level of investigation or process should be followed by institutions in uncovering actual or potential holdings beyond the first intermediate entity level, or exposures at the first level. It is unclear whether institutions are required to ask for details of all exposures which are or could be held by all their counterparties and issuers, and to ask for exposure details from all counterparties to the intermediaries. Practically, it is extremely unlikely that institutions will be able to determine whether an entity holds financial sector entity capital instruments, and even whether it has capacity for such holdings, save where the institution is the owner or sponsor of the intermediate entity. This is not because it is "onerous" or "operationally burdensome" (Article 14b(b)) for institutions, but because it is not possible from available information. EU entities could perhaps be obliged to disclose financial sector entity capital holdings and their capacity to hold such instruments, but this seems unlikely to be practical and would not be enforceable for intermediate entities outside the EU. It is not clear if the lack of available information would mean there was no obligation to estimate a figure, or it could be estimated as a nil return or it was intended that this should trigger the structure-based deduction approach (which would result in a deduction of the full amount of investment as if it were one's own CET1).

6.3 Short positions

6.3.1 It is not clear how short positions should be treated as the text only refers to losses. This needs to be far clearer because, unlike positions held directly, it may not be possible to change or mitigate the positions.

6.4 Example with a hedge fund

6.4.1 It is not clear whether the range of outcomes where exposures could be leveraged is intended. For example, a financial institution provides a 100 loan facility to be drawn against 110 non-financial sector equity collateral to a hedge fund with investor capital of 100. This would give no current "investment" or "funding" as the facility is less than the collateral, but would give a regulatory exposure (from the collateral volatility adjustment) of, say, 15 if provided under stock borrowing terms, and an exposure of 100 if provided as a collateralised loan. The fund might be long 150 of one financial sector equity and short 150 in non-financial sector entity equity, but could in its mandate have up to a 400 long position in financial sector entity equity.

6.4.2 It is not clear in the RTS whether the funding giving rise to the exposure (in the case of a stock borrow) is to be included in the denominator of the Funding%. Assuming the exposure related funding is not counted as well then Funding% = exposure/(exposure+pari passu funding) =100/100 = 100%.

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Compared with a **maximum loss of 15**, we now have at least three possible scenarios:

(a) If the holding is known (Article 14d(3)):
- Indirect Holding = Funding percentage% x CET1 holding = **150 of financial sector entity equity**.

(b) If the holding is not known but the mandate is (Article 14d(6)):
- Indirect Holding = Funding percentage% x mandated CET1 holding = **400 of financial sector entity equity and possibly own capital instruments**.

(c) If neither the holding nor the mandate are known (Article 14d(7))
- Indirect Holding = funding = **100 of own equity**.

6.4.3 If, under its mandate, a hedge fund could go short a multiple of the equity investment or funding but has not, it is unclear whether this should be estimated as an effective short position. Similarly, if it is known that the hedge fund were instead short, say, 50 of a financial institution's own equity, it is not clear if this would count as an offsetting short, or alternatively, whether the potential to have an investment of 400 would mean that despite the short, a long position of 450 would have to be used in the estimate.

6.4.4 As a related consequence of this RTS, hedge funds would be able, by position and information disclosure and mandate amendment, to arbitrage and affect the capital adequacy of the banks in whose equity they are taking positions.

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

7.1 We do not believe the provisions are sufficiently clear and think they could result in overly punitive deductions.

7.2 The precise scope of the intermediate entity is critical to the operation of this text.

7.3 The basis for estimation of positions should be set out more clearly to produce a uniformity of approach.

7.4 The text as drafted may cause financial institutions to deduct from capital most of their lending, which would seem to be an unintended outcome. The capitalisation of hypothetical holdings is a system-threatening measure because, for example, each financial counterparty could end up capitalising the same non-existent financial sector capital instrument.

7.5 It is unclear whether there is a limitation on the maximum amount to be deducted under 14d (as it seems there is in Article 14c(1)). This constraint is critical to align the RTS with the requirement of the CRR. CRR Article 4 (1)(114) states that "'*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;"

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

8.1 The provisions in Article 24b are clear.

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?

9.1 Although both approaches have merits, the requirement that a benchmark rate is calculated from a minimum number of contributors will be easier to police and hence is a superior way to ensure that the benchmark rate is unaffected by the credit standing of the relevant institution. An enhancement to this process would be to ensure that extreme rates were excluded from the calculation of the reference rate but, in order for such a process to work, it would be necessary to have a greater number of contributors than under normal circumstances.

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?

10.1 Per the above, if the index automatically excludes extreme results (high and low), then a seven-bank sample would ensure a five-bank average. If the automatic exclusion was not a feature of the index, then a larger sample size of, say, 10 banks should reduce the effect of extreme results to a de-minimis level.

10.2 As noted above, we believe that indices can best be controlled by monitoring the number of active contributors and by dispersing their published rates. If the market is insufficiently deep to sustain above 7 or 10 contributors, then the combination of a lower contributor hurdle (say five) and a market volume threshold of 60%+ may achieve the same objective.

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)?

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11.1 An institution should be able to include minority interests from any subsidiary which is included in the institution's solo requirement, provided that subsidiary is included in the regulatory consolidation of the institution under chapter 2.

11.2 The amount of eligible minority interest should be determined on the basis of the "hypothetical" capital resources and capital requirements calculated for the subsidiary, using the parent institution's solo rules.

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 supervision on a sub-consolidated basis. What would you propose as conditions?

12.1 An institution should be able to include minority interests in its group consolidated capital resources from any subsidiary included in the group regulatory consolidation under Chapter 2. The decision by a regulator to forego supervision at a sub-consolidated level does not make the minority interests any less valid for capital purposes. We believe this is consistent with the Basel FAQ on minority interests.

12.2 In the situation where a subsidiary is not subject to supervision on a sub-consolidated basis but only on an individual/solo basis, the amount of eligible minority interests could be determined based on "hypothetical" capital resources and capital requirements could be calculated for the subsidiary on a sub-consolidated basis using the local rules that apply to the subsidiary on a solo basis.

12.3 A materiality threshold could also be envisaged in the situation where minority interests arise from a regulated subsidiary which is itself a parent of other financial entities, but where the minority interests arise exclusively from the parent subsidiary. In the situation where its subsidiaries are considered immaterial and, in the absence of supervision on a sub-consolidated basis, the relevant position for calculation of the eligible minority interests could be derived from its solo capital resources and requirements.

12.4 If the subsidiary in question was not a regulated entity, then we understand that the calculation would be undertaken by looking at the immediate higher regulated parent entity level.

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APPENDIX 2

ADDITIONAL QUESTIONS WE WOULD LIKE TO RAISE IN RELATION TO THE PROPOSED RTS MATERIAL

1 The status of mutual funds as "financial sector entities" in respect of CRR (OJ Version) Art 36(1) (h) and (i), and as "intermediate entities" under RTS Article 14a

The activity of a mutual fund is generally to acquire holdings. A mutual fund is therefore generally considered to fall within the definition of a "financial institution" under CRR (OJ Version) Art 4(26), and consequently would fall into the definition of a "financial sector entity" under CRR (OJ Version) Art 4(27). Therefore CRR (OJ Version) Art 36(1) (h) (i) requires a firm to include holdings in mutual funds within the scope of its potential deductions.

If this is not the intention of the CRR, then amendment to the level 1 text is required.

Notwithstanding the apparent requirement to include investments in mutual funds in the scope of potential deductions, RTS Article 14a, 14c and 14d requires a firm to look through a fund to see if it has any investments in financial sector entities.

The requirement to treat a mutual fund as both a financial sector entity and as an intermediate entity is duplicative and could lead to deductions of greater than a firm's investment in the mutual fund.[1]

This duplicative requirement cannot be the intention, and further EBA clarification is needed on this point.

We suggest that a more practical solution for funds, particularly in the trading book where timely analysis of a fund may not be possible within the timeframe of the holding period, would be as follows:

- where it is possible to look through a fund, treat it as an intermediate entity under RTS Article 14c. If a firm finds this operationally burdensome, the fund itself should be treated as a financial sector entity.
- where a fund's mandate is known, treat it as an intermediate entity and apply the most conservative look-through approach as described in RTS Article 14d (excluding paragraph 7). If

[1] For example, if a firm owns 15% of a mutual fund, a full deduction is potentially required under CRR Art 36(i) relating to significant holdings. But in addition, the firm is required to look through that fund, and if it is unable to do so, and is unaware of the investment mandate of the fund, the firm (under RTS Article 14d(7)) has to treat the fund as fully invested in the firm's own Common Equity Tier 1 and thus suffer a further full deduction under CRR Art 36(f)

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a firm finds this operationally burdensome, the fund itself should be treated as a financial sector entity.

- where a firm is not able to determine, on basis of the fund's mandate, the most conservative look-through approach, the fund should itself be treated as a financial sector entity rather than an intermediate entity.

2 Deductions of holdings in own Common Equity Tier 1 instruments (CRR (OJ Version) Art 36(1) (f)

It is not clear what criteria EBA intends to apply in CRR (OJ Version) Art 42 (a) (i) in relation to identifying those short positions which involve no counterparty risk. We would envisage, consistent with the US final guidance, that positions which are executed with a qualifying central counterparty, or which are fully collateralised under a CSA or similar collateral agreement, should be treated as involving no counterparty risk. We should be grateful for EBA confirmation that this interpretation is appropriate.

3 Calculation of net holdings for the purposes of CRR (OJ Version) Art 36(1) (f), (h) and (i)

There are numerous additional items which require further clarification in respect of the detailed calculation of a holding which might contribute to a capital deduction. These include:

1. What is meant by an "index" in relation to the deductions and whether this will be left to institutions or relevant authorities to determine.

2. What is meant by an "index security". Does it mean a security which represents an index or which references an index, for example, ETFs based on the index, derivatives referencing the index, or notes/warrants/other securities for which an index is the underlying reference. Alternatively, does "index security" mean individual securities which are constituents of an index (or any proportionate group of such securities), for example, an equity in a bank which is a constituent of an index.

3. Whether positions should be viewed from a trade-dated perspective rather than value-dated. This is not clear, but a trade-dated approach would be consistent with the intent of the "date of signature" approach in Article 14e(2).

4. What is meant by the requirement, under CRR (OJ Version) Art 45(a)(i), that "the maturity of the short position matches the maturity of the long position". We would regard the requirement as being met if the maturity of the short position exceeds that of the long position (and the US guidance applies both this interpretation and permits matching within the same calendar quarter).

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5. The definition of maturity for instruments that are undated (such as equity) or which have a variable maturity or an ability to terminate early. We would suggest that the longest possible maturity should be used (which clearly for equity holdings would be greater than one year).

6. What the order of interaction of the various long and short positions should be. Whether under CRR (OJ Version) Article 76 an effective long position is reduced first without restriction as to maturity or counterparty risk, and only then under the Articles 42(a), 45(a) and so on, should further relevant short positions be deducted, subject to the various constraints of those Articles.

   - For a position in the trading book, the result of the computation in Article 76 is negative, that is, a net short position, whether this can then be applied to reduce any other long indirect or synthetic holding in the same tier of capital of the same entity.

   - Whether the requirement to calculate underlying exposure to own capital instruments for direct, indirect and synthetic holdings of index securities under Article 42(b) then forms part of the long position in Article 76 if the capital instrument is part of the index.

   - Whether the computation for index securities in Article 45(b) supersedes the requirement in CRR Article 45(a) that short positions must be over one year remaining maturity in order to be recognised and, perhaps more generally, whether it is a correct interpretation that no maturity restriction applies to index securities.

7. In respect of CRR Article 76(a), and Article 14h, whether it would be correct to assume that the *"contractual right to sell"* and the *"contractual obligation to buy"* can apply either where positions are both cash settled or where both are physically settled positions. Examples might be whether cash settled options can be offset against single stock futures, or whether a physically settled forward purchase can be offset with a physically deliverable long put option.

8. Whether the contractual right to sell would be considered as being satisfied if protection were purchased as credit derivatives if the level of seniority of protection were the same as that of the long position.

9. Whether surplus protection from a higher capital level could be applied to reduce the lower capital level position in the same financial institution holding. For example, whether a net short additional tier 1 position could be used to offset a tier 2 long position.

10. Whether, in respect of CRR (OJ version) Art 36(1) (i) (ie, the requirement to deduct **significant** investments) this RTS has any relevance at all. CRR (OJ version) Art 43(a) clearly defines a significant investment in terms of **ownership**, thus ruling out any indirect or synthetic holdings from the determination of the amount to be deducted.

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4 Article 34b, 2. (b)

We believe that there is room for interpretation around the calculation of the minimum capital requirements to be calculated at the sub-consolidated level, namely in what relates to the highlighted bold text under the relevant EBA RTS paragraph below:

(b) for the purpose of the sub-consolidation calculation the amount of Common Equity Tier 1 capital required according to Article 79(1)(a)(i) of Regulation xx/XX/EU [CRR], shall be ***the amount required to meet the Common Equity Tier 1 own funds requirements of that subsidiary at the level of its consolidated situation calculated in accordance with Article 79(1)(a) of Regulation xx/XX/EU [CRR]****. The specific own funds requirements referred to in Article 100 of Directive [inserted by OP] are the one set by the competent authority of the subsidiary; (...)*

The EBA should clarify whether the RWA and capital requirements calculated as per the RTS text above correspond to the RWA/capital requirements as reported by the subsidiary to their local regulator, under local rules and as per the minimum capital adequacy ratios imposed by that regulator supervising the subsidiary on a sub-consolidated basis.

Subsidiaries outside the EU will not comply with the CRR and we interpret that the above is meant to be read as the minimum capital requirements that are applicable in the relevant jurisdiction. This was the position articulated by the EBA at the recent open hearing held on 24 June 2013 and we request that this is addressed explicitly in the RTS.

5 Article 34b, 2. (c)

In a similar vein, clarity is needed in relation to the second calculation, specifically in relation to the highlighted bold text below:

(c) the amount of consolidated Common Equity Tier 1 capital required, according to Article 79(1)(a)(ii) of Regulation xx/XX/EU [CRR],shall be ***the contribution of the subsidiary on the basis of its consolidated situation to the Common Equity Tier 1own funds requirements of the institution for which the eligible minority interests are calculated on a consolidated basis****. For the purpose of calculating the contribution, all intra-group transactions between undertakings included in the prudential scope of consolidation of the institution shall be eliminated.*

We interpret the above to mean that the capital requirements are to be calculated at the sub-consolidated level using the rules applicable to the parent company doing the group consolidation – i.e., for a UK consolidation group, the CRR/ CRD and any additional requirements, including Pillar 2, set by the PRA. The EBA should confirm that this is the case.

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