

FBF Comments on EBA consultation on own funds - Part III.

I. Key Messages

Valuation of synthetic holdings

- Our deepest concern is this Draft RTS stipulates that the exposure shall be the notional amount of the relevant instruments. The notional amount does not allow to properly assess the exposure of the financial institution to capital instrument of financial sector entities. Using the notional amount would lead to unmanageable and disproportionately significant amount of deduction from CET 1 capital, which would make equity capital markets activities in Europe unprofitable and make them disappear. In addition it would lead to inconsistent risk management behaviour between financial and non-financial equity markets, as the notional amount of the instruments would lead to major undue quantitative impacts, uncorrelated with the real nature of the risks. In the appendix 1 of this document, we provide real-life examples which demonstrate that using the notional rather than being conservative, may lead to excessive net short positions (see appendix 1).
- From our viewpoint, the amount to be taken into account for synthetic exposures shall be the “delta” value. Delta calculations provide the most accurate, risk-sensitive and economic approach for calculating trading Book equity exposures. We therefore urge the EBA to allow reliance on the delta in its RTS (see appendix 2).

Definition of indirect and synthetic holdings

- First of all, we propose EBA to consider the following exemptions from the definition of indirect holdings. Since the paragraph 1 of the article 14a only provide non exclusive examples, we encourage EBA to specify explicitly the exemptions to avoid any confusion:
 - For avoidance of doubt, confirmation that entities already subject to the prudential supervision under article 49 of the CRR are exempted from the scope of application of article 14a. Indeed, the application of the look-through approach would negate the treatment provided for in art 49 of the CRR in particular the principles of the supplementary supervision and the consolidated supervision pursuant to art 49(3a).
 - For avoidance of doubt, confirmation that controlled but non prudentially consolidated companies (i.e. companies below the consolidation thresholds) – for which the institution is already submitted to prudential requirements under the CRR - are exempted from the provisions of article 14a.
 - The parent mixed activity holding company of the institution or the subsidiaries of the parent mixed activity holding company: The way the mixed activity holdings defined as part of FSEs in the CRR seems to suggest that for instance most of industrial groups in automotive with insignificant financial activities are also counted in¹. We firmly believe that it is not the intention of the EBA to require banks to deduct indirect holding to these corporates which would lead banks to reduce any indirect investment in them.

¹ Article 4(22) of the CRR : '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;

We are aware that tying back the broader definition of FSE in the CRR to the Basel 3 text is not part of the mandates of EBA. However considering the potential detrimental impact to the EU economy, we urge EBA to exclude the mixed activity holdings from indirect holdings. Additionally, although it is not listed explicitly in the article 14a(C)(i), we would like to ensure that the mixed-activity insurance holding companies are also excluded.

- Defined benefits pension funds: as the LTA will not be operationally manageable in most cases, this treatment is highly likely to have consequences on pension funds investment policy with regards to financial institutions and may lead to massive disinvestments from this sector and/or unwanted concentration of the fund investments on other types of investments which are exempted from such a treatment.
Moreover, article 41 already states that assets in excess of liabilities are to be deducted from CET 1. Applying the LTA according to this draft RTS would therefore result in a partial double deduction for defined benefits pension funds, with an even amplified impact where the institution would fail to apply the LTA.
- The examples of synthetic holdings provided in the paragraph 2 of Article 14a should be completed by any instrument providing long or short exposures to capital instrument of financial sector entities. This is absolutely necessary in order to secure the computation of net long positions in accordance with the article 42 point (a) of the CRR. We therefore recommend a broader wording, referring to the definition of financial instruments in section C of annex 1 of MIFID (see appendix 2).

Look through approach for indirect holdings

- This RTS requires identifying all CET 1 instruments issued by a financial sector entity (FSE) held by an intermediate entity to deduct as indirect holdings. The look-through approach (LTA) is burdensome and costly, particularly for the small ones. For large institutions, implementing the LTA to all the funds in their investment portfolio is almost impossible.
- As an alternative, the draft RTS allows using the structure-based approach to estimate the value of the indirect holdings. Structure-based approach requires taking into account separately the amount that the intermediate entities hold in own CET1 instruments and the amount that the intermediate entities hold in the CET1 instruments of other FSEs on an aggregate basis. Such information is not readily available. If the institution does not know these two amounts, they may be estimated as the maximum amounts that the intermediate entities are able to hold on the basis of their investment mandates. The latter is not available information as funds do not publish it. When the institution is not able to determine on the basis of the investment mandate the maximum amount, the draft RTS requires a full deduction in the same way as the institution's own shares, which is the most punitive approach in terms of capital charge. Although EBA explains that in the event of the CET 1 instruments issued by a financial sector entity were permanently written off, the loss that the institution holding the same indirectly through an intermediary would not be materially different, the full deduction seems to be too harsh to be considered as an alternative.

- This draft RTS does not specify whether the proposed approach is applicable to trading book or not, certainly due to the lack of clarification in the level 1 text. For trading book positions, for which the holding period is supposed to be short, applying the cumbersome LTA does not make sense. Moreover, net long exposure of the trading book to a mutual fund or similar entity is negligible if not flat: any long position would be held as a hedge to, or would hedge, a short position in the same underlying. If EBA insisted on implementing this approach to trading book indirect holdings, we believe as a minimum that the netting of short and long positions should be allowed. In relation to holdings in funds, we would like the draft RTS to clarify that the requirements eventually apply to a net long position: in particular, if a long position in a given fund matches a short position in the fund, LTA shall not be needed.
- For entities which are not exempted from the definition of indirect holdings, EBA should introduce a threshold of materiality upon which the LTA needs to be performed. In that sense we support the kind of approach of article 26 of RTS own funds part 1 of last year where EBA introduced the 3 criteria of determining such materiality, % of net exposure to the capital of financial sector entity, the holding period of short duration and the evidence of strong liquidity. The provision of those materiality thresholds is even more critical in that case than it is for connected clients in respect of transactions with underlying assets as part of large exposure rules (currently open for consultation), especially if this RTS were to cover both the trading-book and banking-book, as it has direct consequences on regulatory capital.

Comments on other parts of RTS: recognition of minority interests from subsidiaries in third countries

- We do not have any particular comment on the broad market indices. As far as the minority interest is concerned, we would like to ensure that minority interests from subsidiaries in third countries are indeed recognized. This RTS refers generally to “subsidiaries” without specifying whether they are inside or outside the EU. The relevant articles 84, 85 and 87 of the CRR on the other hand stipulate that “any additional local supervisory regulations in third countries” should be taken into account in determining the attribution of this excess capital to the minority interests of the subsidiary. Our understanding from the level 1 text is therefore that all the subsidiaries in the third countries within the scope of prudential consolidation of the EU parent are in the scope for this purpose. We believe that it is worth that this RTS clarifies this point in line with the CRR.

II. Answer to specific questions

Questions on deduction of indirect and synthetic holdings:

Question 01:

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

The provisions of article 14a are sufficiently clear and invite the EBA to refer to our key messages.

Question 02:

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.

Article 41 of CRR, already states that assets in excess of liabilities are to be deducted from CET 1. Applying the LTA according to this draft RTS would therefore result in a partial double deduction for defined benefits pension funds, with an even amplified impact where the institution would fail to apply the LTA.

Question 03:

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?

This will have obviously impacts on pension funds investment policies. Pension funds would unduly limit investment in FSEs and increase the concentration in other sectors. This cannot be the intention of this RTS. As said previously, it could lead to a partial double deduction as it is applied in conjunction with the Article 41 of the CRR.

Question 04:

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?

We think this list of examples should be aligned with the annex 1 of MIFID.

Furthermore, the additional comment to the list of proposed synthetic holdings would be that a symmetrical recognition of eligible short synthetic positions should apply (i.e. short call, long put options, short TRS or futures / forward contracts on a single name underlying) when calculating the net long position at underlying level in accordance with CRR.

Question 05:

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 notional amount does not allow to properly assess the exposure of the financial institution to capital instrument of financial sector entities. Using the notional amount would lead to unmanageable and disproportionately significant amount of deduction from CET 1 capital, which would make equity capital markets activities in Europe unprofitable and make them disappear. In the appendix 1 of this document, we provide real-life examples which demonstrate that using the notional rather than being conservative, may lead to excessive net short positions.

Then from our viewpoint, the amount to be taken into account for synthetic exposures shall be the "delta" value. Delta calculations provide the most accurate, risk-sensitive and economic approach for calculating trading Book equity exposures. We therefore urge the EBA to allow reliance on the delta in its RTS.

The net position, calculated in accordance with existing position risk requirements, should be the basis of any deduction. We believe this will be in line with the original intention of the rule: to reduce interconnectedness and promote equity financing of financial institutions from outside the financial sector.

Question 06:

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?

The provisions relating to the deduction of serial or parallel holdings through intermediate entities are sufficiently clear, if it only applies to banking book. From a practical standpoint in the trading book, this clause is operationally unrealistic and is not operationally achievable.

Question 07:

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

As said in the key messages, the information required to use this fallback solution is as difficult to obtain as for the LTA. In general funds do not publish such information. Furthermore, the consequence of not getting the required information being the full deduction, the banks cannot afford using this solution. For French banks, only the LTA is a possible solution and therefore we urge EBA to take into account our request for certain exemptions and introduction of a materiality threshold.

Questions on Broad market indices:

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

We have no comments.

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?

We have no comments.

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?

We have no comments.

Questions on minority interest:

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 have no comments.

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?

From our viewpoint, as intermediary holding is not subject to supervision therefore data on sub-consolidated basis is not verified, the approach on individual basis shall be used for regulated subsidiaries minority interest treatment, as set out in Annex 1, Chapter 2, Section1.

To ensuring the regulatory capital of an unregulated intermediate subsidiary attributable to minority interests support the losses of their subsidiaries as well as the part attributable to the parent company, we propose the following conditions:

- Non-regulated subsidiaries shall not exceed x% of total assets on a sub-consolidated basis;
- Principal activity of the intermediary subsidiary is to holding share capital of the sub-consolidated group;

Appendix 1: Illustrative examples of the unintended consequences of the notional

Trading book illustrative example 1

- The institution sells a capital guaranteed EMTN providing investors with an exposure to the positive performance of bank B shares. From the investor perspective, such product embeds a call option.
- The product creates a short exposure for the institution, which it hedges by buying the proper amount of shares of B.
- It is assumed that in order to perfectly hedge its exposure to the performance of shares of B, the institution needs to buy an amount of shares of B equal to 30% of the value of the EMTN.

Analysis

- If the net position is based on the **notional**, the position of the institution would be 100% of short position (the notional of the EMTN) versus 30% of long position of the hedge, resulting in a **net short position of 70%...**
- ...while from an economic and risk management perspective, the institution is perfectly hedged against the variation in value of the shares of bank B.

Trading book illustrative example 2

- **The institution buys a call option on bank F shares.**
- **To hedge the call option, the institution borrows and sells on the market the bank F shares (a “short sale”) based on the delta of the call option (70% of the notional of the call option for example).**

Analysis

- **The call option is a synthetic long position. The “short sale” is a short position.**
- **If the net position is based on the notional, the position of the institution would be 100% of the long position (the notional of the call option) versus 70% of short position of the hedge, resulting in a net long position of 30%.**

Trading book illustrative example 3

- The institution sells a synthetic exposure in the form of a “converse”: the investor buys call options and sells put options on bank C, with the same notional, strike and maturity.
- The combination of the long call and short put options is equivalent to a forward purchase by the investor.
- It thus creates a short exposure for the institution, which it hedges by buying shares of C for an amount equal to the notional of the put and call

Analysis

- If the net position is based on the **notional**, the position of the institution would be 200% of short position (100% for the short call position and 100% for the long put) versus 100% of long position, resulting in a **net short position of 100%...**
- While from an economic and risk management perspective, the institution is perfectly hedged against the variation in value of the shares of bank B.

In both cases, using the notional leads to a net position which is disconnected from reality, and which rather than being conservative, leads to an excessive net short position.

Banking book illustrative example

- The institution holds an investment in the equity of bank D.
- The institution hedges its investment by buying a put option. In order to reduce the cost of the option, its strike is 60% of the current share price of D.
- The institution thus bears the risk of the first 40% drop in the share price of D, but is then protected against any further drop.

Analysis

- If the net position is based on the **notional**, the position of the institution would be 100% of long position for the cash investment versus 100% of short position resulting from the put option, resulting in a flat position...
- ...while from an economic and risk management perspective, the institution bears significant downside risk on the shares of D.

Here also using the notional leads to a net position which fails to depict reality, and which rather than being conservative, leads to an underestimated net long position.

An example of conceptual quantitative impact over a trading portfolio

- Assuming a trading book activity has a leverage ratio of 3%, the ratio of the aggregate notionals of direct holdings plus derivatives would be much smaller. Several instruments providing exposure are not on the balance sheet (futures and listed options), and but for a few exceptions, the fair value of a derivative is smaller than its notional.
- One can thus reasonably consider that the sum of notionals of all trades would represent more than 100 times the capital. In average, financial holdings are considered to represent one fourth to one third of listed equities. The notionals of transactions on such securities would thus represent more than 25 times the capital.
- Given that there is no reason for the notionals of long and short positions to match each other even if the institution is flat from a risk perspective, the capital requirement will represent several times the present capital, making in any circumstance these activities unprofitable.

Appendix 2: Suggested changes to proposed RTS

Article 14a-

Indirect and synthetic holdings for the purposes of Article 33(1) (f),(h) and (i) of Regulation xx/xxx [CRR]

1. Indirect holdings of capital instruments pursuant to Article 33(1) (f) (h) and (i) of Regulation xx/XX/EU [CRR], shall include but are not limited to, any exposure, including senior exposures, to an intermediate entity that has an exposure to Common Equity Tier 1 instruments issued by a financial sector entity where, in the event the Common Equity Tier 1 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 Common Equity Tier 1 instruments issued by the financial sector entity. Intermediate entities shall be entities other than institutions in the meaning of article 4(4) of Regulation xx/XX/EU [CRR] and shall include: [...]

Indirect holdings may be computed after netting long and short positions in the entities listed above.

2. Synthetic holdings shall include:

- (a) **any holding in a financial instrument as defined in Section C of Annex I of MIFID, which provides exposure to** ~~investments in total return swaps~~ on a capital instrument of a financial sector entity unless it qualifies as an indirect holding as defined at paragraph 1,
- (b) guarantees or credit protection provided to a third party in respect of the third party's investments in a capital instrument of a financial sector entity,
- (c) ~~call options purchased by the institution on a capital instrument of a financial sector entity,~~
- (d) ~~put options sold by the institution on a capital instrument of a financial sector entity or any other actual or contingent contractual obligation of the institution to purchase its own capital instruments,~~
- (e) ~~investments in forward purchase agreements on a capital instrument of a financial sector entity.~~

Article 14e-

Calculation of synthetic holdings for the purposes of Article 33(1) (f),(h) and (i) of Regulation xx/xxx [CRR]

1. Regarding synthetic holdings referred to in paragraph 2 of Article 14a, the amount to be deducted from Common Equity Tier 1 items referred to in points (f), (h) and (i) of Article 33(1) of the Regulation xx/XX/EU [CRR] shall be the **economic exposure to the relevant capital instrument; the "delta" value.** ~~notional amount of the relevant instruments.~~

2. The **delta value calculation and the** deduction shall take place **at** ~~from~~ the date of **minimum capital requirement calculation.** ~~signature of the contract between the institution and the counterparty.~~