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Sent by email to EBA-CP-2013-17@eba.europa.eu

European Banking Authority
Tower 42
25 Old Broad Street
London EC2N 1HQ
United Kingdom

Draft RTS on own funds under Articles 33(2), 69a(6) and 79(3) of the draft CRR

Dear Sir / Madam

Please find enclosed AFME's response to the Draft Regulatory Technical Standards on Own Funds under Articles 33(2), 69a(6) and 79(3) of the draft Capital Requirements Regulation – Part Three (EBA/CP/2013/17). In particular our response draws attention to the proposed approach for determining exposure values for synthetic holdings, and proposes practical approaches for addressing indirect exposures. We have also noted a significant issue not covered in the RTS; that of the maturity restriction for short positions. We would welcome a dialogue with the EBA about these important issues.

Yours sincerely



Michael Percival
Director, Prudential Regulation, AFME



Sohee Jang
Deputy Head of Group Prudential Affairs, BNP Paribas
Chair, AFME Capital Working Group

Association for Financial Markets in Europe

www.afme.eu

London Office: St. Michael's House, 1 George Yard, London, EC3V 9DH T: +44 (0)20 7743 9300 F: +44 (0)20 7743 9301
Brussels Office: Square de Meeus 38 – 40, 1000 Brussels, Belgium T: +32 (0)2 401 8724 F: +32(2) 401 6868
Company Registration No: 6996678 Registered Office: St. Michael's House, 1 George Yard London EC3V 9DH

Consultation response

Draft Regulatory Technical Standards on own funds (part three)

18 July 2013

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the consultation on *Draft Regulatory Technical Standards on Own Funds under Articles 33(2), 69a(6) and 79(3) of the draft Capital Requirements Regulation – Part Three* (EBA/CP/2013/17). AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Over-arching comments

Synthetic holdings

We do not believe it is correct or appropriate to use notional amounts to determine exposure value, as is proposed in Article 14e.

Notional amounts are not representative of the true exposure. They are also not conservative, and in fact could lead to inappropriately large or also inappropriately small deductions from capital (see Appendix 1 for illustrative examples).

Furthermore, the approach is inconsistent with the approach for determining the exposure in the trading book and will lead to unnecessarily different risk management behaviour between financial and non-financial equity markets.

Using the notional amount would lead to an unmanageable and disproportionately large deduction from CET1 capital, making equity capital markets activities in Europe unprofitable and threatening their continued viability. We note that notional amounts are not required in the Basel text nor by the CRR. Thus, we believe that in this RTS the EBA is proposing to introduce a material divergence from the global approach.

We propose that the exposure should be based upon the 'delta' value, where this is already used for the capital calculation. Delta calculations provide the most accurate, risk-sensitive and economic approach for calculating exposures.

Indirect holdings in the trading book

Though the CRR text does not distinguish between indirect holdings in the banking book and trading book, we do not believe that the proposed treatment is appropriate for the trading book. For trading book positions, where the holding period is meant to be short and the asset has to be liquid, applying a look-through approach would make little sense and would be very cumbersome. The net long exposure of a trading book to a fund or similar entity would be negligible if not null as any long position would be held to, or would hedge, a short position in the same underlying. Thus, we consider disproportionate to require a look-through approach for trading book positions. If a look-through approach is to be used for trading book positions it should be only on the basis of the net long position. If EBA insists 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 (please see suggested wording in Appendix 2).

Indirect holdings in the banking book

The use of a look-through approach is not general practice for all institutions in different Member States. The approach is burdensome and costly for small firms and large, for which implementing a look through approach is almost impossible. The EBA's approach must be workable and proportionate.

The structure-based approach must be a viable alternative, but as currently framed it will result in overly punitive deductions. The structure-based approach requires institutions to take 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 financial sector entities on an aggregate basis. Where an institution does not know these amounts (which will generally be the case as the information is not readily available) it may estimate them as the maximum amounts that the intermediate entities are able to hold on the basis of their investment mandates. This information is not published by many funds. Thus, institutions will have to fully deduct exposures in the same way own shares are treated. This is the most punitive approach, but is almost the inevitable outcome given lack of information availability.

We propose that the EBA instead approaches the look-through in the following way:

- EBA should list the following explicit exemptions from the definition of intermediate entities to complement the non-exhaustive list in Article 14a(1):
 - For the 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 specific treatment provided for in Article 49 of the CRR and the principles of the supplementary supervision.
 - For the avoidance of doubt, confirmation that controlled but non 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 are defined as part of FSEs in the CRR seems to suggest that, for instance, most automobile industrial groups with insignificant financial activities

would come within the definition¹. We firmly believe that it is not the intention of the EBA or policy-makers to require banks to deduct indirect holdings of these corporates, which would lead banks to reduce any indirect investment in them. We are aware that it is not part of the EBA's mandate to restrain the broader definition of FSE in the CRR to align with the Basel 3 text. However, considering the potential detrimental impact to the EU economy, we urge EBA to exclude the mixed activity holdings from intermediary entities. Additionally, although it is not listed explicitly in the Article 14a(c)(i), we would like to ensure that mixed-activity insurance holding companies are also excluded.

An alternative approach short of a full exclusion could be to apply a materiality test. The US Final Rules have taken this approach by putting in place a test to determine if an organisation is 'predominantly engaged' in financial services. To meet the definition financial services activities must make up 85% of an organisation's gross revenues or assets. As well as this there are de minimis levels for small or insubstantial investments, below which an organisation would not be considered a financial institution. Another alternative could be to apply a look-through approach to deduct only a part of the exposure to the organisation, representing the proportion that is engaged in financial activities. Whatever approach is chosen, it is likely that implementation will be data intensive and require significant resource and time. We ask that the EBA, in conjunction with the Commission, allow as much time as possible for firms to implement changes, especially where they relate to requirements that are relatively more recent (e.g. mixed activity holding companies or specific look through treatment). Though the LEI initiative could eventually assist in implementation, this initiative is still in its infancy.

- Defined benefits pension funds: as the look through approach 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 CET1. Furthermore, the pension cost (used to finance the acquisition of all pension fund assets, including financial sector entities) will reduce CET1, as will the pension fund liability. Applying the look through approach according to this draft RTS would therefore result in a double deduction for defined benefits pension funds, with an even greater impact where an institution fails to apply the look through approach.

- For entities that are not exempted, EBA should introduce a threshold of materiality upon which the look-through needs to be performed. In that sense we support the kind of approach of Article 26 of RTS on own funds (part 1) consultation, where EBA introduced three criteria for determining materiality: % of net exposure to the capital of financial sector entity, a holding period of short duration, and evidence of strong liquidity. We note that a materiality threshold has not been proposed either for the RTS on connected clients for large exposures, currently open for consultation. Unlike the look through

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".

approach required within large exposure framework, which is only a backstop measure, this look through approach requirement has direct consequences for the regulatory capital of European banks. Therefore, a materiality threshold is more appropriate in this context.

Assessment of 'significant investment'

We consider the definition of 'significant investment' in Article 14f to go beyond the text of CRR Article 43(a). Specifically, we do not consider the gross long value of direct, indirect and synthetic positions to convey any form of 'ownership' (as required in Article 43(a)) when acting as intermediary for client positions. We recommend that the EBA implement a definition consistent with 'ownership' as defined in Directive 2007/14/EC (the Transparency Directive), which defines how Member States should require the disclosure on holdings of voting rights or instruments that enable acquisition of voting rights. A consistent definition would also be operationally beneficial as systems and processes will already exist to calculate the amount of holdings a firm has, and will therefore reduce the need for additional investment due to another definition.

Minority interests (MI)

We seek confirmation of the treatment of third country holding companies and banking groups headed by a holding company rather than an institution.

The status of third country holding companies is unclear because of the wording in CRR Articles 81 and 82, which indicates that the subsidiary must either be an institution or an undertaking that is subject by virtue of applicable national law to the requirements of the CRR. This is problematic as third countries will of course implement Basel III rather than EU law. Since Recital 38 indicates that it was the co-legislators intention to include intermediate holding companies within scope (and Basel III supports this interpretation), we believe that third country holding companies should be included, provided they are subject to prudential regulation and supervision that results in a similar outcome to that under the CRR. Not recognising such entities within scope would break the chain of consolidations, thus making MI from institutions below the holding company, that would otherwise qualify, ineligible. Structural reform measures, such as the Liikanen proposals in the EU and national measures such as Section 165 of Dodd Frank in the US, are likely to increase the incidence of holding companies within banking groups. Therefore, we strongly urge the EBA to confirm the status of third country holding companies as being within scope. An alternative would be to deem the requirement for sub-consolidation to have been met by the consolidation at the highest level within a jurisdiction.

The treatment of groups headed by a non-operating holding company, with an institution as the immediate subsidiary, is also unclear. CRR Article 84 and following apply the calculation of MI to the 'institution'. Since the top institution will not be the subsidiary of an institution, Article 84 suggests that there should be no restriction on the MI of the main operating bank. Any other interpretation would favour one group structure over another, potentially raising right of establishment issues. Furthermore, the consolidation of the group will be materially the same as the sub-consolidation of the top institution sub-group. Structural reform initiatives could potentially increase the incidence of such group structures. We therefore seek confirmation that the MI of the top institution within a group is not restricted.

Maturity restriction

The issue of the 'maturity restriction' has not been addressed in the draft RTS, and yet is a significant issue for the industry. The issue relates to the maturity restriction applied to short

positions to determine the 'net long position' in an underlying exposure, and the implication of this for trading book exposures resulting from market making activities. Only short positions which match the maturity of a long position or have a residual maturity of at least one year are eligible to be included in the population of short positions. We believe that this requirement is inappropriate for trading book positions and will lead to large capital deductions that are not reflective of an institution's actual exposure.

Though this requirement is incorporated into the Level 1 text the industry has been in discussions with supervisors to explore mitigating approaches for implementing the requirements. The US in particular has included some guidance on the definition of 'matching', for example, in its Basel Final Rules (i.e. that the residual maturity of a short position is at least equal to that of a long position, and that maturities in the same calendar quarter are deemed matching). We would welcome a dialogue with the EBA on these approaches to assess whether the EBA would be able to provide for a consistent approach under either an RTS, through the Q&A process, or through the issuance of guidelines.

More detailed considerations, including responses to questions

Question 1

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

There are a number of things that need further clarification in Article 14a(1), as specified below:

1. The expression 'but not limited to' is superfluous, as the reference to 'any exposure' would already take account of all possible situations where the firm has risk to the intermediate entity.
2. 'Any exposure' is a vague term, subject to multiple interpretations. From a practical standpoint only holdings of capital instruments of an intermediate entity (i.e. direct holdings of common equity, preference shares (AT1) or subordinated debt instruments (T2) of the intermediate entities) will have features of loss absorbance and, therefore, will be exposed to the losses arising from the drop in the value of the capital instruments of other financial entities. The examples provided in the RTS for serial and parallel holdings do suggest that an institution needs to hold capital instruments of those intermediate entities. However, the text of the article is not specific and may be subject to various assumptions. Since the examples are for consultation purposes only, there might be danger that the final RTS article will not reflect this very essence of the proposed serial and parallel holdings.

Consider, for example, a general situation where there is an interest rate swap between the firm and the intermediate entity (pension fund, mutual fund, etc.) and the latter holds capital instruments of financial sector entities. The interest rate swap would fall under the definition of 'any exposure', but it is quite obvious that this type of exposure should not be subject to the requirements of Art. 14a-14i of the RTS.

3. Similarly, in order to apply the indirect holding treatment in a consistent way and avoid confusion in this sense, the text in points (b) and (c) should contain an explicit reference to 'direct holdings' by the intermediate entities in the capital instruments of financial sector entities. Were these intermediate entities to hold shares of financial sector entities indirectly, via an index or synthetically via derivatives, it would be impossible for the firm who tries to look through the intermediate entity, or in case of serial structure through multiple intermediate entities, to assess the size of its indirect holding.

Questions 2 and 3

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.

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?

Article 36(1)(e) of the CRR already requires the firms to deduct the defined benefit pension fund asset recognised on their balance sheets. Furthermore, the pension cost (used to finance the acquisition of all pension fund assets, including financial sector entities) will reduce CET1, as will the pension fund liability. Therefore, the new requirement introduced in the draft RTS (which is not present or implied by the CRR) to look through the defined benefit pension fund to capture the indirect holdings is, in our view, a duplication. Although the rationale regarding the deduction of the defined benefit pension fund asset recognised on the balance sheet is understandable and follows the logic of deriving the real tangible common equity of a firm (similarly to the deduction of the intangible assets, goodwill), the requirement to look through to the assets of the pension fund managed by the firm is disproportionate in the sense that it ignores the diversification/offsetting effects of the other assets within the scheme. Typically pension schemes will have substantial allocations to high quality fixed income assets such as top-rated government bonds/swaps which could be expected to appreciate in value in a period of market turbulence (in a flight to quality scenario one would expect these assets to increase in value).

In addition, some EU jurisdictions (e.g. the UK PRA) require firms to hold capital against a 1-in-200 year stress event applied to the pension scheme assets and liabilities. This would typically translate to a 40% haircut to equities (both financial and non-financial). Requiring such an approach in Pillar 2 and deducting financial institution investments will lead to a double-counting of capital requirements/deductions.

Furthermore pension schemes will often have professional fund managers actively managing their equity portfolios who could reasonably be expected to reduce their allocation to financial institutions at times of market stress and exit fully before default. Scoping in underlying financial institution positions would give no credit to the active manager role.

We suggest an exemption for where financial institutions in pension schemes represent no more than say 15-20% of the scheme assets. That is, given all the diversification effects and dynamic management mentioned above, the rules should only focus on situations where there is significant financial institution risk, as there is no significant contagion risk to the firm itself.

If the EBA nevertheless decides to apply a deduction we support proposals to avoid double-counting by reversing the order in which certain deductions are applied, such that any deduction for exposures to financial sector entities is applied first, following which the deduction for the net assets in the pension scheme is applied. This avoids the situation where both the net pension fund assets and the exposure to financial sector entities are deducted, despite the fact that the financials exposures contribute to the net assets.

Question 4

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?

With the view of preserving consistency, we consider that there should be a symmetrical approach to both synthetic long positions (listed in the RTS in Article 14a(2)) as well as synthetic short positions where these are eligible under the CRR for netting purposes (Article 45 and Article 75. We have proposed some additional wording in Appendix 2 to ensure that it is clear that a symmetrical approach should be applied.

Question 5

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 accurately reflect the exposure of the financial institution to capital instruments of financial sector entities. Using the notional amount would lead to an unmanageable and disproportionately large deduction from CET1 capital, making equity capital markets activities in Europe unprofitable and threatening their continued viability. The new restriction would create an undesirable internal conflict with the Basel Framework for trading book positions. 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 Appendix 1 we provide real-life examples which demonstrate that using the notional, rather than being conservative, may lead to excessive net short positions.

From our viewpoint, the amount to be taken into account for synthetic exposures should be the 'delta' value, where this is used as the basis of the capital calculation. Delta calculations provide the most accurate, risk-sensitive and economic approach for calculating exposures. We urge the EBA to allow reliance on the delta in its RTS and have suggested wording in Appendix 2.

Question 6

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?

There is an obvious conflict between the rationale of the RTS, which is targeting indirect investments where intermediate entities either fall completely outside prudential regulation or are not part of the same prudential consolidation, and the transparency that is required of prudentially regulated institutions to look through to the balance sheets of these entities. Therefore, the burden is disproportionately put on prudentially regulated firms.

From a practical standpoint, the degree of visibility that is assumed to be present according to the RTS is achievable only in two realistic scenarios:

1. in the case of exchange traded funds
2. where institutions and intermediate entities specified in Article 14a are part of the same groups in the sense of accounting consolidation

Given the limited visibility in other cases (private funds or pension funds), the applicability of the serial investment look-through approach, in cases where there is more than one subsequent investments in the chain, is not realistic.

Question 7

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

Both the default approach and the structure-based approach require the firms to have visibility over the assets of the intermediate entity. In this respect they are effectively equally burdensome.

The investment mandates referred to under the structure-based approach (Article 14d(6)) are not always detailed enough to provide information on specific investments to be made by the fund or SPV, which makes them an inappropriate source of information in the sense required by the RTS (for example, definitions of financial exposures will not necessarily align with the CRR). Moreover, to ensure consistency amongst all institutions that might have investments via the same intermediate entities, there should be a widely used source of information recognised as a reliable source within the industry. We propose that EBA works with ESMA to ensure such a platform is created in order that the structure-based approach is practically a realistic alternative.

The requirement to deem all investments in an intermediate entity, where there is no visibility over the investments of the latter, as significant under the point 4 of Article 14d, and even worse, as investments in own CET1 instruments under point 7 of Article 14d, will have a disproportionate effect, especially in the latter case.

In our view the methods proposed in the RTS should be reflective of real practical examples of indirect holdings. It would also be beneficial if EBA were to provide examples of the calculation at least in the form of Annexes to the RTS (not only in a descriptive form in the Articles 14c and 14d).

Questions 11 and 12

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)?

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?

As noted in the 'overarching comments' section above, it is vital that the scope of the MI requirements is clarified, namely that third country holding companies are confirmed as eligible and that the treatment of groups headed by holding companies is clarified. Also addressed below are (i) individual consolidation, (ii) insight on situations where sub-consolidation is not required, and (iii) situations where a third country holding company is not subject to consolidated Basel capital requirements but is subject to requirements that result in a similar prudential outcome.

Third country holding companies

Articles 81 and 82 of the CRR set out the eligibility requirements for subsidiaries. As holding companies are not institutions then their inclusion within scope relies on whether they meet the requirements for being an undertaking that is subject, by virtue of applicable national law, to the requirements of the CRR. However, by the very nature of their location they will be subject to the national application of Basel III rather than EU law. Provided that the implementation of the local law results in a similar outcome to that under the CRR, both in regulatory and supervisory terms, we believe that it is appropriate that these entities are deemed within scope. There is a role for the Commission to undertake assessments about whether local laws result in broad outcomes in line with those under the CRR. Such assessments should consider each prudential and supervisory framework holistically rather than seeking exact equivalence, which in practice will never be the case.

Recital 38 indicates the intention of the co-legislators to include intermediate holding companies. Footnote 23 of the Basel III rules and the FAQs on definition of capital suggest a broad definition of 'bank', to include entities that are subject to the same prudential standards and supervision as a bank, and which do not have to be supervised on a standalone basis. Third country holding companies in deemed-equivalent jurisdictions will meet these requirements. Further, we believe it is within the EBA's remit to interpret Articles 81 and 82 in this way since the CRR will not be transposed into national law within the EU, as it is directly applicable, thereby suggesting that it was intended to cover legislation resulting in similar outcomes.

Banking groups headed by EU parent holding companies

Clarity is required where the main operating institution (Top Bank) is the subsidiary of a non-operating holding company (Hold Co). CRR Articles 84 and following require the 'institution' to calculate the eligible minority interest within its subsidiaries. As Top Bank is the subsidiary of a holding company, and Hold Co is not an institution as defined by Article 4(3), our interpretation is that there is no requirement to restrict any MI within the full group consolidation (to Hold Co) beyond any restrictions that will have arisen from applying the Article 84 calculations in assessing the capital of the Top Bank group itself (if such a Top Bank sub-consolidation is required). Furthermore, the full group consolidation will be materially the same as the Top Bank group, as all the exposures of Hold Co are likely to be intra-group into the Top Bank consolidation. Any other interpretation would favour one group structure over another, potentially raising right of establishment issues. Structural reform initiatives such as Liikanen will potentially increase the incidence of holding company group structures within the banking sector and, therefore, it is imperative that this issue is addressed.

Another alternative way of addressing the issue would be to deem the requirements for sub-consolidation to have been met by the highest level of consolidation within a jurisdiction including holding companies, with no restriction on the MI of the immediate subsidiary bank.

Individual consolidation

Individually consolidated entities should be regarded as within scope of the MI requirements.

Individual consolidation allows a bank and certain qualifying subsidiaries to be considered to be a single entity for supervisory purposes. Such entities will not be institutions. However, by virtue of being part of the individual institutions returns, they will be undertakings that are subject to the Regulation. As already established above, the Basel III FAQs indicate it is not necessary for subsidiaries to be supervised on a standalone basis for them to be within scope. Furthermore, there are stringent regulatory requirements, including case by case review, on the inclusion of subsidiaries within the individual consolidation. Therefore, as they are subject to prudential regulation and supervision, such entities should be regarded as within scope.

Situations where sub-consolidations are not required

Currently sub-consolidations are not necessarily required for every possible consolidation point within a banking group's structure. For example, in the EU parent holding company section² above, a sub-consolidation may not be required for Top Bank group, although there will be the full consolidation at Hold Co, because in practice consolidations are required at the highest point within a jurisdiction. The situation may also arise in third countries³, where consolidated supervision is undertaken locally, but returns are not submitted on the sub-group to the consolidating supervisor.

Minority interest matters at the point at which capital requirements are monitored. At other points, there will be neither (i) supervisory requirements imposed on which to perform the calculations, nor (ii) returns to which the calculation can be reconciled. Therefore, provided that consolidations are prepared at those points (i.e. the highest point within a jurisdiction) and the scope of consolidation covers all the entities that would be required in any sub-consolidation, the requirement for sub-consolidation should be deemed to have been met. In the case of third countries, there will be equivalence determinations and supervisory co-operation agreements should address any additional information requirements.

Situations where a third country holding company is not subject to consolidated Basel capital requirements but is subject to requirements that result in a similar prudential outcome

We consider that the CRR would allow recognition of the minority interest in the case of subsidiaries that are parents in a third country and, though they are not subject to capital requirements themselves, are subject to capital requirements on a de facto basis (equivalent to Article 81(1)(a)(ii)). This is the case when the third country holding company is not subject to minimum requirements but is required by law to be funded through common equity (with no possibility to leverage through external funding nor from other companies of the same group) and whose only activity is to hold the stakes in the subsidiaries (no other intragroup operations are allowed). As the parent holding company must finance its subsidiaries' stakes with equity the minimum level of capital of the subsidiaries determines the minimum level of equity in the holding company and, if all of these subsidiaries are subject to capital requirements, the requirements that apply to the risk weighted assets of the companies also apply to the consolidated group. A similar outcome would be obtained if a capital requirement on a solo basis were to be imposed at the parent company level and the stakes in the subsidiaries are deducted in the calculation of the parent's capital.

When these conditions apply we believe that the de facto holding company minimum capital requirement should be used for the calculation of the minority interest that can be included in the consolidated CET1 as it is established in Article 84 of the CRR.

For illustration purposes, take as an example a financial group where the parent company is a Holding Company which participates in financial Subsidiary A (\$100) and in financial Subsidiary B (\$50) fully funded by equity (equivalent to CET1 under Basel III). Both subsidiaries are subject to minimum capital requirements of 10%. Subsidiary A has Risk Weighted Assets (RWA) of \$600 and Subsidiary B of \$500. Thus, the minimum capital requirement for A is \$60 and for B is \$50, which implies that as minimum the Holding Company should finance the \$110 capital needs required by regulation. The excess of capital in Subsidiary A results in a correspondent excess of capital at the Holding level in the same amount, \$40. If there are minority interests equivalent to 25% of the holding capital, then 25% of the \$40, that represents

² This section needs to be read in conjunction with that on EU parent holding companies.

³ This section needs to be read in conjunction with that on third country holding companies.

the excess over the regulatory minimum, should be deducted from consolidated CET1 (per Article 84(1)(a)(i)).

The holding company should be subject by law to the following constraints for this treatment to apply:

- 1) The activity of the holding company is restricted to the holding of stakes in financial institutions that are subject to prudential capital requirements;
- 2) The funds for holding such participations must be common equity, and the holding company cannot incur debt;
- 3) The balance sheet of the holding company provides a full accounting consolidation for all subsidiaries and is subject to a full independent audit by an established firm.

Appendix 1: Illustrative examples of the unintended consequences of use 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 appropriate number 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 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's 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 allocated to the trading book. On 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 allocated to the trading book.
- 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 these activities unprofitable.

Appendix 2: Suggested changes to the draft 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, but are not limited to the following forms:

- (a) investments in total return swaps on a capital instrument of a financial sector entity,
- (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.

Similarly, synthetic holdings may include short positions in financial instruments as synthetic short for the purpose of calculating the net position in capital instruments of financial sector entities where these short positions are eligible in accordance with Article 42 and 75 of the CRR.

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 the minimum capital requirement calculation. ~~signature of the contract between the institution and the counterparty.~~