Consultation response

Draft Regulatory Technical Standards on the prudential treatment of software assets under Article 36 of Regulation (EU) No 575/2013 (Capital Requirements Regulation - CRR)

amending Delegated Regulation (EU) 241/2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the council with regard to regulatory technical standards for Own Funds requirements for institutions

July 2020

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the European Banking Authority's (EBA's) consultation on Draft Regulatory Technical Standards on the prudential treatment of software assets. 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.

Introduction

Software is a strategic asset for banks, enabling them to serve clients where and when needed, to develop cyber security measures, and to deliver digital services competitively. Software displays some special characteristics, namely its capacity to generate income, its key importance in banking operations, and in facilitating the implementation and embedding of regulatory requirements.

Out of all of the assets that form part of the intangible asset items of an institution, software displays some special characteristics, namely its capacity to generate income, its relative importance in banking operations, and in facilitating the implementation and embedding of regulatory requirements. These aspects indicate that software has value and hence should be treated in a different way than other intangible assets.

It is positive therefore, that the issue of the prudential treatment of software has been recognised in the CRR. It is critical that the mandate given to the EBA is finalised in a manner that will support investment in technology and help to redress the unlevel playing field between EU banks, non-banking actors and with banking actors in other jurisdictions. Furthermore, in order for banks to be able to benefit from the non-deduction, it is imperative that the RTS is delivered as soon as

Association for Financial Markets in Europe
London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971
Frankfurt Office: Bürohaus an der Alten Oper, Neue Mainzer Straße 75, 60311 Frankfurt am Main, Germany
T: +49 (0)69 153 258 967
www.afme.eu

practicable. As such, we encourage the EBA to maintain close cooperation with the Commission and co-legislators, such that the RTS can be adopted and in force by the end of September 2020. To help expedite the process, we also suggest that the RTS enters into force the day after publication rather than the standard 20 days.

Proposed prudential treatment of software

Q1 In case some software assets are classified within tangible assets in your institution, what are the main reasons for doing so and what is the percentage of this classification compared with the classification as intangible?

Consistent with the rationale outlined in the consultation paper and in line with IFRS, software assets are classified as tangible assets when they form an integral part of the related hardware and are therefore treated under IAS 16 "Property, Plant and Equipment".

Q2 Do you have any comment on the proposed approach for the prudential treatment of software assets?

Accounting Value

The industry believes the most appropriate value for software is its accounting value. As such we would like to express our disappointment that the EBA's preferred approach is a material departure from the accounting treatment, which we believe to be sufficiently prudent.

The accounting rules provide sufficient safeguards that these assets will be used by banks and generate future economic benefits. We wish to highlight that the EBA's approach is particularly detrimental, in comparison to the accounting approach, for software under development. IAS 38 (paragraph 57) prescribes that software under development shall only be recognised once banks demonstrate e.g. the technical feasibility of completing it, the intention to complete and use it and how it will generate probable future economic benefits. Note that expenditure on research shall be recognised as an expense when it is incurred (IAS 38.54). In addition, like any software asset, in case there is an impairment trigger banks are required to write the assets down to their recoverable amount. Therefore, we call on the EBA to provide a more appropriate treatment of software under development, avoiding the need for a full deduction from capital.

Prudential Amortisation

The industry welcomes the EBA's choice of a simple and practicable prudential approach based on software amortisation, but believe that the proposed approach is mis-calibrated (see Q3) and additional considerations should be made with respect to the alternative options set out in the consultation paper (see Q4).

Q3 What is your view on the calibration of the prudential amortisation period?

Calibration to value in resolution

The level 1 CRR text seeks an exemption from the deduction of intangible assets from Common Equity Tier 1 (CET1) items in case of *"prudently valued software assets, the value of which is **not** negatively affected by resolution, insolvency or liquidation of the institution"*. As such, the intent from the level 1 text appears to be to allow a full non-deduction of prudently valued software operating under normal going concern conditions.

The EBA, however, has interpreted its mandate to develop draft regulatory technical standards *"to specify the application of the deductions referred in to point (b) of paragraph 1, including the materiality of the negative effects on the value which do not cause prudential concerns."* as needing to calibrate the framework based on software assets that **are** negatively affected by gone concern scenarios. In fact, the EBA noted in the public hearing on 23 June 2020 that it is of the view that a prudential framework based on software amortisation would appropriately reflect the pattern of the recoverable value of software *in a gone concern scenario, in line with the requirements of the Level 1 text*[1]. We believe therefore, that the EBA approach of calibrating the framework in its entirety to the recoverable value of software assets in a gone concern scenario, is unduly prudent and not in line with the intent of the Level 1 text agreed by co-legislators.

The EBA has calibrated the prudential amortisation period on the useful expect life (UEL) observed for software assets after the acquisition date by the acquired, which on the basis of the evidence the EBA collected (noted as not always retrievable[2]), ranged between 1 and 3 years. This approach is unduly prudent as it is focussed on value in resolution, whilst disregarding the fact that the majority of software is not negatively affected by resolution. Whilst we understand that the EBA has sought a simple methodology that does not apply a different treatment for different categories of assets, it is not appropriate to calibrate the period for prudential amortisation on resolution, insolvency or liquidation alone.

In the credit risk framework, for instance, the capital requirements for of a portfolio of loans is not calculated using the risk weight of the loan with the worst credit profile alone, but is rather a function of the weighted average risk weight of all of the loans in the portfolio. This is analogous to calibrating the prudential amortisation approach based on a weighted average of UEL for software assets not affected by resolution, insolvency or liquidation (6 years) and the UEL for software assets affected by resolution, insolvency or liquidation (1-3 year). Using (extremely) conservative assumptions for the ratio of software assets affected:unaffected by resolution, insolvency or liquidation that exist in the market of 50:50, the weighted average i.e. (50% x 6yrs) + (50% x 2yrs) demonstrates that changing the prudential amortisation period to 4 years would still be prudent. This is further shown as prudent when comparing to the average time to default of 5.4 years[3] among entities initially rated at speculative grade according to the "S&P 2018 Annual Global Corporate Default and Rating Transition Study".

Level Playing Field

The European prudential treatment of software creates competitive disadvantages for European financial institutions in comparison with other entities that must not deduct these investments, such as Fintech companies and banks in other jurisdictions e.g. the US. Non-deduction using the prudential amortisation approach is a positive step in addressing that unlevel playing field, although there remains a large gap between the proposed amortisation approach and zero deduction for non-regulated competitors and 100% risk weight for the full stock of software in the US. As such, it is important that the calibration of the prudential amortisation period is increased to 4 years to reduce the competitive disadvantage, as well as to address the mis-calibration. As banks become increasingly digital, the impact from an unlevel playing field will become ever more material.

Q4 What is your view on the proposed alternative approaches illustrated above?

Option B is most preferred by the industry for the reasons outlined below:

Option A would require an additional data capture process for all capitalization bookings per software asset to be able to identify the start date of prudential amortization. Additional data

---

1 See note related to Option 4: Prudential amortisation, slide 14: [Public Hearing Presentation]

2 Para 12: "Full detailed information in all cases since several transactions occurred many years in the past was not always retrievable, in particular for resolution and liquidation cases in a pre-BRRD world, and sometimes due to some confidentiality issues. Moreover, even when accessible, the degree of information contained in evaluation reports for the valuation of software was quite limited."

3 With an associated standard deviation of five years.

quality processes would also need to be established to adhere to the required regulatory standards - this data is currently not required to be stored.

Option B is easier from an implementation perspective and all of the necessary input data is available and would allow for the new regime to be implemented as quickly as possible. The alignment of prudential and accounting data in Option B is not only desirable to limit the operational constraints of banks and the EBA, but it is also more fundamentally desirable that both frameworks be aligned as closely as possible.

Whilst Option B is the clear preference, we believe that the calibration of the UEL should be increased to 4 years. Beyond this draft RTS, we believe future work should include providing some recognition of software under development, rather than the full deduction proposed.

Cost benefit analysis/Impact assessment

Q5 If considered needed, please provide any complementary information regarding the costs and benefits from the application of these draft RTS.

Data Quality

The analysis performed by the EBA in assessing the capital benefits on CET1 ratio of 19.8bps in 2018 from applying Option B is based on an assumption that we believe to overestimate the benefit. The EBA performed its analysis on the assumption that 'the investments in software are assumed to be capitalised in full as of 31 December of each year'[4]. In reality, investments by banks and across the financial sector are made throughout the year. As such, a more realistic assumption would be to assume such investments are evenly spread across the year.

The EBA's estimation of the potential benefit of prudential amortisation under Option B should therefore be viewed as a 'best case' scenario, with the more realistic assumption of investments being evenly distributed resulting in the potential benefit being 20% lower than estimated by the EBA.

Impact analysis of changing the UEL calibration

Whilst the EBA has recommended a calibration of 2 years, no data has been shown as to the impacts of the benefits of changing the calibration to 3 years, which is within the 1-3 year observed by the EBA, or longer (4 years) as we believe justified as outlined in Q3.

Taking the example of an asset with a useful economic life of 6 years, bought for €100m at the beginning of the calendar year, the average benefit from applying the prudential amortisation over the life of the asset is:

- 18.4% using an amortisation period of 2 years;
- 36.8% using an amortisation period of 3 years; and
- 55.2% using an amortisation period of 4 years

See Annex for supporting analysis.

As is evident, the benefit is markedly different dependent on the UEL. Capital over and above that required from an accounting perspective is held against the asset under each of these calibrations, with 2 years providing the least capital relief and being the least conducive to promoting investment, resilience and competition.

[4] Page 32, Paragraph 11: Consultation paper

Q6 If considered material, please provide your own estimate on the difference in the impact of prudential amortisation treatment between (i) assuming the capitalisation date of software assets as the starting point for prudential amortisation (ie. Option A illustrated in this CP) and (ii) assuming the date of accounting amortisation as the starting point for prudential amortisation, but fully deducting from CET1 items the costs capitalised until this date is (i.e. Option B illustrated in this CP).

Due to the limited timeframe for this consultation, we have a limited data set for the purposes of answering this question.

Other comments

Q7 Please provide any additional comments on the Consultation Paper

Summary

In summary, the industry would support an improved prudential amortisation approach, which uses an amortisation period of 4 years under Option B. This will help support digitilisation initiatives, such as the new Digital Finance Strategy for Europe[5] proposed by the Commission and supported by the EBA, which will require significant capital investment across the financial system. In a second step, post-finalisation of the current draft RTS, we call on EU authorities to provide a more appropriate treatment to software assets under development under Option B than the full deduction proposed.

The COVID crisis has evidenced the importance of a strong IT network for business continuity and resilience, with banks carrying on crisis monitoring, business as usual operations and customer support with all their employees at home. We believe that our proposal to extend the prudential amortisation period is in the best interest of safety and soundness of the European financial system and will facilitate banks' investments in software as a key factor for competitiveness and resilience of the European banking sector which would in turn enhance resilience of the real economy.

Monitoring Exercise

The EBA states in the consultation that it is its intention to closely monitor the evolution of the investments in software assets going forward, including the link between the proposed prudential treatment and the need for EU institutions to make some necessary investments in IT developments in areas like cyber risk or digitalisation in particular. We believe this will highlight the conservatism of the current approach proposed and that any monitoring exercise should be done with a view of improving the calibration to facilitate competitiveness and resilience, the merits of which we have outlined above.

AFME contact

Sahir Akbar, Managing Director, Prudential Regulation and Head of Finance

sahir.akbar@afme.eu

+44 (0)20 3828 2732

[5] https://eba.europa.eu/eba-supports-commission%E2%80%99s-proposal-new-digital-finance-strategy-europe

ANNEX

Capital benefit of prudential amortisation versus current approach of full deduction

Table 1

Bank X Calculation of cost of prudential treatment (€m)	Analysis using UEL of 2 years for Prudential Amortisation 31/12/2021	31/12/2022	31/12/2023	31/12/2024	31/12/2025	31/12/2026
Accounting Treatment						
Gross Book Value	100	100	100	100	100	100
Accounting Accumulated amortisation	17	33	50	67	83	100
Net Carrying amount	83	67	50	33	17	0
Current prudential treatment						
CET1 Deduction	83	67	50	33	17	0
Prudential amortisation						
CET 1 Deduction	33	67	50	33	17	0
Capital held against RW assets	4	0	0	0	0	0
Total cost of prudential amortisation	37	67	50	33	17	0
Benefit of prudential amortisation approach	46	0	0	0	0	0
Capital benefit	55%	0%	0%	0%	0%	0%
Weighted average benefit over UEL:	18.40%					

Table 2

Bank X Calculation of cost of prudential treatment (€m)	Analysis using UEL of 3 years for Prudential Amortisation 31/12/2021	31/12/2022	31/12/2023	31/12/2024	31/12/2025	31/12/2026
Accounting Treatment						
Gross Book Value	100	100	100	100	100	100
Accounting Amortisation	17	17	17	17	17	17
Accounting Accumulated amortisation	17	33	50	67	83	100
Net Carrying amount	83	67	50	33	17	0
Current prudential treatment						
CET1 Deduction	83	67	50	33	17	0
Prudential amortisation						
CET 1 Deduction	17	33	50	33	17	0
Capital held against RW assets	5	3	0	0	0	0
Total cost of prudential amortisation	22	36	50	33	17	0
Benefit of prudential amortisation approach	61	31	0	0	0	0
Capital benefit	74%	46%	0%	0%	0%	0%
Weighted average benefit over UEL:	36.80%					

Table 3

Bank X Calculation of cost of prudential treatment (€m)	Analysis using UEL of 4 years for Prudential Amortisation 31/12/2021	31/12/2022	31/12/2023	31/12/2024	31/12/2025	31/12/2026
Accounting Treatment						
Gross Book Value	100	100	100	100	100	100
Accounting Amortisation	17	17	17	17	17	17
Accounting Accumulated amortisation	17	33	50	67	83	100
Net Carrying amount	83	67	50	33	17	0
Current prudential treatment						
CET1 Deduction	83	67	50	33	17	0
Prudential amortisation						
CET 1 Deduction	8	17	25	33	17	0
Capital held against RW assets	6	4	2	0	0	0
Total cost of prudential amortisation	14	21	27	33	17	0
Benefit of prudential amortisation approach	69	46	23	0	0	0
Capital benefit	83%	69%	46%	0%	0%	0%
Weighted average benefit over UEL:	55.20%					