

III

(Preparatory acts)

EUROPEAN CENTRAL BANK

OPINION OF THE EUROPEAN CENTRAL BANK

of 8 November 2017

on amendments to the Union framework for capital requirements of credit institutions and investment firms**(CON/2017/46)**

(2018/C 34/05)

Introduction and legal basis

On 2 and 20 February 2017 the European Central Bank (ECB) received requests from the Council of the European Union and the European Parliament, respectively, for an opinion on a proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012 ⁽¹⁾ (hereinafter the 'proposed amendments to the CRR').

On 17 and 20 February 2017 the ECB received requests from the European Parliament and the Council of the European Union, respectively, for an opinion on a proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures ⁽²⁾ (hereinafter the 'proposed amendments to the CRD').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union since the proposed amendments to the CRR and the CRD contain provisions affecting the ECB's tasks concerning policies relating to the prudential supervision of credit institutions in accordance with Article 127(6) of the Treaty and the European System of Central Banks' contribution to the smooth conduct of policies pursued by the competent authorities relating to the stability of the financial system, as referred to in Article 127(5) of the Treaty. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

General observations

The ECB supports the Commission's banking reform package, which will implement important elements of the global regulatory reform agenda in Union legislation. The Commission's proposal is expected to substantially strengthen the regulatory architecture, thereby contributing to the reduction of risks in the banking sector. Such progress on risk reduction will pave the way for concurrent and commensurate progress on risk sharing.

This opinion addresses issues of particular importance to the ECB, which have been divided into two sections: (1) changes to the existing Union regulatory and supervisory framework; and (2) implementation of internationally agreed supervisory standards.

⁽¹⁾ COM(2016) 850 final.

⁽²⁾ COM(2016) 854 final.

1. **Changes to the existing Union regulatory and supervisory framework**

1.1. *Pillar 2 refinements*

- 1.1.1. The proposed amendments to the implementation of the Pillar 2 requirements of the Basel III framework ⁽¹⁾ in the Capital Requirements Directive ⁽²⁾ (CRD) seek to achieve greater supervisory convergence in the Union by more clearly defining the elements of the capital stack and introducing Pillar 2 guidance on additional own funds, as well as by significantly tightening the conditions under which competent authorities may exercise their supervisory powers in this context.
- 1.1.2. While in general the ECB supports supervisory convergence, the proposal to develop regulatory technical standards on additional own funds requirements is not the appropriate tool for achieving this objective.

First, Pillar 2 requirements are institution-specific, which requires competent authorities to use supervisory judgement. Solely relying on the regulatory technical standards of the European Banking Authority (EBA) or using them for parts of the risk elements would not result in an institution-specific, risk-based approach that takes into account the diversity of institutions' risk profiles, and would in fact prevent the competent authorities from keeping pace with risks and industry developments.

Second, the EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) ⁽³⁾ already provide a common basis for consistent implementation of the SREP in the Union, which enables an adequate degree of supervisory judgement and may be supplemented by using EBA peer reviews. Over recent years, convergence has improved considerably with the implementation of these Guidelines ⁽⁴⁾ and the implementation of the ECB's SREP methodology, which is consistently applied across the Single Supervisory Mechanism (SSM) ⁽⁵⁾.

Considering these positive developments, the ECB is of the view that the current framework is adequate and that the single market will continue to benefit in terms of convergence from the existing tools, possibly supplemented by making further use of EBA peer reviews.

- 1.1.3. Additionally, the proposed amendments to the CRD grant credit institutions, and not supervisory authorities, the power to decide, within certain limits, on the composition of the own funds held to meet Pillar 2 requirements and exclude the possibility of setting Pillar 2 requirements so that they are met in full with Common Equity Tier 1 capital. The ECB is of the view that supervisory authorities should retain the power to set a composition requirement for additional own funds and to require that additional own funds requirements must be met solely with Common Equity Tier 1 capital. From a prudential perspective, the banking crisis and more recent market events have shown that there may be significant challenges in dealing with, e.g., additional Tier 1 instruments, whose loss-absorbing capacities are not as efficient as Common Equity Tier 1 capital and whose costs would jeopardise credit institutions' profitability even further. In addition, the ECB's practice since it assumed its prudential supervisory tasks has been to set Pillar 2 requirements to be met with Common Equity Tier 1 capital. By requiring the buffers to be met using only Common Equity Tier 1 capital, the Union legislative bodies established their preference for the highest quality capital. A change in practice would result in less predictability for credit institutions and an unlevel playing field.

⁽¹⁾ Available on the website of the Bank for International Settlements (BIS) at www.bis.org

⁽²⁾ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

⁽³⁾ See Guidelines EBA/GL/2014/13 of the European Banking Authority of 19 December 2014 on common procedures and methodologies for the supervisory review and evaluation process (SREP).

⁽⁴⁾ See the EBA Report on the convergence of supervisory practices (EBA-Op-2016-11), 14 July 2016, available on the EBA's website at www.eba.europa.eu

⁽⁵⁾ On the basis of Article 4(1)(f) of Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63) (SSMR), the ECB carries out supervisory reviews and for that purpose has defined a common SREP methodology, see in particular the ECB Guide to banking supervision of November 2014, available on the ECB's website at www.ecb.europa.eu. As a result, consistency in the additional requirements imposed on significant credit institutions has increased markedly. In particular, with regard to significant credit institutions within the SSM, the correlation between the overall SREP scores and capital requirements has increased from 26 % prior to 2014 to 76 % in 2016 (see page 44 of the 2016 SSM SREP methodology booklet, available on the ECB's Banking Supervision website at www.bankingsupervision.europa.eu).

- 1.1.4. Whilst the introduction of a common basis for imposing capital guidance will assist in the consistent implementation of such guidance throughout the Union, the ECB considers that the proposed amendments to the CRD should reflect more clearly the need for flexibility in the determination of Pillar 2 guidance. In particular, the relationship between the stress test threshold and the determination of the Pillar 2 guidance should be taken into account. Since supervisory stress tests serve as a starting point for setting Pillar 2 guidance, the proposed amendments to the CRD should, in line with current international best practice, also allow competent authorities to apply a fixed threshold in stress tests across all credit institutions, which may be lower than the total SREP capital requirements (TSCR). The flexibility to use a fixed threshold should be available as a permanent option. Moreover, the use of the TSCR should be tailored to the methodology used in the stress test. For example, the use of the TSCR threshold in the adverse scenario requires the application of a dynamic balance sheet approach. In addition, a provision regarding a three-year review should be included in the proposed amendments to the CRD.
- 1.1.5. Furthermore, the way in which the Pillar 2 guidance interacts with the combined buffer requirements should be further clarified. In particular, potential conflicts with the policy objective of the countercyclical capital buffer should be avoided. This includes removing the reference to addressing 'cyclical economic fluctuations' as a policy objective of Pillar 2 guidance. In addition, although any overlap between Pillar 2 guidance and Pillar 2 requirements should be avoided, the proposed amendments to the CRD need to clarify that, where a stress test identifies additional types of credit risk in a hypothetical situation and these are part of the Pillar 2 requirements, competent authorities retain the ability to apply measures addressing such risks in the Pillar 2 guidance.
- 1.1.6. The proposed amendments to the CRD limit competent authorities' powers to require credit institutions to provide them with supplementary or more frequent information. Although the ECB fully supports the underlying objective of avoiding duplication of reporting and reducing reporting costs, the possibility to require ad hoc granular data is essential to properly assess credit institutions' risk profiles for, inter alia, the purpose of the SREP. These risks are difficult to fully capture *ex ante* through harmonised reporting, particularly due to the manner in which credit institutions' activities and risks develop. Moreover, competent authorities will always need to collect additional granular information in order to adequately assess credit institutions' strengths and weaknesses regarding specific risks or asset classes, e.g. in respect of non-performing loans. Therefore, the ECB is of the view that these limitations should be removed from the proposed amendments to the CRD.
- 1.1.7. Competent authorities should be allowed to impose own funds requirements whenever interest rate risk is a material source of concern and not only when risks exceed a certain predefined threshold. Furthermore the mandate proposed for the EBA to specify certain concepts for the purpose of the review of credit institutions' exposure to interest rate risk arising from non-trading book activities suggests an exhaustive list of circumstances in which supervisory measures are required as a result of potential changes in interest rates⁽¹⁾. The ECB takes the view that competent authorities should be given more flexibility in imposing supervisory measures.
- 1.1.8. The proposed amendments to the CRD require competent authorities to consult resolution authorities prior to the adoption of any additional capital requirement⁽²⁾. While the ECB supports the objective of achieving effective coordination with resolution authorities, the proposal for formal consultation of resolution authorities prior to determining additional own fund requirements or providing guidance as specified in the CRD would prove unnecessarily burdensome and unduly formalistic in practice, without improving the substance of the current arrangements. Moreover, the existing Memorandum of Understanding between the ECB and the Single Resolution Board⁽³⁾, which was implemented for the first time in the context of the development of the 2016 SREP decisions, already ensures efficient cooperation. Taking into account the non-binding nature of capital guidance, the decision to impose such guidance should remain outside the framework of joint decisions and should be subject only to an exchange of information between college members.

⁽¹⁾ See the proposed new Article 98(5a) of the CRD.

⁽²⁾ See the proposed new Article 104c of the CRD.

⁽³⁾ Memorandum of understanding between the Single Resolution Board and the European Central Bank of 22 December 2015 in respect of cooperation and information exchange, available on the ECB's website at www.ecb.europa.eu

1.2. *Interaction of micro and macroprudential powers*

The ECB is generally supportive with regard to removing Pillar 2 as an instrument from the macroprudential toolkit, but reiterates its view that removing Pillar 2 requirements should not result in authorities having insufficient tools to carry out their mandate and achieve their policy objectives ⁽¹⁾. Hence, the ECB's support for the proposed elimination of Pillar 2 requirements from the macroprudential toolkit is subject to the proviso that the toolkit is broadened and rendered operational. An operational and effective macroprudential framework is especially important in a monetary union where macroprudential policies are needed to address country-specific or sector-specific imbalances, thereby playing a key complementary role in addressing the heterogeneity in financial and business cycles across Member States and, in this manner, helping to maintain the integrity of the Single Market and safeguard financial stability. At the same time, the revised framework should avoid facilitating ring-fencing decisions that could increase the risk of market fragmentation and create impediments to banking system consolidation.

More generally, the ECB reiterates the importance of a thorough macroprudential review, as highlighted in the ECB contribution to the European Commission's consultation on the review of the Union's macroprudential policy framework. In the meantime, with regard to improving the operational effectiveness of the macroprudential framework, as a minimum the following adjustments to the current framework are required as a matter of priority. First, the present hierarchy for the sequencing of the activation mechanism (the so-called 'pecking order') should be withdrawn. The present pecking order provides adverse incentives regarding the selection of instruments and results in a bias towards inaction. Second, the wide variety of notification and activation procedures for macroprudential measures should be streamlined, simplified and harmonised. This would entail, *inter alia*, establishing a unified and simplified activation procedure for the use of the macroprudential tools provided for in Article 458 of the Capital Requirements Regulation ⁽²⁾ (CRR) and harmonising the activation procedures for different capital buffers in such a way as to allow the macroprudential authorities to act in an efficient, effective and timely manner. In this regard, changes to the rules relating to the other systemically important institutions buffer and the systemic risk buffer should also be considered in order to clarify the policy purpose of these buffers, thereby eliminating overlaps and enhancing the effectiveness of their use by authorities. Third, the process set out in Article 136(3) of the CRD should be streamlined in such a way that each designated authority assesses the appropriate countercyclical capital buffer rate on a quarterly basis but sets or resets the rate only if there is a change in the intensity of cyclical systemic risks. In this context, the procedures for notifying the countercyclical buffer rate should also be amended to require designated authorities of Member States participating in the SSM to also notify the information specified in points (a) to (g) of Article 136(7) of the CRD to the ECB. Finally, the ECB considers it of paramount importance that the macroprudential policy framework is revised at regular intervals, taking account of developments in the analytical framework as well as practical experience with policy implementation. In this regard, a provision for comprehensive review of the macroprudential framework within the next three years, including the scope and appropriateness of the toolkit, should also be introduced.

1.3. *Cross-border waiver for prudential requirements*

1.3.1. The ECB generally supports the introduction of the possibility for a competent authority to waive the application of prudential requirements on an individual basis to a subsidiary whose head office is located in a Member State different to that of its parent undertaking, which is consistent with the establishment of the SSM and the banking union.

1.3.2. Additional prudential safeguards and technical modifications could address any potential financial stability concerns resulting from the application of this waiver mechanism to the banking union, which is still moving towards completion. In particular, the following two additional preconditions could be introduced in order for subsidiaries to benefit from the waiver: (a) the subsidiaries eligible for the waiver must not by themselves exceed a certain threshold, e.g. the thresholds for significance set out in the SSMR; and (b) the waiver should be subject to a floor of 75 %, e.g. the minimum own funds requirement could be reduced at most from 8 % to 6 % of the total risk exposure amount. In this regard, the guarantee would only be needed in relation to the amount of own funds requirements actually waived. Furthermore, the ECB recommends that these conditions should be reviewed three years after their entry into force and that consideration should, in particular, be given to whether the floor should be lowered further in the light of the evolution of the banking union.

⁽¹⁾ See the ECB contribution to the European Commission's consultation on the review of the EU macroprudential policy framework (12 December 2016), available on the ECB's website at www.ecb.europa.eu

⁽²⁾ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

- 1.3.3. The proposed amendments to the CRR should additionally clarify that a parent undertaking's guarantee of a subsidiary must be appropriately reflected in the prudential requirements for credit risk applicable to that parent undertaking. In particular, the parent undertaking should have 100 % of the subsidiary's voting rights.
- 1.3.4. Finally, appropriate transitional arrangements for implementing the cross-border capital waiver should be put in place, taking into account the planned further progress on the banking union outlined in the Commission Communication to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions on completing the Banking Union ⁽¹⁾ (hereinafter the 'Communication on completing the banking union').

1.4. *Implementation of International Financial Reporting Standard 9 (IFRS 9)*

The proposed amendments to the CRR provide for a phase-in period for expected credit loss provisions under IFRS 9 ⁽²⁾ to mitigate the impact of IFRS 9 on credit institutions' regulatory Common Equity Tier 1 capital ⁽³⁾. The ECB recommends that the period for transitional measures for IFRS 9 should start on 1 January 2018 with a linear phasing-in ⁽⁴⁾. In this context, the presidency of the Council is encouraged to fast track the legislation implementing the transitional arrangement for IFRS 9.

Moreover, it would be preferable to only apply the phase-in to the initial Common Equity Tier 1 reduction on 1 January 2018 (static approach) and not the expected loss amounts calculated under IFRS 9 at the relevant reporting date in the transition period (dynamic approach), since the latter approach would effectively delay the full application of IFRS 9 ⁽⁵⁾.

To avoid double counting of amounts added back to Common Equity Tier 1 capital, the ECB recommends making corrections during the transition period to all parts of the CRR that assume that Common Equity Tier 1 capital is reduced, i.e. for the add-back to Tier 2 capital, for non-deducted deferred tax asset amounts, and for reductions in exposure values for the standardised approach to credit risk, the leverage ratio and the large exposure framework.

The transitional measures should be mandatory for all institutions; otherwise institutions opting out could compel other institutions to frontload as well, which would counteract the very purpose of allowing more time to adapt to the initial Common Equity Tier 1 reduction when moving to IFRS 9.

1.5. *Additional deductions and adjustments to Common Equity Tier 1 capital*

The ECB welcomes the Commission's clarification on the scope of Article 104(1)(d) of the CRD and Article 16(2)(d) of the SSMR as set out in the Report from the Commission to the European Parliament and the Council on the Single Supervisory Mechanism established pursuant to Regulation (EU) No 1024/2013 (hereinafter the 'Report on the SSM') ⁽⁶⁾ and, in particular, the confirmation that competent authorities are allowed to require a credit institution to apply specific adjustments (deductions, filters or similar measures) to own funds calculations where the accounting treatment applied by the credit institution is considered not to be prudent from a supervisory perspective. The ECB is of the view that such a clarification should be included directly in the text of the CRD to ensure legal certainty.

1.6. *Intermediate EU parent undertaking*

The ECB welcomes the requirement to establish intermediate EU parent undertakings for third-country banking groups with two or more institutions established in the Union, provided that certain criteria are met or thresholds are exceeded ⁽⁶⁾, since this will allow the consolidating supervisor to evaluate the risks and financial soundness of the entire banking group in the Union and to apply prudential requirements on a consolidated basis.

⁽¹⁾ COM(2017) 592 final.

⁽²⁾ See International Accounting Standards Board, IFRS 9 Financial Instruments (2014), available at www.ifrs.org

⁽³⁾ See the proposed new Article 473a of the CRR.

⁽⁴⁾ In line with the proposed new paragraph 96A of the Basel III document, see BCBS Standards: Regulatory treatment of accounting provisions – interim approach and transitional arrangements, March 2017, available on the website of BIS at www.bis.org. On the basis of this paragraph, the percentages for each year are determined on a straight line basis.

⁽⁵⁾ COM(2017) 591 final.

⁽⁶⁾ See the proposed new Article 21b of the CRD.

However, certain aspects of the proposed amendments to the CRD require further clarification in order to avoid regulatory arbitrage. First, the requirement should apply to both third-country credit institutions and branches (i.e. also in cases where the Union operations of the third-country group carried out, partially or exclusively, via branches). Second, once an intermediate EU parent undertaking is established, it should be a requirement that the existing branches of the same third-country banking group exceeding a certain threshold are re-established as branches of a credit institution authorised in the Union to prevent regulatory arbitrage opportunities, since supervision of third country branches is not harmonised. It is also important, in the longer term, to harmonise the regulatory and supervisory framework of third-country branches in the Union. Third, whether the intermediate EU parent undertaking is established as a financial holding company, a mixed financial holding company or a credit institution, it should be ensured that the framework for determining supervision on a consolidated basis does not result in an outcome that is not appropriate and could compromise the exercise of efficient and effective supervision by competent authorities supervising entities belonging to the third country group on an individual basis. Consequently, where the intermediate EU parent undertaking is established as a credit institution, and in order to level the playing field, the introduction of a criterion similar to that set out in Article 111(5) of the CRD, which currently applies to financial holding companies and mixed financial holding companies, should be explored. Moreover, the scope of application and the process linked to the implementation of Article 111(5) of the CRD should be clarified. Fourth, in the event of conflict between third-country laws and the requirement for a single intermediate EU parent undertaking, which could prevent or unduly complicate compliance with the intermediate EU parent undertaking requirement, a derogation should be explored to give competent authorities, in exceptional circumstances, discretion to allow the establishment of two separate intermediate EU parent undertakings (or to allow the carving out of specific entities from the single intermediate EU parent undertaking). In this case, the threshold for the intermediate EU parent undertaking requirement should be applied at the level of the whole third-country group, before the discretion is exercised, so that the exercise of this discretion does not result in a circumvention of the applicable thresholds for establishing an intermediate EU parent undertaking, as provided for in the proposed amendments to the CRD.

1.7. *Proportionality in reporting*

As regards the reporting obligations of smaller institutions the ECB generally supports a proportionate approach. In some instances, smaller institutions should be subject to simplified reporting requirements in accordance with their size, complexity and riskiness.

The proposed reduction in the frequency of regulatory reporting ⁽¹⁾ by small credit institutions prevents competent authorities from adequately supervising these credit institutions ⁽²⁾. Regulatory reports are highly relevant, since they are among the most important sources of information for the ongoing supervision of smaller institutions. The availability of adequate information allows competent authorities to adjust the intensity of their supervisory actions with respect to such institutions. Moreover, although a reduction in the frequency of reporting would reduce compliance costs for smaller credit institutions from a human resources perspective, it would be unlikely to be less burdensome from an IT perspective since smaller institutions would still need to put appropriate IT systems in place, and the majority of these costs have already been incurred.

Instead of reducing the frequency of regulatory reporting the ECB suggests that the scope of reporting for smaller institutions could be amended, once the EBA has assessed the financial impact on credit institutions of Commission Implementing Regulation (EU) No 680/2014 ⁽³⁾ in terms of compliance costs and supervisory benefits ⁽⁴⁾.

Consistent application of the principle of proportionality should be recognised more systematically throughout the CRR. Specific cases should be identified where a more proportionate treatment could reduce compliance costs without compromising the prudential supervisory regime. A more proportionate approach could also be provided for, in particular in the areas of internal governance and the fit and proper regime, remuneration, and disclosures.

⁽¹⁾ See the proposed new Articles 99(4), 101(5), 394(3), and 430(1) of the CRR.

⁽²⁾ This proposal would affect around 80 % of all less significant institutions.

⁽³⁾ Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council (OJ L 191, 28.6.2014, p. 1).

⁽⁴⁾ See the proposed new Article 99(7) of the CRR.

1.8. *Automatic restrictions on distributions*

As regards the proposed amendments to the CRD on the maximum distributable amount (MDA), the ECB welcomes the clarification regarding the capital stack. In addition, the ECB proposes that all interim/year-end profits not already included in Common Equity Tier 1 capital (net of distributions already paid out) should be included in the MDA and not only those profits generated after the last distribution. The focus on the most recent distribution or payment limits the profits that may be used for calculating the MDA. Credit institutions often have multiple decision dates for paying out coupons, dividends and bonuses. The more frequently a credit institution makes decisions regarding or pays distributions, the shorter the period over which profits are generated and thus the lower the amount of profits eligible to be used in the MDA calculation. This restriction is not justified if the interim/year-end profits generated, but not yet included in Common Equity Tier 1 capital, are higher than the distributions made.

1.9. *Credit and counterparty credit risk*

1.9.1. While Level 2 legislation has comprehensively clarified modelling in terms of credit, market and operational risk, such specificities are still lacking as regards counterparty credit risk. The ECB recommends that the CRR should be amended to request the EBA to develop regulatory technical standards with specific assessment criteria for the Internal Model Method (IMM) and for the advanced credit valuation adjustment (A-CVA) method. These regulatory technical standards should set out in more detail the materiality assessment for model changes and extensions for both IMM and A-CVA. Finally, a provision should be added requiring credit institutions to obtain approval from competent authorities in order to apply the A-CVA approach.

1.9.2. Credit institutions that have already implemented the IMM do not use it exclusively, and use other (non-internal) methods to calculate some of their exposures. This raises concerns that a great number of credit institutions might not be able to comply with the requirement that the IMM must not be applied in combination with other methods. To this end, the CRR should be amended to allow credit institutions to obtain permission to use the IMM for counterparty credit risk on a permanent partial basis, as they may for other risk types.

1.9.3. Furthermore, the current CRR rules for determining the maturity parameter should be extended to cover derivative and securities financing transaction exposures and open-term transactions.

1.9.4. The definition of the supervisory delta proposed by the Commission for the new standardised approach to measuring counterparty credit risk exposures should be aligned with the mathematically correct Basel Committee on Banking Supervision (BCBS) standards.

1.10. *Treatment of financial holding companies and mixed financial holding companies*

1.10.1. The ECB supports the harmonisation and enhancement of supervision over financial holding companies and mixed financial holding companies. It is important that actions for consolidated supervision can be directly targeted towards a banking group's parent undertaking, regardless of whether it is an institution or a holding company. In this respect, the fundamental supervisory objective is to ensure that the parent undertaking carries out its steering and coordination over its subsidiaries in a way that effectively advances the consolidated supervision. In general, the new regime should allow for the particular characteristics of a financial holding company or a mixed financial holding company and its role within a group to be sufficiently taken into account, in order to avoid excessive impediments to the group's functioning.

1.10.2. Some aspects of the proposed amendments to the CRD and the CRR would benefit from improvement or clarification. For example, clarification is needed on how the proposed amendments regarding the authorisation of financial holding companies and mixed financial holding companies relate to the existing rules on the supervision of qualifying holdings. Additionally, the proposed amendments to the CRD and the CRR do not indicate with sufficient clarity which of the current provisions referring to a 'credit institution' should be understood as including a financial holding company and a mixed financial holding company for the purposes of consolidated supervision. Further specification is also needed in relation to the ongoing supervisory measures that the consolidating supervisor may apply to a financial holding company and a mixed financial holding company.

1.10.3. In addition, the effect of the proposed amendments on Article 111 of the CRD needs to be considered. It is of particular concern that the consolidating supervisor might be located in a different jurisdiction from the financial holding company or the mixed financial holding company. The consolidating supervisor would then need to ensure compliance with consolidated requirements by a financial holding company or a mixed financial holding company established in a different Member State. The proposed amendments to the CRD should include provisions that set out in greater detail how to carry out efficient cross-border cooperation in such a case.

- 1.10.4. Finally, the proposed amendments to the CRD should include provisions that clarify the treatment of existing financial holding companies and mixed financial holding companies falling under these provisions.

1.11. *Supervision of large cross-border investment firms*

Large and complex bank-like investment firms providing investment services that impact upon their balance sheet, particularly those with cross-border operations, can pose increased financial stability risks as well as an increased risk of spill-over effects on other banks. The ECB takes the view that the consolidated and solo supervision of large cross-border, bank-like investment firms in the Union warrants further consideration, to ensure prudent and consistent supervisory standards commensurate with the risks these firms can pose. One of the possible options would be to amend the CRD/CRR in order to ensure that large cross-border investment firms are considered as credit institutions ⁽¹⁾. This would be relevant for investment firms that frequently carry out bank-like activities of a type that are also carried out by banks. For investment firms that are not in that category, the current differentiation of treatment reflected in national arrangements should be preserved.

1.12. *National powers*

- 1.12.1. The SSMR confers on the ECB specific tasks relating to the prudential supervision of credit institutions, with a view to contributing to the safety and soundness of credit institutions and the stability of the financial system. These tasks are carried out with full regard for the unity and integrity of the internal market and the equal treatment of credit institutions, and with a view to preventing regulatory arbitrage ⁽²⁾. For this purpose, the ECB is required to apply all relevant Union law and where this law is composed of directives, the national legislation transposing those directives ⁽³⁾, in particular the CRD and the Bank Recovery and Resolution Directive ⁽⁴⁾ (BRRD). However, some supervisory powers are not specifically mentioned in Union law and differences in national legislation result in asymmetries in the ECB's supervisory powers across participating Member States.

- 1.12.2. In this regard, the ECB has already examined the scope and extent of existing supervisory powers and has developed an approach for ensuring a consistent interpretation of the ECB's powers. Despite this clarification of the ECB's competences, providing these existing supervisory powers with a common legal basis in Union law would trigger a requirement for their transposition and help clarify the interpretation of whether a specific power granted under national law is within the remit of a specific task conferred on the ECB. Furthermore, it would foster a level playing field in Union banking supervision through the harmonisation of competent authorities' supervisory powers. To achieve this, Union law should include a clear reference to additional supervisory powers in a number of areas, to avoid legal uncertainty with regard to the ECB's direct supervisory powers and to ensure a level playing field with regard to supervisory powers across the banking union. These areas mainly relate to acquisitions in third countries, mergers, asset transfers and other strategic decisions, the amendment of credit institutions' statutes and their shareholders' agreements on the exercise of voting rights, the provision of credit to related parties, the outsourcing of activities by credit institutions, supervisory powers regarding external auditors and additional powers related to the authorisation of credit institutions.

1.13. *Fit and proper assessment and key function holders*

- 1.13.1. Currently, the CRD does not establish requirements for the procedure to be used by competent authorities when carrying out assessments on members of the management bodies. As a consequence, national practices differ considerably in relation to the timing of the assessment, deadlines, and on whether the assessment takes place before or immediately after appointment. The ECB recommends amending Union law to further harmonise the processes for 'fit and proper' assessments.

⁽¹⁾ See Communication on completing the banking union, p. 19 and Report on the SSM, p. 8.

⁽²⁾ See the first paragraph of Article 1 of the SSMR.

⁽³⁾ See Article 4(3) of the SSMR.

⁽⁴⁾ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190).

- 1.13.2. Key function holders have an important impact on the day-to-day management of credit institutions and in their overall governance structure. The ECB recommends that Union law should be amended to include a definition of key function holders and to clarify the definition of senior management. Moreover, to harmonise national approaches, a provision should be introduced on the powers of competent authorities when assessing key function holders in significant institutions.

1.14. *Exchange of information*

The current Union framework makes few specific references to the need for cooperation between the competent authorities responsible for prudential supervision and anti-money laundering authorities⁽¹⁾. There are also no explicit provisions governing cooperation between the competent authorities responsible for prudential supervision and the authorities responsible for applying rules on structural separation. The ECB proposes that the CRD's provisions on exchange of confidential information should be amended to explicitly provide for cooperation with these other authorities.

1.15. *Enforcement and sanctions regime*

The list of infringements subject to sanctions under the CRD does not include a number of important breaches, i.e. in respect of Pillar 1 capital requirements, supervisory regulations and decisions issued by a competent authority, the requirement to apply for prior permission and obligations to notify the competent authority. Member States therefore have discretion as to whether to provide the competent authorities with the power to impose administrative penalties in such cases. This approach may lead to inconsistencies between the Member States and undermine the effective enforcement of prudential requirements. To counter this, the ECB proposes to expand the list of infringements subject to sanctions.

1.16. *Options and discretions*

- 1.16.1. The existence of national options and discretions in prudential regulation prevents a single rulebook from being realised at Union level and adds an extra layer of complexity and costs, while allowing opportunities for regulatory arbitrage. In particular, options for Member States create obstacles to the efficient operation of the SSM, which must take into account different regulations and practices in the participating Member States. The concurrent and divergent exercise of such options results in a regulatory patchwork that can hamper the smooth functioning of ECB supervision within the participating Member States and as regards exposures related to third countries.

- 1.16.2. In some cases, these divergences also affect supervisory powers. Thus, those unwarranted options and discretions, which are not justified from a prudential perspective, should be harmonised directly in Level 1 legislation. Similarly, the introduction of new options and discretions should be discouraged, as is the case, for example, in the proposed amendments to the CRR in the area of equity investments in funds.

1.17. *Own funds requirements for exposures to central counterparties (CCPs)*

The ECB supports the introduction of a predefined exemption period into the proposed amendments to the CRR as regards own funds requirements for exposures to CCPs. This predefined exemption period would allow institutions to consider a third country CCP, which has applied, in accordance with Article 25 of Regulation (EU) No 648/2012 of the European Parliament and of the Council⁽²⁾, to be a qualifying CCP. Such an exemption period is important in order to provide institutions with legal certainty regarding the treatment of their exposures over a relevant time horizon. Nonetheless, the ECB believes that providing a maximum exemption period of five years after the date of submission of an application for recognition (where the Commission has not yet adopted an implementing act) could be considered excessive in the light of the potential financial stability implications stemming from exposures to non-recognised third country CCPs. The ECB therefore suggests establishing a shorter maximum exemption period for exposures to third country CCPs that have not yet been recognised under Article 25 of Regulation (EU) No 648/2012.

⁽¹⁾ Neither the CRD nor Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC (OJ L 141, 5.6.2015, p. 73) provide specifically for cooperation of this kind.

⁽²⁾ Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201, 27.7.2012, p. 1).

2. Implementation of internationally agreed supervisory standards

The ECB welcomes the implementation of internationally agreed supervisory standards in Union law. Given the interconnectedness of the global financial system, global standards are necessary to ensure comparability and a level playing field.

2.1. Leverage ratio

- 2.1.1. The ECB supports the introduction of a leverage ratio requirement in Union law and its calibration at 3 %, which is in line with the BCBS standards and the recommendations of the EBA ⁽¹⁾. The ECB recommends that the detailed implementation of the leverage ratio standards in the Union duly takes into account the outcome of ongoing international discussions, notably within the BCBS, as well as any further developments at international level.
- 2.1.2. The proposed amendment to the CRR eliminates the existing discretion for competent authorities to exempt from the leverage ratio exposure measure any intragroup exposures already exempted from risk weights and exposures arising from the pass-through of regulated savings ⁽²⁾, and instead introduces automatic exemptions for these exposures ⁽³⁾. The ECB is of the view that credit institutions should be permitted to exclude these exposures from the leverage ratio only if *ex ante* approval is given by the competent authority, following an assessment of the underlying leverage related risks as is the case in currently applicable Union law. In respect of significant institutions in the SSM the assessment is based on the ECB Guide on options and discretions available in Union law ⁽⁴⁾.
- 2.1.3. If the exemption of exposures arising from officially supported export credits ⁽⁵⁾ is to be maintained it should be limited to the extent necessary, insofar as warranted by Union-wide necessity rather than national preferences, as it constitutes a deviation from the BCBS standards. The automatic exemption of exposures arising from promotional loans from the exposure measure ⁽⁶⁾ also deviates from the BCBS standards and conflicts with the rationale of the leverage ratio as a non-risk-based measure. Further, this automatic exemption is not in line with the EBA recommendations and impedes an efficient comparison of leverage ratios across the market. Finally, the wording of several exemptions, which are often unclear in terms of the conditions to be satisfied, may allow institutions to interpret the exemptions in different ways, possibly resulting in the exemptions having a wider application and not being targeted towards very specific cases.
- 2.1.4. The ECB supports the introduction of a leverage ratio surcharge specifically for global systemically important institutions (G-SIIs), which should be based on the international standards regarding the design and the calibration of such requirements once finalised. Additional requirements for G-SIIs should reflect their systemic relevance and provide the additional loss-absorbing capacity necessary to ensure supplementary protection against their potential failure.
- 2.1.5. The proposed amendments to the CRR also provide for the offsetting of the initial margin in the case of derivative exposures related to client clearing, which is another element that deviates from the BCBS standards. The treatment of the initial margin for these transactions is a sensitive issue that is currently under review at international level. Implementation in the Union should reflect the conclusions of this review once it is finalised ⁽⁷⁾.
- 2.1.6. The proposed amendments to the CRR retain the current approach for calculating the leverage ratio on the basis of the balance sheet at the end of the quarter ⁽⁸⁾. The ECB recommends reviewing this provision, taking into account the ongoing international discussions regarding the reference period for calculating the leverage ratio.
- 2.1.7. The question of how to treat central bank reserves for the purposes of calculating the leverage ratio exposure is another sensitive issue that is currently under review at international level. The implementation of the leverage ratio under Union law should take into account the conclusions of this review once it is finalised.

⁽¹⁾ EBA Report on the leverage ratio requirements under Article 511 of the CRR (No. EBA-Op-2016-13), 3 August 2016, available on the EBA's website at www.eba.europa.eu

⁽²⁾ See the proposed new Article 429a(1)(j) of the CRR.

⁽³⁾ See the proposed new Article 429a of the CRR.

⁽⁴⁾ See the ECB Guide on options and discretions available in Union law (consolidated version), November 2016, available on the ECB's Banking Supervision website at www.bankingsupervision.europa.eu

⁽⁵⁾ See the proposed new Article 429a(1)(f) of the CRR.

⁽⁶⁾ See the proposed new Article 429a(1)(e) of the CRR.

⁽⁷⁾ See the BCBS Consultative Document: Revisions to the Basel III leverage ratio framework, 25 April 2016, available on the website of BIS at www.bis.org

⁽⁸⁾ See the proposed new Article 429(2) of the CRR read in conjunction with Article 14(2) of Implementing Regulation (EU) No 680/2014.

- 2.1.8. The ECB concurs with the recommendations of the EBA that CCPs should not be subject to a leverage ratio requirement even if these entities hold a banking licence in some Member States. The exemption of these CCPs from the leverage ratio is justified by the specific safeguards imposed on CCPs by Regulation (EU) No 648/2012 and by the fact that liabilities of CCPs, such as margins held in the form of deposits, are mainly accumulated for risk management purposes rather than for funding investment activities.
- 2.2. *Net stable funding ratio (NSFR)*
- 2.2.1. The proposed amendments to the CRR deviate from the BCBS standards regarding the treatment of Level 1 high quality liquid assets by applying a 0 % required stable funding (RSF) factor and not a 5 % factor⁽¹⁾. The ECB proposes that a stable funding requirement should be maintained for Level 1 high quality liquid assets (excluding cash and central bank reserves, which should be subject to a 0 % RSF factor), since these assets are subject to some price risk over a time horizon of one year, even in the absence of a stress scenario. Introducing the same treatment as in the liquidity coverage ratio is not appropriate, considering the different timeframes of the two standards.
- 2.2.2. The proposed amendments to the CRR also deviate from the BCBS standards with regard to the treatment of future funding risk in derivative contracts⁽²⁾. The ECB welcomes the mandate given to the EBA to report to the Commission on the opportunity to adopt a more risk-sensitive measure⁽³⁾, given that the BCBS standards are not sufficiently risk sensitive⁽⁴⁾. However, the proposed transitional arrangements contain certain conceptual shortcomings that introduce regulatory arbitrage opportunities, and their impact on credit institutions has not yet been assessed. Therefore, until a more appropriate methodology has been identified, the ECB proposes that the transitional regime should be aligned with the BCBS standards.
- 2.2.3. As regards the treatment of secured lending transactions, the proposed amendments to the CRR apply a lower RSF factor to secured and unsecured transactions with financial counterparties with a remaining maturity of less than six months than provided for under the BCBS standards⁽⁵⁾. A holistic review of factors applied to all secured transactions included in the NSFR should be carried out, based on in-depth analysis, to determine whether the factors for specific collateral and maturities are calibrated properly. Until such a review is undertaken, the ECB proposes that the RSF factors provided for under the BCBS standards should be applied.
- 2.2.4. The proposed amendments to the CRR include an exemption from the NSFR requirement for assets and liabilities directly linked to general covered bonds complying with Directive 2009/65/EC of the European Parliament and the Council⁽⁶⁾ and for soft bullet and conditional pass-through bonds meeting certain maturity trigger criteria⁽⁷⁾. The ECB supports the EBA's recommendation that only fully matched funding pass-through covered bond structures should be exempted, given that they pose no funding risk to the issuing bank⁽⁸⁾. In contrast, the ECB proposes that other covered bonds should not be exempted from the NSFR since these bonds, similarly to other longer-term liabilities, have significant funding risks not mitigated by their structural features. Considering the importance of covered bonds in bank funding, a de facto exemption of most outstanding covered bonds results in a significant dilution of prudential standards.

⁽¹⁾ See the proposed new Article 428r(1)(a) of the CRR, and paragraph 37 of the BCBS document Basel III: the net stable funding ratio, October 2014 (hereinafter the 'BCBS NSFR framework'), available on the website of BIS at www.bis.org

⁽²⁾ See the proposed new Article 428u(2) and Article 428x(2), (3) and (4) of the CRR.

⁽³⁾ See the proposed new Article 510(4) and (5) of the CRR.

⁽⁴⁾ See Eurosystem contribution to the European Commission's DG FISMA consultation paper on further considerations for the implementation of the net stable funding ratio in the European Union, 14 September 2016.

⁽⁵⁾ See the proposed new Article 428s(b) and Article 428u(1)(a) and (b) of the CRR, and paragraphs 38 and 39(b) of the BCBS NSFR framework.

⁽⁶⁾ Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32).

⁽⁷⁾ See the proposed new Article 428f(2)(c) and (d) of the CRR.

⁽⁸⁾ See Recommendation 6 of the EBA Report on Net Stable Funding Requirements under Article 510 of the CRR (EBA Op/2015/22) of 15 December 2015, available on the EBA's website at www.eba.europa.eu

2.3. *Fundamental review of the trading book*

2.3.1. The ECB welcomes the proposal for the implementation in Union law of the new BCBS standard on market risk resulting from the fundamental review of the trading book (FRTB)⁽¹⁾. The ECB recommends that the detailed implementation of the FRTB standard in the Union, in particular the appropriate transitional arrangements, duly takes into account the outcome of ongoing international discussions, notably at the BCBS, as well as any further developments at international level. In addition the currently envisaged two-year implementation period may not be sufficient for institutions to demonstrate their compliance with the model requirements and for supervisors to properly assess and approve market risk models. This is due to the fact that the technical specification of a number of important aspects of the internal models approach will be provided in regulatory technical standards, which will only be available well after the entry into force of the proposed amendments to the CRR. For this reason, it would be advisable to lengthen the implementation phase.

2.3.2. The proposed transitional regime which introduces a significant downwards recalibration (by 35 %) of the FRTB capital requirements over a period of three years, is a cause for concern because it could result in market risk capital requirements significantly below current levels for specific institutions. While a transitional period may help to mitigate the impact on credit institutions' capital requirements, the ECB proposes that the transitional calibration should be phased out gradually, according to a predefined schedule, and combined with a floor to prevent market risk capital requirements falling below current levels.

With regard to the additional changes to the market risk framework with a view to achieving greater proportionality, the ECB considers the proposed amendments to the CRR that allow institutions with small trading books to use simplified approaches to be an adequate addition, as long as the thresholds for application are kept at the levels set in the proposal. However, the proposed simplified standardised approach should be sufficiently risk-sensitive and lead to capital requirements that are adequate when compared to the new approaches applicable to larger credit institutions. To this end, future revisions of the CRR should take account of relevant developments at BCBS level.

2.3.3. The proposed amendments to the CRR do not incorporate some key elements of the BCBS standards, such as the specification of the profit and loss attribution test, directly in the Level 1 legislation, leaving them to future delegated legislation. The ECB proposes that these elements should be included directly in the CRR, with only technical specifications being implemented in technical standards.

2.3.4. The proposed amendments to the CRR grant a significant amount of modelling freedom to credit institutions, which could lead to serious divergences in supervisory practices and risk modelling. To counter this, the ECB proposes that restrictions to modelling developed as part of the FRTB on the basis of comparative studies should be incorporated in the CRR.

2.3.5. Unlike the BCBS standards, the proposed amendments to the CRR allow credit institutions to choose, without any restrictions, the trading desks for which they apply for internal model approval and those for which they will maintain the standardised approach. In order to prevent regulatory arbitrage, competent authorities should be able, based on the approach chosen by the credit institutions for comparable trading desks, to determine the inclusion of trading desks that they consider should be within the scope of the internal models approach.

Specific ECB staff drafting proposals in respect of the proposed amendments to the CRR and the CRD are set out in a separate technical working document accompanied by an explanatory text to this effect. The technical working document has not been adopted by the Governing Council. The technical working document is available in English on the ECB's website.

Done at Frankfurt am Main, 8 November 2017.

The President of the ECB

Mario DRAGHI

⁽¹⁾ BCBS Standards: Minimum capital requirements for market risk, January 2016, available on the website of BIS at www.bis.org