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Financial Stability, Financial Services and Capital Markets Union, European Commission

Comments on the Proposed Reforms to EU Banking Rules

Japanese Bankers Association

On November 23, 2016, the European Commission (the "Commission") published a comprehensive package of reforms to EU Banking Rules, comprising of amendments to the Capital Requirements Regulation ("CRR"), the Capital Requirements Directive ("CRD") and the Bank Recovery and Resolution Directive ("BRRD").

We, the Japanese Bankers Association ("JBA"), recognize that the EU and Japan each has a significant presence in both the global economy and the financial markets, and plays a key role in the setting of international standards regarding financial regulations. Therefore, it is crucial for both EU and Japan to respect and comply with these international standards to ensure the credibility and effectiveness of the standards.

We, however, are concerned that the proposed reforms to EU banking rules recently published by the Commission are not entirely consistent with international regulatory framework and include requirements that may have adverse effects on economic and financial activities in both EU and Japan. Our concerns and thoughts are stated below in sections 1 through 4.

We acknowledge that the activities of EU corporations and financial institutions have contributed to the Japanese economy. Likewise, we believe that activities of Japanese corporations and financial institutions, including member banks of JBA, have contributed to the EU economy. We strongly believe that both the EU and Japan should maintain a deep reciprocal relationship so that companies in the EU and Japan can continue to contribute to each other's economy.

1. Requirement for non-EU financial institutions to establish an intermediate parent undertaking.

Article 21b of the CRD proposal requires non-EU financial institutions to establish an intermediate parent undertaking ("IPU") simply because Global Systemically Important Institutions (G-SIIs) have more than one subsidiary in the EU. It is our concern that this requirement would impose an unnecessary burden on non-EU financial institutions while its benefit is not necessarily clear. Therefore, we believe that it would be necessary to carefully consider the consequences of this requirement.

(1) Negative impact arising from ring-fencing

According to the proposal, non-EU financial institutions are required to group their subsidiaries operating in the EU and manage capital and liquidity under the IPU. This action, however, would lead to the ring fencing of capital and liquidity within the IPU, undermining the flexibility of non-EU financial institutions in accommodating the needs of their affiliates in other jurisdiction.

Our concern is that this requirement may lead other jurisdictions to introduce similar ring-fencing requirements in order to ensure financial stability within their own jurisdictions. If respective jurisdictions introduce ring-fencing, this could end up with a fragmentation of global financial markets and the international financial regulatory framework, with foreseeable consequences in terms of higher concentration of financial activity within certain markets and lower levels of competition. These developments would translate into higher costs for banks and negative repercussions in terms of banks' abilities to finance the real economy and economic growth.

The Commission had previously expressed its concern that the proposed Intermediate Holding Company ("IHC") requirement imposed on foreign banking organizations by the U.S. would give rise to a negative impact through ring-fencing and retaliatory actions by other jurisdictions.[1] Such a concern is still the case, and we have similar concerns with regard to the Commission's present proposal.

[1] The letter of August 2013 sent from Mr. Barnier, the former member of the Commission, to Mr. Bernanke, the then chairman of the Federal Reserve, concerning the U.S.'s Intermediate Holding Company ("IHC") requirement
https://www.federalreserve.gov/SECRS/2013/May/20130530/R-1438/R-1438_041913_111076_515131431183_1.pdf

(2) Consequences of the establishment of an IPU

The Commission indicates the purpose of requiring the establishment of an IPU is "to simplify and strengthen the resolution process of third-country groups with significant activities in the EU."

Many financial institution groups establish an overseas subsidiary by business line (e.g., commercial banking, trust banking and securities) under the parent company in the home jurisdiction. For financial institution groups with such a corporate structure, grouping business-line-based subsidiaries within the EU under an IPU would lead to a weakening of their global governance structure. Moreover, if business lines are separated between jurisdictions, this may become an impediment to executing a business-line-based liquidation strategy or to taking necessary actions in times of recovery or resolution.

In addition, the Commission's proposal requires non-EU financial institutions to consolidate their small subsidiaries in different member states in the EU that may not qualify as a "material sub-group" on their own, under an IPU. However, this proposal does not set forth a detailed supervision and resolution framework for IPUs as a whole, and hence it is not clear how the framework that the Commission proposes will actually work within the EU.

Therefore, we believe that it is highly questionable whether the IPU requirement would actually contribute to simplification and strengthening of the resolution process of non-EU financial institutions; indeed, we believe that it is probable that such a requirement will have the opposite effect, and will needlessly complicate and weaken the resolution process.

(3) Leveraging of the European resolution college

Article 89 of the BRRD proposal illustrates the mechanism which facilitates cooperation between resolution authorities in the EU (i.e. the European resolution college). We believe that such mechanism can work for non-EU financial institutions with multiple subsidiaries in the EU and without an IPU.

We believe that this mechanism will ensure flexible and effective resolution of non-EU financial institutions and thereby enhance resolvability without the burden of establishing an IPU.

(4) Call for evidence and cost benefit analysis

The call for evidence and cost benefit analysis apply to the proposed reforms of CRR/CRD, except for article 21b of the revised CRD proposing the requirement to establish an IPU.

We believe that it would be preferable for the Commission to provide financial institutions and non-EU authorities with an opportunity for dialogues, including public consultation, in order to collect evidence and conduct cost benefit analysis regarding the requirement to establish an IPU as well.

2. Consideration for the IPU requirements

If non-EU financial institutions are to be required to establish IPUs, we then request that the Commission to give careful considerations to the following points.

(1) Non-EU G-SIIs

We believe that it is not necessary to automatically require G-SIIs to establish an IPU.

A non-EU G-SII may have a small amount of total assets in the EU despite having more than one subsidiary in the EU. Further, a non-EU G-SII's overall operations in the EU may be very simple despite having more than one EU subsidiary. The impacts on the EU financial system of the bankruptcy of a non-complex G-SII with few assets in the EU would be limited, even if that G-SII has more than one subsidiary in the EU.

Therefore, in determining whether to apply the IPU requirements, it would be appropriate to take into account proportionality; that is to say, the degree of impact on the EU financial system and the group-level resolution strategy. Also the determination whether to apply the requirement should take into account the results of consultations with home authorities or at the CMG.

(2) Revisions to the proposed threshold for the IPU requirement

① Exclusion of branch assets

EU subsidiaries of non-EU financial institutions are subject to the regulations of the EU or member states where they are located, and the competent authorities of the EU or member states undertaking the supervisory role and oversee the resolution process.

On the other hand, with respect to EU branches of non-EU financial institutions, in principle, the competent authorities in the home country undertake the supervisory role and oversee the resolution process.

The treatment of subsidiaries and branches is clearly different. When assessing the threshold for the IPU requirement, it would be appropriate to take into account only assets of EU subsidiaries of non-EU financial institutions in the calculation of the threshold, and to exclude assets of the branches of non-EU financial institutions located in the EU from the calculation.

② Raising the threshold for the IPU requirement

In setting a quantitative threshold for the IPU requirement for all non-EU financial institutions including G-SIIs, we believe that the threshold of "total assets of EUR 30 billion" is too low as a threshold for total assets of the IPU on a consolidated basis, including EU subsidiaries and branches. We assume the figure refers to the EU single supervisory mechanism's threshold, but we note that this threshold is based solely on total assets of a stand-alone financial institution, not on a consolidated basis.

Furthermore, we note that the proposed threshold is too low compared to the threshold for the US IHC requirement (i.e. USD 50 billion).

Therefore, we believe that it is appropriate to raise the proposed threshold.

(3) Treatment of branches

EU branches of a non-EU financial institution belong to the same legal entity as the head office of the financial institution and are subject to regulations and supervision by the home country authorities. On the other hand, EU subsidiaries are subject to regulations and supervision in the EU or member states where they are located. If debts and credits of EU branches are required to be held under an IPU which is an EU entity, a significant amount of cost will be imposed and customers of non-EU financial institutions will be significantly affected because a corporate personality of the EU branches has to be legally changed.

The Financial Stability Board ("FSB") recognizes this distinction in its final rule on "Principles on Loss-absorbing and Recapitalization Capacity of G-SIBs in Resolution" and the consultative document "Guiding Principles on the Internal Total Loss-Absorbing Capacity of G-SIBs," treating branches as an integral part of a foreign bank head office and excluding them from the scope of internal TLAC.

We strongly support the Commission's proposal not to group branches of a non-EU financial institution under an IPU.

(4) Subsidiaries to be grouped under IPUs

We believe it appropriate to clarify that "institution" for purposes of the IPU requirement should be defined as including credit institutions and investment firms in accordance with the definition under the CRD (i.e. institutions holding a license for banking or securities businesses), while those nonbanks and other financial institutions that do not have a license for banking or securities businesses should be excluded from the IPU requirement.

In addition, it would be appropriate to exclude from the IPU requirement any

subsidiaries that hold a banking license for undertaking ancillary services (e.g. settlement services) but that engage in a non-banking business as their core business (such as those subsidiaries that specialize in asset administration services).

Further, in the case of non-consolidated companies and minority investments, it is likely that there is another company that has more control over them. We therefore consider that it should be clarified that such non-consolidated companies and minority investees also should not be grouped under IPUs.

3. Considerations in light of Brexit

Given that Brexit is expected to take place, it would be unreasonable to subject UK subsidiaries to an IPU requirement. Therefore, it should be clarified that subsidiaries located in the UK are excluded from the scope of article 21b of the proposed CRD revision.

Moreover, since non-EU financial institutions will be inevitably influenced by Brexit (e.g. they will need to review their organizational structure in Europe), we believe that a reasonable conformance period of at least three years should be provided after the UK leaves the EU and before implementing any IPU requirement.

4. Deference to international regulatory framework

In order to maintain the effectiveness of the Basel regime and also to ensure a global level playing field, national authorities have respected international regulatory framework and strived to align their national regulations with such framework.

Some aspects of the proposed reforms to EU banking rules are not consistent with the international regulatory framework published by the Basel Committee on Banking Supervision or the FSB. Such proposed frameworks to EU banking rules, if enacted, would trigger similar trends in other jurisdictions and prompt regulatory fragmentation, and as a result, may undermine the credibility and the effectiveness of international regulatory framework. It is our understanding that EU regulatory authorities have shared similar concerns in this respect.[2]

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[2] ECB President Draghi commented “regulatory measures should be implemented in a balanced way that ensures a level playing-field globally.” Vice-President of the European Commission Dombrovskis commented that “it is important to maintain a level playing field across both jurisdictions (in implementing TLAC)” and in another occasion that “ What would happen if financial sector rules in New York, Hong-Kong, London, Paris, Frankfurt or Singapore were very different? First, these centres would become more exposed to risks being imported from jurisdictions with less stringent rules. Second, it would become more expensive for global financial institutions to comply with different legal requirements. Third, regulatory differences would give financial institutions incentives to engage in regulatory arbitrage”.
See the website set forth below for respective comments.

Particularly with respect to the introduction of internal TLAC in the EU, there are two concerns as described in paragraphs (1) and (2) below. Going forward, internal TLAC should be introduced in a way consistent with the international framework.

(1) Process for determining the internal TLAC requirement in the EU

The primary objective of the proposed reforms to EU banking rules is to introduce the internal TLAC requirement within the EU and ensure consistency with the international framework.

However, the proposed reforms to EU banking rules are inconsistent with international framework. The proposed rules set the internal TLAC requirement at 90% of external TLAC without any consultation between home and host authorities. In contrast, the FSB's TLAC Term Sheet provides as follows: "each material sub-group must maintain internal TLAC of 75% to 90% of the external Minimum TLAC requirement that would apply to the material subgroup if it were a resolution group, as calculated by the host authority. The actual Minimum Internal TLAC requirement within that range should be determined by the host authority of the material sub-group in consultation with the home authority of the resolution group."

Currently, a process for determining the internal TLAC requirement is under discussion at a global level based on the FSB's consultative document "Guiding Principles on the Internal Total Loss-absorbing Capacity of G-SIBs." Any final rule regarding determination of internal TLAC in the EU should be consistent with the FSB's guidance, and therefore should be determined after the Guiding Principles are internationally agreed.

(2) Scope of application of the internal TLAC requirement in the EU

In order to ensure consistency with the FSB's internal TLAC framework, the scope of application of the internal TLAC requirement in the EU, if imposed on non-EU financial institutions, should be the "material sub-group" in line with the international framework. Therefore, whether an IPU is subject to the internal TLAC requirement would be determined based on whether the IPU is a material sub group. Whether an IPU is a material sub-group should be determined through consultation between home and host authorities.

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http://www.ecb.europa.eu/press/key/date/2016/html/sp161118.en.html
http://europa.eu/rapid/press-release_SPEECH-16-3336_en.htm
http://europa.eu/rapid/press-release_SPEECH-17-261_en.htm

Furthermore, while internal TLAC requirements for non-bank entities are currently consulted as part of the FSB's "Guiding Principles on the Internal Total Loss-absorbing Capacity of G-SIBs," we would request careful considerations to the inclusion of EU non-bank entities in the scope of internal TLAC.