BPFI views on European Commission "Daisy Chain" proposal

February | 2022

Summary

The European Commission proposal to move from an approach of risk weighting investments in own funds instruments of subsidiaries within the scope of consolidated supervision to a full deduction of both own funds and eligible liabilities instruments represents a major change to the current capital requirements applied to banks. As a consequence, the impact on certain EU banking entities with intermediate parents is expected to be materially significant. Simply put, under the new regime such entities will be forced to (1) issue further Internal MREL at the intermediate entity and (2) optimise the capital structure within subsidiaries in order to meet the new obligations.

In the more immediate term, however, this could result in intermediate parent entities breaching their MREL requirements as a result of having to deduct both own funds and eligible liabilities instruments, which in turn, could result in impacted entities having to reduce lending to the economy at this critical juncture. It is therefore welcome that both co-legislators have recommended extending the phase-in of the deduction regime to coincide with the SRBs binding MREL requirements of 01 Jan 2024.

It should also be added that this proposal was not accompanied by an impact assessment, while the EBAs initial work on the regime only conducted a draft qualitative assessment, which makes it challenging for co-legislators to fully understand the true impact of the changes being proposed.

Background

In 2016, Irish impacted entities were informed by the SRB and Bank of England (BoE) that its preferred resolution strategy was for a single point of entry (SPE) bail-in strategy through a group holding company.

The rationale for this approach is that in the event of resolution, a holding company structure would better prevent against any disruption of the operational subsidiaries, while it would also avoid any legal conflicts with creditors rights as laid down under Irish national law in a resolution scenario.

It should be noted that prior to the establishment of the holding company structure, Irish entities were structured via an operating company with separate subsidiaries (see appendix for comparison). If this previous group structure was still in place, the current challenges posed by the daisy chain proposal would not materialize as the group would comply with BRRD Art 45f (1) on a consolidated basis and also benefit from the derogation laid down in Art 72 (e) (5) of the Commission proposal e.g. "*The deduction shall not apply to institutions and entities that are not themselves resolution entities where they are*

required to comply with the requirement referred to in Articles 45c and 45d of Directive 2014/59/EU on a consolidated basis."

Under the current proposal, we believe an un-level playing field will emerge between different group structures, which runs counter to the initial BRRD Art 45f (6) requirement that the deduction regime shall have an *"outcome equivalent to that of a full direct subscription".*

Potential solutions

In order to mitigate against any unintended consequences, while preserving the intention of the daisy chain proposal, there are a number of measures co-legislators could take in order to ensure a more proportionate treatment is applied to impacted entities. In our view these could include:

- **(Measure 1).** Limiting the deduction regime to the internal MREL requirements only (e.g. "cap" the deduction) and excluding from the regime any excess own funds/eligible liabilities held by subsidiaries. In our view, the European Parliament's approach to Art 72 (e) (5) looks to incorporate this more proportionate regime into the legislation and which we would urge co-legislators to support in the final text. However, we would recommend a slight adjustment to the drafting in order to align with the exact iMREL requirements in BRRD (e.g. the text should read Art 45C (2) (a) and (b) BRRD which specifically refers to the Loss Absorption Amount (LAA) and Recapitalization Amount (RCA)).
- **(Measure 2)**. Allow intermediate parent entities to comply with MREL requirements on a sub-consolidated basis. This would have a similar effect of not double counting MREL resources but would align with the amount of MREL required to be held and mitigate against the capital impact. To achieve this, the following could be explored by 1) extending the derogation under Art 72 (e) (5) to entities on a sub-consolidated basis once approved by resolution authorities or 2) amend BRRD Art 45f (1) to allow entities meet MREL requirements on a sub-consolidated basis. However, we are aware that neither Council or Parliament text includes such amendments, and in this sense Measure 1 may be more politically acceptable.

Why these measures make sense?

1. **Ensures a level playing field between group structures**. As laid out above, due to certain EU banks having an operating company between the holding company and subsidiaries, which would also be subject to internal MREL requirements, the current proposal creates an unlevel playing field with that of similar Opco structures due to the deduction regime. In our opinion, this would not deliver on co-legislators objective in BRRD to create a deduction regime that has equivalent outcomes to a direct subscription regime. This issue was raised by the FSB (e.g., the sum of the parts problem) when agreeing on the final TLAC term sheet, and was mitigated through the application of internal TLAC to only material entities, and with a scalar applied to requirements between the range of 75-90%, neither of which feature in the European application of TLAC, or extended MREL framework. By capping the deduction at the

minimum internal MREL of the subsidiary it would help mitigate against such a disproportionate outcome, while preserving the intention of co-legislators as laid down in BRRD Art 45f (6).

2. **CRR Art 49 (2) already incorporates a deduction regime.** The existing Art 49 (2) CRR already permits competent authorities to introduce a deduction regime under specific circumstances. In our view, this should be taken into consideration by co-legislators when making the current changes. This existing approach ensures that where authorities are concerned about the resolvability of a particular entity, for example in the case of complexity, the existing powers are appropriately tailored to deal with such situations, without unintentionally impacting all entities.

3. **Helps avoid unintended consequences.** In our view, by capping the deduction regime unintended impacts that we believe are contrary to the aim of co-legislators, can be avoided. Specifically, by capturing all holdings of own funds and eligible liabilities, we are concerned that this will capture excess eligible items/instruments, incentivizing firms to actually reduce MREL holdings to a minimum in entities contrary to the overarching objective. For example, the current drafting is broad in scope and looks to apply deductions to all holdings of own funds and eligible liabilities. However, in practice, firms may issue internal MREL above regulatory requirements so that other eligible items/instruments (e.g., CET1) can be used for other business purposes, like acquisitions. Unless amended, we believe entities will be incentivized to reduce this excess amount to the regulatory minimum, potentially reducing the resilience built up in many subsidiaries. More broadly, it should be noted that many entities established entity structures in close coordination with EU and third country resolution authorities, where legal considerations and effective resolution strategies were closely analyzed.

DRAFTING SUGGESTIONS

1. (Measure 1) – Limit deduction of own funds and eligible liabilities to iMREL requirements only (e.g. "cap" the deduction) as laid down in the Parliament text

Art 72 (e) (5)	
European Parliament text	**BPFI suggested drafting**
'5. Institutions and entities shall deduct from eligible liabilities items their holdings of own funds ***instruments*** and eligible liabilities ***instruments where all of*** the ***following*** conditions ***are met:*** ***(a) the own funds instruments and eligible liabilities instruments are held by an institution or entity that is not itself a resolution entity but that is a subsidiary of a resolution entity or of a third-country entity that would be a resolution entity if it were established in the Union;*** ***(b) the institution or entity referred to in point (a) is required to comply with the requirements laid down in Article 92b of this Regulation or in*** Article 45f of Directive ***2014/59/EU;*** ***(c) the own funds instruments and eligible liabilities instruments held by the institution or entity referred to in point (a) were issued by an institution or entity referred to in Article 92b(1) of this Regulation or in Article 45f(1) of Directive 2014/59/EU*** that ***is not itself a resolution entity and that***	'5. Institutions and entities shall deduct from eligible liabilities items their holdings of own funds ***instruments*** and eligible liabilities ***instruments where all of*** the ***following*** conditions ***are met:*** ***(a) the own funds instruments and eligible liabilities instruments are held by an institution or entity that is not itself a resolution entity but that is a subsidiary of a resolution entity or of a third-country entity that would be a resolution entity if it were established in the Union;*** ***(b) the institution or entity referred to in point (a) is required to comply with the requirements laid down in Article 92b of this Regulation or in*** Article 45f of Directive ***2014/59/EU;*** ***(c) the own funds instruments and eligible liabilities instruments held by the institution or entity referred to in point (a) were issued by an institution or entity referred to in Article 92b(1) of this Regulation or in Article 45f(1) of Directive 2014/59/EU*** that ***is not itself a resolution entity and that belongs***

belongs to the same resolution group ***as the institution or entity referred to in point (a).*** The deduction ***established in the first subparagraph shall be limited to the amount of own funds instruments and eligible liabilities instruments held by the institution or entity referred to in point (a) of the first subparagraph that have been issued by the institution or entity referred to in point (c) of the first subparagraph of this paragraph in order to comply with the requirements set out in Article 45(2), points (a) and (b), of Directive 2014/59/EU.***	to the same resolution group ***as the institution or entity referred to in point (a).*** The deduction ***established in the first subparagraph shall be limited to the amount of own funds instruments and eligible liabilities instruments held by the institution or entity referred to in point (a) of the first subparagraph that have been issued by the institution or entity referred to in point (c) of the first subparagraph of this paragraph in order to comply with the requirements set out in Article 45C(2), points (a) and (b), of Directive 2014/59/EU.***
Justification	
We fully support the Parliament text but would suggest a minor drafting change to clarify that the “cap” should be set at the Loss Absorption Amount (LAA) and Recapitalization Amount (RCA)) as laid down in BRRD Art 45c.	

2. (Measure 2) – allow sub-consolidation on the application of minimum requirements for own funds and eligible liabilities

Art 72 (e) (5)	
European Commission proposal	**BPFI suggested drafting**
5. Institutions and entities required to comply with Article 45c of Directive 2014/59/EU that are not themselves resolution entities shall deduct from eligible liabilities items their holdings of own funds and eligible liabilities that meet the conditions of Article	5. Institutions and entities required to comply with Article 45c of Directive 2014/59/EU that are not themselves resolution entities shall deduct from eligible liabilities items their holdings of own funds **instruments** and eligible liabilities **instruments** that meet

45f(2) of that Directive of their subsidiaries that belong to the same resolution group. The deduction shall not apply to institutions and entities that are not themselves resolution entities where they are required to comply with the requirement referred to in Articles 45c and 45d of Directive 2014/59/EU on a consolidated basis. For the purposes of this paragraph, the reference to eligible liabilities items shall also be understood as a reference to eligible liabilities referred to in Article 45f(2), point (a), of Directive 2014/59/EU	the conditions of Article 45f(2) of that Directive of their subsidiaries that belong to the same resolution group. The deduction shall not apply to institutions and entities that are not themselves resolution entities where they are required to comply with the requirement referred to in Articles 45c and 45d of Directive 2014/59/EU on a consolidated **or sub-consolidated** basis **when permitted by the resolution authority.** For the purposes of this paragraph, the reference to eligible liabilities items shall also be understood as a reference to eligible liabilities referred to in Article 45f(2), point (a), of Directive 2014/59/EU
Justification	
The concept of sub-consolidation is already laid down in CRR. Aligning the deduction regime with Art 49 (2) CRR is therefore another option that co-legislators could consider to help mitigate the unintended consequences of the new deduction regime. By including this principle within Art 72e (5) under the conditionality of regulatory approval, would help ensure a level-playing field and would also be consistent with the existing prudential framework laid down in CRR.	

3. (Measure 2) – new proposal – allow sub-consolidation on the application of minimum requirements for own funds and eligible liabilities

Art 45f BRRD – Application of the minimum requirement for own funds and eligible liabilities to entities that are not themselves resolution entities	
European Commission proposal	**BPFI suggested drafting**
	1. Institutions that are subsidiaries of a resolution entity or of a third country entity, but are not themselves resolution entities, shall

	comply with the requirements laid down in Article 45c on an individual basis, **or on a sub-consolidated basis where permitted by the resolution authority.**

Justification
As an alternative to the sub-consolidation drafting above, co-legislators could also allow intermediate parent entities to comply with MREL requirements on a sub-consolidated basis, similar to the regime under CRR for own funds. This would have a similar effect of not double counting MREL resources but would align with the amount of MREL required to be held and would mitigate the capital impact. To achieve this, co-legislators could adjust BRRD Art 45f point 1 to also include "on a sub-consolidated basis where permitted by the resolution authority". Note: this would require members to determine capital and MREL requirements on a sub-consolidated basis to implement this alternative approach. As such, it could entail other changes for entities and is not contained in either Council or Parliament reports.

Appendix – Comparison between current and former group structures of Irish impacted entities