Detailed Answers from Bank of England Response to the European Commission Call for Evidence on the EU Regulatory Framework for Financial Services, January 2016

A- Rules affecting the ability of the economy to finance itself and grow

Unnecessary regulatory constraints on financing

The Commission launched a consultation in July on the impact of the Capital Requirements Regulation on bank financing of the economy. In addition to the feedback provided to that consultation, please identify undue obstacles to the ability of the wider financial sector to finance the economy, with a particular focus on SME financing, long-term innovation and infrastructure projects and climate finance. Where possible, please provide quantitative estimates to support your assessment.

Example 1: CRD IV, CRR
Macroprudential toolkit in CRDIV

Issue: CRDIV/CRR contains a number of articles that allow national authorities to deviate from the maximum harmonising microprudential rules in order to address and mitigate macroprudential and financial stability risks. These areas cover: additional buffers for systemic banks (Art 131 and 133 of CRD), measures to address risk weights (Art 124 and 164 CRR) and the countercyclical buffer (Art 130 and 135-140 of CRD). In addition, Pillar 2 and Art 458 of CRR provides flexibility to address macroprudential risks in ways not otherwise provided for in other parts of the legislation. This flexibility is a vital component of the macroprudential toolkit, allowing the Single Market to function effectively across multiple jurisdictions with varied structural market features and we fully support this 'macroprudential carve out' in CRR.

The macroprudential flexibility is considered to promote the economy – this has been echoed by a number of speakers, including Vitor Constancio. Concerns though have been raised by both industry and European authorities regarding the complexity of the framework (as Member States have used different measures to address similar risks), as well as areas of overlap in the measures (an issue raised by the Commission and EBA), jointly contributing to compliance complexity (highlighted by cross-border firms and industry groups).

The diversity of tools applied by member states so far evidence the differences present in national economies across the EU. The Commission is required to review the macroprudential toolkit under Article 513 of CRR and there will be an opportunity to update the toolkit based on lessons learnt over the past two years.

Evidence: Differences in national markets and economies is highlighted in the ESRB's real estate report. EBA and ESRB's reports on macroprudential policy measures applied across the EU, as well as the EBA Opinion and the ESRB's response to the European Commission's call for advice regarding the macroprudential rules in CRD IV/CRR.

https://www.eba.europa.eu/-/eba-publishes-report-on-macroprudential-policy-measures

https://www.eba.europa.eu/-/eba-publishes-opinion-on-measures-to-address-macroprudential-or-systemic-risk https://www.esrb.europa.eu/pub/commentaries/html/index.en.html

Solution: The Commission is required to review the macroprudential toolkit under Article 513 of CRD IV and the Bank believes this review will provide sufficient opportunity for improvements based on the experiences of Member States over recent years.

Example 2: Solvency II
Consideration of inclusion of macroprudential tools in Solvency II

Issue: We are still at an initial stage of considering what, if any, macroprudential tools should be available to national competent authorities (NCAs) as part of Solvency II. However, we have identified concerns with how regulators could respond to a period of substantial market stress.

Example: It is unclear whether the use of the power to declare an exceptional adverse scenario, which allows firms to have an extended recovery period, would be productive. Furthermore, the Solvency II 'ladder of intervention', has a clear microprudential focus, but this means that NCAs have very limited scope to take actions through individual firms to address system-wide crises. In the UK, one explanation of the lack of procyclical behaviour in the insurance sector during the recent financial crisis is that certain actions were taken with respect to the industry as a whole rather than on an individual firm basis (see a speech[1] by Andrew Bailey). These actions were taken in recognition of the exceptional market volatility at the time, and the long-term investment horizon of insurers. However, a similar regulatory response may not be possible under Solvency II, which would restrict the ability of the sector to withstand short-term financial market volatility.

Example 3: Solvency II
Excessive volatility of the risk margin in Solvency II

Issue: The calculation of the risk margin is sensitive to current interest rates. This sensitivity is likely to have significant absolute and hedging costs for firms when there are short term variations in the risk-free rate. Such a degree of volatility is likely to be undesirable from a microprudential and macroprudential point of view.

Example: The Bank estimates that for example, a 50bps increase in risk-free rates would reduce the risk margin for the UK life sector by around 20%. This sensitivity was recently highlighted in a speech by Sam Woods.[2]

Solution: The Bank believes that the risk margin should reflect a valuation of risks that a third party would be taking on, and indeed be sensitive to interest rate conditions, but should be designed in a way that delivers more stable outcomes. This will support stability in the insurance balance sheet, and support the role of insurers as long-term investors in the real economy.

Example 4: Solvency II
Treatment of infrastructure investments under Solvency II

[1] http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech782.pdf
[2] http://www.bankofengland.co.uk/publications/Pages/speeches/2015/861.aspx

Issue: We welcome the European Commission recent proposed amendment to the standard formula for a more tailored treatment for qualifying infrastructure assets. The Bank expects Solvency II will support insurers' investment in long-term assets.

Example 5: CRD IV, CRR **Securitisation**

Issue: The Simple, Transparent and Standardised (STS) criteria and the revised capital framework for securitisation will encourage the development of simple and robust securitisation transactions, getting rid of the complex features whose risks were not always well understood by investors (e.g. re-securitisations, excessive maturity transformation, and complex tranching structures). Thereby, they will encourage the return to the market of 'real money investors' rather than leveraged structures seen before the crisis, such as Structured Investment Vehicles and Collateralised Debt Obligations (SIVs and CDOs). Requirements on due diligence and risk retention will be harmonised, to ensure that they are applied consistently throughout the financial sector. These requirements will help ensure that incentives are better aligned for all securitisation transactions. The right balance however needs to be struck between giving investors detailed and standardised information while maintaining proportionality and avoiding an undue reporting burden for issuers.

Example: The European Commission estimates that if EU securitisation issuance was built up again to pre-crisis average, it would generate between €100-150bn in additional funding for the private sector (source: European Commission - Fact Sheet: A European framework for simple and transparent securitisation, published on 30 September 2015)

European securitisations performed well throughout the crisis from a credit standpoint. The cumulative default rate was only 0.05% on European consumer-related securitisations, including SME CLOs, between Q3 2007 and Q3 2013 inclusive; in comparison US loans, including subprime loans, experienced default rates of 18.4% over the same period (source: Standard & Poor's, quoted in BoE / ECB discussion paper "The case for a better functioning securitisation market in the European Union").

European securitisation issuance declined by 87% from 2007 to 2014 inclusive; the corresponding US decline was only 46% (source: AFME). One reason for the difference was the relatively strong development in the issuance of the US Government Sponsored Enterprises, whose issuance declined by only 22% over the same period.

Solution: The Commission's proposed securitisation regulation includes two proposals that are meant to help facilitate lending to the real economy, in particular SME lending. First, it includes a dedicated set of STS criteria for multi-seller asset backed commercial paper (ABCP) conduits. This may be particularly helpful to SMEs since the exposures securitised in such transactions are often directly or indirectly to SMEs (e.g. trade receivables, and leasing contracts where the underlying obligor is an SME). Second, it proposes to grant a specific capital benefit to some synthetic transactions (where a public body provides a guarantee so that only parts of the risks on SME loans remain with bank lenders).

As part of this agenda, we understand that the Commission is reviewing the capital charges for STS securitisations under the Solvency II standard formula. We support this review, since current charges could be lowered without jeopardising protection for policyholders, especially at longer durations. In its review, the Commission should also consider the appropriate level of charges for non-STS securitisations, so that the relative incentive to invest in non-STS securitisations is preserved.

Market Liquidity

Please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on market liquidity. Please elaborate on the relative significance of such impact in comparison with the impact caused by macroeconomic or other underlying factors.

Example 1: CRD IV, CRR
Leverage ratio in CRDIV (Countercyclical leverage ratio buffer)

Issue: While the risk-weighted capital measures are structured as minimum and buffer requirements, no such differentiation is considered for the leverage ratio so far. We think this could lead to inconsistencies and unintended consequences.

Risk-weighted buffers have been introduced in order to ensure that systemic banks are held to more stringent capital requirements than other banks. Not mirroring these buffers in the LR framework would mean that systemic banks may be incentivised to expand their balance sheets through low risk-weight assets and that they wouldn't be held to a higher capital requirements if they are leverage-constrained.

Without an equivalent countercyclical leverage ratio buffer, the effectiveness of the countercyclical buffer could be impaired. If risk-weighted requirements alone are increased, firms would face an incentive to shift towards assets with lower estimated risk weights during a credit upswing. And banks which are leverage-constrained would not face an incentive to reduce their rate of credit extension or have to build a capital buffer during a period of heightened cyclical risks.

Example: As above.

Example 2: CRR
Leverage ratio in CRDIV (Inclusion of client clearing)

Issue: The Basel Committee is currently considering how to treat derivative exposures for centrally cleared client transactions. Derivatives dealers have argued that the leverage ratio imposes excessive capital requirements on centrally-cleared client trades, which they say could affect the viability of existing business models and ultimately the provision of client clearing services. Though the leverage ratio does not normally allow collateral to reduce exposures, the Bank supports an exception being made to allow initial margin to reduce leverage exposures for centrally cleared client trades to ensure continuity and affordability of client clearing services.

Example and suggestion: as above

Example 3: CRR
Leverage ratio in CRDIV (Inclusion of central bank reserves)

Issue: Non-financial corporates and non-bank financial institutions rely on short-term (sub-30-day) deposits with banks to manage their cash efficiently. These counterparties are most likely to withdraw funds in stressed conditions, so the EU Liquidity Coverage Ratio (LCR) significantly increases the amount of high-quality liquid assets (HQLA) that banks must hold against some of these deposits. And leverage requirements have reduced banks' willingness to hold HQLA. At the same time: a) low interest rates are supporting the supply of short-term wholesale deposits; and b) banks have sought to shrink their customer funding gaps, thus reducing their structural demand for wholesale deposits.

In response, banks are restricting the quantity of deposits they accept. While quantity reduction is an intended consequence of regulation, there is evidence that at certain times – particularly quarter-ends – some corporates now find it difficult to place desired short-term cash deposits with banks LCR also creates strong incentives for banks to reclassify certain deposits to achieve more favourable regulatory treatment (though as the LCR regime has only just taken effect, it may be too early to see evidence of this happening). And in a market-wide stress event, leverage constraints might make robust banks less willing to accommodate large deposit inflows, which could further impair market function.

Example: as above.

Suggestion: In response to concerns about deposit flows during market stress, we may wish to consider flexibility in the leverage-ratio framework. With a framework that includes leverage buffers, supervisors can distinguish between buffer breaches reflecting: (a) deposit inflows; or (b) capital-depleting losses, and be more willing to accommodate (a) – this could support market function during stress.

We could consider adjusting the definition of leverage exposure. If central bank reserves were excluded from the leverage exposure measure, banks could recycle deposit inflows into reserves without a decrease in their leverage ratio. That might also facilitate policy measures by central banks to increase the supply of reserves in response to market stress.

<u>Example 4: MiFID/MiFIR</u>

Pre- and post-trade transparency under MiFID II

Issue: ESMA has published draft technical standards for MiFIR / MiFID II, which are currently under consideration by the European Commission. Amongst other things, this package will bring greater pre- and post-trade transparency to bond and derivative markets. We support the principle of greater transparency in financial markets, which can have a positive impact on market liquidity by improving price discovery and competition. However, for less liquid financial instruments, there may be a need to strike a balance between transparency and market liquidity. In particular, the pre-trade reporting requirements, as they stand, could have a harmful effect on the liquidity of derivative and corporate bond markets. By requiring quotes to be published immediately, the dealers may be subject to predatory trading risk and therefore increase bid-ask spreads to compensate for this.

Example: We estimate that the bid-ask spreads (a proxy for cost of trading in illiquid markets) for sterling interest rate swaps may increase by up to 55%, and the bid-ask spreads for sterling corporate bonds may increase by up to 15%, as a result of the pre-trade transparency requirements.

Suggested solution: According to Bank of England's analysis, the unintended consequences of pre-trade transparency requirements on market liquidity can be substantially reduced by re-calibrating some of the parameters in the technical standards. Specifically, we suggest reducing the size-specific-to-instrument threshold for derivatives, and increasing the average number of trades per day criterion and the issuance size criterion for the liquidity status of bonds.

Proportionality/preserving diversity in the EU financial sector

Are EU rules adequately suited to the diversity of financial institutions in the EU? Are these rules adapted to the emergence of new business models and the participation of non-financial actors in the market place? Is further adaptation needed and justified from a risk perspective? If so, which, and how?

Example 1: CRD IV, CRR
Proportionality in banking regulation

Issue: Unlike other large jurisdictions, such as the USA, the EU applies the same rules to all its banks in seeking to achieve a level playing field. Consistent standards are key to delivering safety and soundness in the financial system and thus the Single Market. That is particularly the case for large, internationally active banks. But a "one size fits all" approach of common binding rules for all banks, no matter what their size, complexity or level of cross-border activity, can cause distortions given that the costs of regulation tend to bear more heavily on smaller banks. Policy makers need to weigh the desirability of the same rules for all firms with wider objectives, including growth, financial stability and effective competition. More proportionate, differentiated rules are more likely to enable banks of different size and business model to compete on an equal footing across the EU than the same rules applied to all banks.

The costs of regulation must be proportionate to the benefits. The benefits and costs vary across banks of different size and business model. Often the benefits of regulation are proportionately bigger for larger or more complex banks, while to the extent that regulation imposes fixed costs those will tend to bear more heavily on smaller banks.

The financial stability benefits from regulation of large, internationally-active banks mean these firms should meet the global standards that are designed with such banks in mind. Broadly speaking, EU regulation already reflects the greater benefits from applying tighter requirements to such banks. For example, higher capital buffers are required for large, interconnected banks and recovery and resolution planning is also tighter. But aspects of EU regulation are not fully consistent with those global standards, partly due to the need to apply rules across all banks.

Suggestion: A differentiated approach would allow the EU to align regulation of larger banks more closely with global standards, thus supporting financial stability. But it can also recognise the lower benefits, and sometimes higher costs, from regulation of smaller banks. More proportionate rules can help to promote competition and growth. That, in turn, can enhance the resilience of the banking system: lower barriers to entry foster competition, allowing new banks to substitute for any loss in the provision of finance by less resilient firms, while growth improves loan performance, supporting profitability. While there are clearly challenges in putting a more proportionate approach into effect, including defining the boundary between groups of banks to which different rules might be applied, these have been overcome in other jurisdictions, such as the United States which applies a narrower set of regulatory rules to smaller banks, and only applies global standards to large, internationally-active banks. The gains for the EU of adopting a similar approach could be material.

A more proportionate approach could be adopted for many aspects of bank regulation. For example, there is a case for ensuring that regulatory reporting requirements do not go beyond what is necessary for effective supervision of smaller banks. Regulation could also be tailored to business models: the benefits from the prospective application of the Net Stable Funding Ratio (NSFR) should be larger for banks that rely more heavily on wholesale funding. Differentiated approaches should be carefully designed to avoid unintended distortions: there is a need to reduce the competitive imbalances that exist between firms using model-based approaches for estimating mortgage risk weights relative to firms on standardised approaches. These imbalances can have unintended effects on the safety and soundness of banks by encouraging banks on standardised approaches to compete for riskier mortgages, where the capital differentials are less marked. Finally, remuneration policy should also be proportionate to the risks the policy is meant to mitigate and the cost it imposes on a firm.

For investment firms, the principle of proportionality should be an integral element of the Commission's review of investment firms under CRR.

Example 2: CRR, Part 8 **Proportionality in banking regulation (Pillar 3 reports)**

Issue: The CRR requires all credit institutions to produce either consolidated or solo Pillar 3 reports on an annual basis at a minimum, subject to exemptions for disclosure of information which is not material and disclosures by certain intermediate subsidiaries. This represents a significant regulatory burden particularly for smaller credit institutions and evidence suggests that, even for larger credit institutions, not all of the data provided in Pillar 3 reports are regularly used by analysts and other relevant users. The BCBS is in the process of revising its Pillar 3 framework to develop disclosure requirements that are more useful (for example more comparable and consistent across banks, and published more frequently). The result hopefully is a set of disclosure requirements that are believed to meet the cost/benefit test for internationally active firms; the issue is whether that is also the case for other firms and, if not, how the requirements might be modified.

Example: The BCBS undertook extensive outreach with users of Pillar 3 data during its ongoing review of the Pillar 3 framework and found that the vast majority of data provided by credit institutions were not used by the users. (See paragraphs 2 and 16-25 of http://www.bis.org/publ/bcbs286.pdf) Those outreach sessions were also used to confirm that the changes at that point being proposed were more likely to be used. However, there is more interest in the analyst community in the bigger – typically more internationally active – firms, so the benefits of disclosures, and how disclosures are used, can vary when one considers smaller firms. The new Basel requirements also require greater use of standardised templates and more frequent publication of those templates. Internationally active firms are typically more able to bear such burdens than smaller firms.

Suggestions: If it transpires that Basel's revised Pillar 3 regime is not suitable for all types of CRD IV firm, would prefer to have some form of differentiated regime. One possible differentiation might be to include, for smaller firms, clear guidance on some form of elevated application of materiality, fewer mandatory templates and less frequent disclosures, but we would need to take care not to end up with another Pillar 3 regime that is regarded by users as not particularly useful.

Example 3: Directive: EMIR Level 1, Article 4
Proportionality in banking regulation (Clearing obligation)

Issue: Under EMIR, all financial institutions will have to centrally-clear certain OTC derivatives transactions ('the clearing obligation'), regardless of the size of their OTC business.[3] However, many small financial firms (who typically use derivatives for hedging purposes) are encountering difficulties gaining access to clearing, with many clearing providers unwilling to take on their business due to the low value of transactions these firms undertake, in conjunction with the operational costs of on-boarding and continuing to serve clients' clearing activity.

This implies that, when the clearing obligation comes into force in the EU for certain OTC interest rate and credit derivatives from 2016, some small financial firms may not have access to clearing and so be unable to trade OTC derivatives. This may have a significant impact on some of their business models. For example, in the UK building societies use OTC derivatives to hedge interest rate risks arising from their offering of fixed-rate mortgage lending. There is a risk that some building societies will be unable to access client clearing at an affordable cost (if they can have access at all), putting them at a disadvantage to competitors who have more ready access to clearing. If so, this could have adverse effects for the fixed rate mortgage market - including on competition. Other small financial firms could suffer similar impacts.

Other jurisdictions have implemented G20 agreements around central clearing without burdening their small financial firms. For example, Australia, Canada, Japan and the USA exempt (or plan to exempt) these firms, primarily through the use of an exemption threshold (e.g. U.S. firms with less than $10bn of derivative hedging activity are exempt).

In this context, mandatory clearing for small EU financial firms is seen to be a disproportionate requirement (especially given their de minimis contribution to systemic risk) which introduces obstacles to the ability of the wider financial sector to finance the EU economy and SMEs in particular. The UK, along with other international industry and regulatory bodies, raised this issue in its response to the European Commission's 2015 Consultation Paper on the review of EMIR, which is still ongoing.

Example: The UK Building Societies Association has provided several case studies of the potential impact on the fixed rate mortgage market which accounted for 82% of gross

[3] Financial institutions within EMIR are broadly defined as: banks, investment firms, building societies, mutual funds, insurance funds and pension funds.

residential lending in 2014 in the UK.[4]. One includes a small building society (total assets: £2bn) with total mortgage loans of £80m and a hedging requirement (given a typical reliance on fixed-rate lending) of £12m gross notional per annum. It would likely transact using three tranches of £4m spread over the year. With only one clearing provider still prepared to offer services to small societies individually, the minimum annual cost of clearing three to four transactions will be between £25,000 and £65,000. At the lower boundary, this represents the cost of employing an additional member of staff. These figures are comparable for many other small building societies, none of which are likely to need more than ten derivative trades a year and do not pose a risk to financial stability.

Suggestion:
Proposal to change the Level 1 text:

- *Exempt small financial institutions (defined by level of activity or balance sheet size) from the clearing mandate in respect of hedging/protection contracts only –*

Proposal to change the Level 2 (Regulatory Technical Standards):

- *Utilise a recent precedent in which interest rate swaps (IRS) transacted by covered bond vehicles formed a separate class which is not captured by the clearing mandate – e.g. the class of derivative could be IRS entered into for protection purposes only.*

Example 4: CRR Article 26
Impact of IFRS9 on banks using the standardised approach

Issue: IFRS 9 applies (subject to endorsement) from 1 January 2018. Its requirements for expected credit losses are in line with the post-financial crisis calls of many constituents, including the Financial Stability Board[5]. It may however have a disproportionate effect on regulatory capital for those firms who use the standardised approach (SA) to calculate capital against credit risk compared to those who use internal ratings (IRB) approaches. These firms tend to be smaller banks.

Firms which use SA deduct the accounting impairment provision (which is expected to be significantly higher under IFRS 9) without adjustment from core equity tier 1 capital (CET1). Thus, higher provisions will directly reduce CET1. By contrast, banks that have supervisory permission to calculate capital for credit risk using IRB approaches only deduct accounting provisions from CET1 to the extent that they exceed 'regulatory expected loss (EL)', with any excess of provisions over regulatory EL added back to Tier 2 capital, up to a cap.

Example: The financial effect of IFRS 9 is not yet known. However, Bank of England analysis suggests that firms using IRB approaches will be able to have accounting provisions increase substantially before regulatory capital is affected. The CRR rules require that firms using SA approaches, on the other hand, see capital reduced on a pound for pound basis as accounting provisions increase.

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[4] Bank of England, Financial Conduct Authority, 'Mortgage Lenders and Administrators Statistics' available at: http://www.bankofengland.co.uk/pra/Documents/regulatorydata/mlar/2015/q1.pdf

[5] See paragraph 33 of the 2009 Report of the Financial Stability Board to G20 leaders

Suggestion: The EU could, working with the Basel Committee on Banking Supervision and through the European Banking Authority, consider ways of mitigating the effects of IFRS 9 on the capital of banks using the SA approach. Such ways might include consideration of deductions or SA re-calibration.

B- Unnecessary Regulatory Burdens

Reporting and disclosure obligations

The EU has put in place a range of rules designed to increase transparency and provide more information to regulators, investors and the public in general. The information contained in these requirements is necessary to improve oversight and confidence and will ultimately improve the functioning of markets. In some areas, however, the same or similar information may be required to be reported more than once, or requirements may result in information reported in a way which is not useful to provide effective oversight or added value for investors.

Please identify the reporting provisions, either publicly or to supervisory authorities, which in your view either do not meet sufficiently the objectives above or where streamlining/clarifying the obligations would improve quality, effectiveness and coherence. If applicable, please provide specific proposals. Specifically for investors and competent authorities, please provide an assessment whether the current reporting and disclosure obligations are fit for the purpose of public oversight and ensuring transparency. If applicable, please provide specific examples of missing reporting or disclosure obligations or existing obligations without clear added value.

Example 1: CRR, CRD IV
Liquidity reporting under CRDIV

Issue: We agree it is necessary that the reporting for liquidity regulation has rigorous adoption processes. However, we believe that for small changes to legal texts [delete: and] or technical standards a more streamlined and accelerated approach would substantially improve the process and reduce unnecessary burdens on banks and regulators caused by redundant reporting and duplicate reporting.

Example: The LCR as set out in the Delegated Act (COMMISSION DELEGATED REGULATION (EU) 2015/61) has been in force since 1st October 2015. It required an update to the ITS for LCR reporting (as set out in CRR) which was completed by the EBA but is yet to be adopted by the European Commission. Once this is adopted and published in the official journal there will be an additional 6 months delay until implementation of the ITS. This could lead to up to a year of redundant reporting based on the CRR LCR standard which no longer applies to credit institutions.

Suggestion: We understand that it is of the utmost importance that these standards undergo a rigorous adoption process but we would welcome any positive adjustments that could be made to streamline and accelerate the process, particularly in the case of small changes that are made to standards.

Contractual documentation

Standardised documentation is often necessary to ensure that market participants are subject to the same set of rules throughout the EU in order to facilitate the cross-border provision of services and ensure free movement of capital. When rules change, clients and *counterparties are often faced with new contractual documentation. This may add costs and might not always provide greater customer/ investor protection. Please identify specific situations where contractual or regulatory documents need to be updated with unnecessary frequency or are required to contain information that does not adequately meet the objectives above. Please indicate where digitalisation and digital standards could help to simplify and make contractual documentation less costly, and, if applicable, identify any obstacles to this happening.*

Example 1: BRRD

Contractual recognition language in Article 55 of BRRD

Issue: Article 55 of the Directive 2014/59/EU (BRRD) requires the inclusion of contractual recognition language, by which the creditor recognises that the liability may be bailed in, into all non-EU liabilities apart from those excluded from bail-in (e.g. secured liabilities,[6] covered deposits, liabilities to employees, liabilities with a remaining maturity of less than seven days etc.) and preferred deposits (except where third country statute or binding agreements relating to EU resolution authority bail-in apply).

The requirement captures unsecured debt instruments as well as operational liabilities, liabilities related to trade financing and liabilities to financial market infrastructures (FMIs) among others. A liability will not count towards meeting the Minimum Requirement for Own Funds and Eligible Liabilities (MREL) if it lacks contractual recognition language. Any failure by institutions to add such a contractual term will not however prevent the Bank from exercising its bail-in powers in relation to the relevant liability (although it will not be sure whether such an action would be recognised under the law of the third country).

Firms have indicated that the requirement is too broad, potentially putting EU firms at a disadvantage relative to non-EU firms in non-EU jurisdictions. Firms have further indicated that compliance with the requirement is disproportionate relative to the loss absorption value provided, should compliance be achieved.

Examples: In particular the following specific types of liabilities have been identified as particularly challenging with regards to the inclusion of contractual recognition language:

- **Liabilities to clearing and settlement systems outside of the EU.** Firms have argued that it is highly unlikely that non-EU financial market infrastructures (FMIs) would agree to amend their rules in order to allow for the contractual recognition requirement, as some of these contracts are non-negotiable. There is a risk that access of European firms to clearing, payment and settlement systems in third countries—and thus to the markets they serve—would be restricted.
- **Liabilities connected to the financing of international trade (letters of credit, bank guarantees and performance bonds).** The terms governing trade finance are often not between the bank and the beneficiary to whom the liability will be owed and the beneficiary is not the client of the bank. Contingent liabilities - for example under letters of credit - are generally not recorded as liabilities on the balance sheet or viewed as part of the loss absorbing capacity of the institution.

[6] But note that the contractual recognition language must be included to those secured liabilities that may become unsecured, unless a contractual obligation to maintain full collateralisation exists under EU or equivalent third-country law.

- **Standard term contracts under local law or with foreign public authorities (leases, purchases and rental of equipment, IT, supplies, services, utilities).** Firms have argued that such liabilities should not be subject to bail-in as they are operational and would not add much loss-absorbing value in resolution. We note that BRRD article 44 (2) (g)(ii) currently excludes only liabilities to a commercial or trade creditor arising from the provision to the institution of goods or services that are **critical** to the daily functioning of its operations from bail-in, leaving operational liabilities which are not regarded as critical within scope.

Solution: The difficulties presented above illustrate the need to reassess the current scope of Article 55, with a view to ensuring that it achieves its objective in providing much needed loss absorption capacity in resolution, while being proportionate in its reach. The Bank of England regards liabilities to non-EU FMIs, trade finance liabilities and operational liabilities as particularly challenging. It does not however have further comments at this stage as to the ideal scope of Article 55. The Bank will further consider its position and engage with the Commission in due course.

C- Interactions of individual rules, inconsistencies and gaps

Links between individual rules and overall cumulative impact

Given the interconnections within the financial sector, it is important to understand whether the rules on banking, insurance, asset management and other areas are interacting as intended. Please identify and explain why interactions may give rise to unintended consequences that should be taken into account in the review process. Please provide an assessment of their cumulative impact. Please consider whether changes in the sectoral rules have affected the relevancy or effectiveness of the cross-sectoral rules (for example with regard to financial conglomerates). Please explain in what way and provide concrete examples.

Example 1: CRD IV, CRR **Leverage ratio in CRR (Inclusion of client clearing and central bank reserves)**

See Market Liquidity section.

Example 2: Solvency II **Ultimate Forward Rate (UFR) under Solvency II**

Issue: In order to establish a truly harmonised approach to insurance regulation, it is essential that the valuation of the insurance balance sheet is done on a consistent basis. Solvency II represents an important step forward in achieving that. But differences remain in the way that discount curves are derived and applied under different currencies and in different national markets, which can lead to large differences in the solvency positions of firms according to where they are located in the EU. Finding a common basis would improve comparability between different jurisdictions.

Example: Differences remain in the way that currency-specific discount rates are extrapolated to the regulatory ultimate forward rate (UFR), reducing comparability between business of different currencies. Given the current low rate environment, the regulatory euro curve is significantly higher that the market euro curve.

Example 3: Solvency II **Treatment of sovereign exposures under Solvency II**

Issue: There is an absence of spread risk and concentration risk charges for EU government bonds. The Basel Committee on Banking Standards if looking at this issue for banking. An equivalent approach could be considered for insurers.

D- Rules giving rise to possible other unintended consequences

Risk

EU rules have been put in place to reduce risk in the financial system and to discourage excessive risk-taking, without unduly dampening sustainable growth. However, this may have led to risk being shifted elsewhere within the financial system to avoid regulation or indeed the rules unintentionally may have led to less resilient financial institutions. Please indicate whether, how and why in your view such unintended consequences have emerged.

Example 1: CRD IV

CRDIV bonus cap

Issue: The bonus cap requires institutions to set a maximum ratio of 1:1 between the variable and fixed components of total remuneration for those staff members subject to the CRD remuneration provisions (material risk takers). This ratio may be increased to a maximum of 2:1 on the agreement of shareholders, owners or members of an institution. A discount rate may be applied to a maximum of 25% of total variable remuneration paid in instruments deferred for not less than five years. The discount rate if applied has the impact of marginally increasing the maximum ratio.

The UK believes that variable remuneration should constitute a substantial portion of overall pay in order to ensure that a meaningful amount of pay is at risk and that incentives can be better aligned with the longer term interests of firms. In this respect, the bonus cap is counter-productive as it reduces the scope for effective risk adjustment to incentives through the application of malus and clawback and reduces flexibility in banks' cost bases.

Example: The UK's Pillar 3 remuneration disclosures show that fixed pay for the material risk taker population increased as a proportion of total pay from 28% in 2013 to 54% in 2014, the year the bonus cap was first applied. The Fair and Effective Markets Review concluded that between 2011 and 2014 the proportion of fixed pay for CEOs and their direct reports rose considerably. Thus a significantly lower proportion of pay is now at risk and subject to downward adjustment in the event of misconduct or risk management failings. This undermines the objective of the CRD remuneration provisions which is to secure a stronger and more effective alignment between risk and reward.

Solution: Art.161 CRD requires the Commission, with the EBA, to report by 30 June 2016, with a legislative proposal if appropriate, on the impact of the CRD remuneration provisions and, in particular, on the impact of Art.94.1(g) (the bonus cap) on competitiveness and financial stability and on staff working outside the EEA given that the CRD remuneration provisions have global reach. Inputs to this review by regulators and firms should provide scope for making the case for the negative impact of the cap on the achievement of the objectives of the CRD provisions and the FSB Compensation Principles and Standards.

Example 2: CRD, Article 141

Restrictions on Maximum Distributable Amount (MDA) under CRDIV

Issue: The usability of capital buffers under CRDIV may be restricted by the attitude of bank executives to **maximum distributable amount (MDA) restrictions** that apply automatically when banks use combined buffers. The role of capital buffers is to absorb unexpected losses

– for example, in periods of stress – allowing banks to rebuild capital while continuing to lend to support the economy. Banks should be willing to use capital buffers when necessary and need not hold significant excess capital on top of regulatory buffers. Under CRR, banks using buffers face automatic and escalating restrictions on payments of bonuses and dividends, including on Additional Tier 1 instruments, such as contingent capital.

Anecdotal evidence from firms suggests that they intend to maintain voluntary buffers above the combined buffer in order to avoid breaching it and impacting investors. Banks may also be concerned about the uncertainty that distribution restrictions may create about their financial strength to the outside world, and so may choose to deleverage instead. As a result, banks may effectively act as if buffers are an extension of their minimum capital requirements. These sentiments go against the intention of the buffers, making them 'unusable'. This therefore points to an argument for changing the framework if this will become the behaviour once (i) the buffers are phased in full; and (ii) banks have gained some predictability with the buffer settings of the macroprudential authorities in the countries where they have significant exposures.

Example: See above.

Example 3: CRD IV

Design of the Countercyclical Buffer (CCyB) in CRDIV

Issue: The issue is relevant for those firms whose risk weighted assets (RWA) are dominated by market risks.

The bank-specific CCyB for each firm is determined by the proportion of its credit risk weighted assets held in different jurisdictions multiplied by the CCyB rates in operation in those jurisdictions. Bank-specific CCyB is then applied to firms' total RWAs (ie to its overall capital requirement). This could have a disproportionate impact on an investment firm that is subject to the CCyB, for example by scaling up the firm's total capital requirement, even though the firms' activities could be quite unrelated to the UK cycle and the firm only had a minority of credit exposures within the UK.

Example: A firm with £100m domestic credit risk, no foreign credit risk and £10bn of market risk would attract a full 100% CCYB applied to its total exposures (£10.1bn). This could have a disproportionate impact on these firms as their other market exposures may not be domestic.

Example 4: DGSD

Protected limits under the Deposit Guarantee Schemes Directive (DGSD)

Issue: The recast **Deposit Guarantee Schemes Directive (DGSD)** establishes common standards across the EU for protecting savings in banks and building societies. Although the original DGSD of 2010 set a protected limit of €100,000, which was converted into a sterling limit of £85,000, the recast of the DGSD in 2014 required the sterling limit to be re-set using the euro/sterling exchange rate in place on 3 July 2015, leading to a lower figure of £75,000. Since there was no allowance for a transitional period, this severely constrained the ability of the UK authorities to warn or announce to either firms or depositors that a reduction in the limit was imminent, with an undesirable impact on depositor confidence.

Solution: Any future revision to the €100,000 coverage limit in the DGSD should take into consideration the impact on non-euro Member States and their ability to ensure depositor confidence.

Example 5: Solvency II, DGSD, FICOD **Other Issues**

Definition of 'Financial Institutions' under Solvency II: Solvency II requires that entities which would be "financial institutions" according to Article 4(26) of the CRR should be treated according to CRR valuation in the group solvency calculation. This is a broad category, including (for example) holding companies which are not intermediate insurance holding companies or mixed financial holding companies and dedicated finance vehicles. This means that many groups which do not have any entities regulated under the CRR may have to implement CRR valuation procedures for the capital resources and notional requirements of these entities, which poses a significant administrative burden.

Disclosure requirements in the Deposit Guarantee Schemes Directive (DGSD): NCAs have very little discretion on disclosure to depositors. The DGSD prescribes the text of the main source of disclosure to depositors (the Information Sheet). This actually has the potential to confuse depositors. There is a question on this front on the broader principle of subsidiarity and the balance of competences - while standardising the requirement to issue disclosure is a worthwhile initiative, prescribing the exact words in the Level 1 text at an EEA level does not allow NCAs to take individual circumstances into account. The UK has found this particularly challenging especially around how banks can communicate to depositors about the upcoming reduction in the protection limit

Supplementary supervision under the Financial Conglomerates Directive (FICOD): Following the implementation of FICOD1, we have noticed that FICOD tends to capture several "asset management/investment" groups which use life insurance subsidiaries to offer access to portfolios under management via unit-linked policies (allowing clients to benefit from life-insurance tax wrappings). We are of the view that this is an unintended consequence of the recent changes to FICOD. FICOD affords significant flexibility to waive the requirements of FICOD where the PRA deem its application as inappropriate, and so this unintended consequence does not typically result in an additional regulatory burden, but does often result in an administrative burden since firms need to apply to waive or modify FICOD requirements.

For example, the different balance sheet treatment of underlying assets under management (AUM) for unit-linked policies (included on the balance sheets of insurers) and AUM for asset managers/investment firms (treated as off-balance sheet) means that the default balance sheet metric to compare the significance of insurance and investment/banking subsidiaries in FICOD often results in the significance of any life insurers in the group being overstated. This default metric can be modified to e.g. include off-balance sheet items, but in the UK this is only possible by following a waiver process.

The introduction of Solvency II renders FICOD much less relevant for most insurance-led conglomerates, as the Solvency II group capital calculation will take account of banking/investment business within a group (including any CRR buffers), as well as reporting of intra-group transactions and risk concentrations within a SII consolidation group. Most if not all of the additional governance requirements established in FICOD could be established using Solvency II group governance requirements. However, FICOD may still have an impact on these groups by extending the scope of group supervision further up the chain of ownership, as well as allowing for a broader assessment of the availability of capital of group undertakings to the rest of the group as part of the group capital adequacy requirements than Solvency II allows.