High-level overview of Bank of England Response to the European Commission Call for Evidence on the EU Regulatory Framework for Financial Services, January 2016

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A- <u>RULES AFFECTING THE ABILITY OF THE ECONOMY TO FINANCE ITSELF AND GROW</u>

The regulatory framework must contain the appropriate tools and flexibility to strengthen resilience and support growth…

Macroprudential toolkit in CRDIV

1. Bank analysis has found that the active use of macroprudential tools to vary capital requirements over time in response to changing cyclical risks can make the framework more efficient, eliminating the need for banks to maintain larger capital buffers than warranted by the risk environment and supporting sustainable growth.[1]

2. CRD IV introduced a substantial **macroprudential toolkit** into EU legislation, including buffers for systemic entities (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 provide flexibility for macroprudential risks not covered 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 diversity of tools applied by member states so far is evidence of the differences present in national economies across the EU. The Commission is required to review the macroprudential toolkit under Article 513 of CRR and the Bank believes this review will provide covers the necessary ground, and in general, that this crucial element is working effectively.

Consideration of inclusion of macroprudential tools in Solvency II

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

Excessive volatility of the risk margin in Solvency II

4. The calculation of the **risk margin** in Solvency II 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, because it promotes procyclical investment behaviour.

[1] Supplement to the December 2015 Financial Stability Report, The framework of capital requirements for UK banks, Bank of England, December 2015:
http://www.bankofengland.co.uk/publications/Documents/fsr/2015/fsrsupp.pdf

Treatment of infrastructure investments under Solvency II

5. 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.

… and regulation should underpin a dynamic financial sector…

Securitisation

6. Securitisation can support growth both as a financing tool and by facilitating credit risk transfer. Tightening of regulations for **securitisation** contributed to a more subdued EU market in securitisations in recent years. The Bank has worked closely with the ECB and the Commission to develop an EU framework for simple, transparent and standardised securitisation. One important remaining priority is to lower capital requirements for securitisations in Solvency II.

Leverage ratio in CRDIV
(*This also falls under interaction of rules, inconsistencies and gaps)*

7. The Bank supports the introduction of the **leverage ratio** for EU banks as a complement to existing risk-weighted capital requirements. The leverage ratio makes the capital framework robust to the inherent errors and uncertainties in risk weights. The Bank's view is that the leverage ratio requirements and buffers should be 35% of risk-weighted requirements and buffers. So the 8.5% Tier 1 risk-weighted ratio equates to a 3% Tier 1 leverage ratio; and systemic and countercyclical buffers are likewise translated into leverage ratio equivalents at 35%[2]. This ensures that Pillar 1 risk-weighted and leverage ratio requirements are equally binding for all banks at all times. As a consequence, it ensures that more systemic banks subject to higher risk-weighted requirements are not subject to looser leverage requirements than less systemic banks.

8. The leverage ratio is a simple measure and there should be a high bar to making adjustments to it. Nonetheless, we should also be aware of the potential for unintended consequences, including for market liquidity. As explained further below, the Bank supports the current review by the Basel Committee of the **treatment of derivatives exposures for centrally-cleared client transactions within the leverage ratio exposure measure**.

9. The EU has implemented the G20 commitment to move derivatives markets to central clearing. Access to central clearing, however, depends on the willingness of banks to act as clearing members. There is a risk that more banks will exit the client clearing market because they do not believe they can generate an economic return on capital, leading to concentration of activity on a few providers. The Bank therefore thinks that the leverage treatment of derivatives exposures for centrally-cleared client transactions within the leverage ratio exposure measure needs to be reviewed. The Bank supports allowing client initial margin to offset potential future exposure on centrally-cleared client transactions when calculating the leverage exposure measure.

[2] The ratio of 3 to 8.5 is approximately equal to 35%. This relationship is maintained when buffers are added.

10. Under CRDIV firms are required to disclose their leverage ratio at quarter-ends. There is now significant evidence that this incentivises firms to reduce their exposures significantly around quarter ends in an attempt to **“window-dress” their disclosed leverage ratio**. The independent Office of Financial Research has published a research paper that shows that this behaviour is prevalent amongst EU banks that are subject to quarter-end reporting. US banks that are subject to the US leverage ratio requirements do not engage in window dressing because they are required to average their exposures during the quarter. Window dressing not only flatters leverage but may also lead to large moves in interbank rates around quarter end that could have unintended consequences for market liquidity and the smooth transmission of monetary policy. The Bank has required daily averaging of on-balance sheet exposures and monthly averaging of off-balance sheet exposures for reporting purposes for its own leverage ratio framework.

11. The Bank also supports **a review of the inclusion of central bank reserves** in the leverage exposure measure. The combination of the Liquidity Coverage Ratio and Leverage Ratio has caused banks to re-price short-term wholesale deposits. In large part, this is an intended consequence of regulation. But market intelligence is that some non-financial corporates and non-bank financial institutions now struggle to find any bank to accept overnight deposits (particularly at quarter-ends).[3] A further concern is that in stressed markets, safe banks may be unwilling to accept inflows of deposits, creating blockages in the flow of funds. 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.

Pre- and post-trade transparency under MiFID II

12. Finally on market liquidity, ESMA has published draft technical standards for 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, where there a sub optimal liquidity, transparency pursued in the wrong direction can be damaging to 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.

… and where legislation is inefficient or inconsistent it should be reviewed…

Proportionality in banking regulation

[3] Averaging exposures over the quarter for leverage ratio purposes will help but is likely not to be a panacea.

13. A **more differentiated approach to banking regulation according to the size of firms could facilitate competition, growth and stability**. The Bank's response to the Commission's consultation on how revised bank capital requirements have affected lending set out some aspects of regulation that could be adjusted.[4] These include:

- Less onerous regulatory reporting requirements, including Pillar 3 disclosure requirements.
- Narrowing the gap between capital requirements based on standardised approaches to those based on internal models where they are unduly large, both by making standardised approaches more risk sensitive and by constraining internal models from producing excessively low capital.
- Considering whether small firms need to be subject to all elements of the regulatory framework: for example, firms below a certain threshold might be exempt from the Net Stable Funding Ratio.
- Exempting small financial counterparties from the clearing obligation under the European Market Infrastructure Regulation (EMIR). Some UK firms are finding it difficult to gain access to central clearing on cost-effective terms. We are concerned that some may decide to cease hedging interest rate risk: for example on fixed rate mortgage lending.[5]

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

Impact of IFRS9 on banks using the standardised approach

14. The impact of the **IFRS9 accounting standard** on regulatory capital ratios may also be greater for firms using the standardised approach for credit risk capital requirements than firms using internal model-based approaches. This is because firms using internal models already deduct one year of expected losses from regulatory capital and this can be offset against the new accounting provisions. For a standardised approach portfolio, when IFRS 9 is implemented, whilst the standardised approach risk weights won't change (so they will still reflect expected future incurred losses (EL) and unexpected future incurred losses (UL)), their accounting provisions will include provisions for both current incurred losses and some expected future incurred losses. The result will be that, unless the standardised approach is amended in some way, some expected future incurred losses will be reflected both in the deductions and in the risk weights. It is that effect that we think needs to be corrected for to ensure SA firms are not unfairly treated relative to IRB firms.

In general, we think regulators should seek to ensure that the introduction of IFRS9 has a neutral effect on bank capital ratios unless loanbooks have experienced significant credit deterioration, where the new standard appropriately requires provisions (against lifetime expected loss) to be recognised sooner than under the current 'incurred loss' accounting standard.

[4] Response of the Bank of England to the European Commission's public consultation on the possible impact of CRR and CRDIV on bank financing of the economy, Bank of England, October 2015: http://www.bankofengland.co.uk/pra/Documents/crdiv/responsecrrcrdivbankfinancing.pdf
[5] Bank of England, HMT and Financial Conduct Authority response to the European Commission's Consultation on the Review of the European Market Infrastructure Regulation (EMIR), September 2015: https://ec.europa.eu/eusurvey/publication/emir-revision-2015?language=en

B- UNNECESSARY REGULATORY BURDENS

Liquidity reporting under CRDIV

15. We agree it is necessary that rules on liquidity reporting have rigorous adoption processes. However, we believe that for small changes to legal texts 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.

Contractual recognition language in Article 55 of BRRD

16. Implementation of the **Bank Recovery and Resolution Directive** marks an important step in establishing a comprehensive recovery and resolution regime that makes it more possible for banks to fail without endangering public funds. However, **Article 55**, which aims to ensure loss absorbing capacity in resolution through requiring the inclusion of bail-in contractual recognition language into non-EU liabilities, requires re-assessment. The requirement is very broad in scope. This could lead to legal uncertainty in some situations, while in others, it poses a burden that is disproportionate to the additional loss-absorption capacity achieved. Particular challenges are posed by liabilities to non-EU financial market infrastructures, trade finance liabilities and operational liabilities.

C- INTERACTION OF INDIVIDUAL RULES, INCONSISTENCIES AND GAPS

Ultimate forward rate and treatment of sovereign exposures under Solvency II

17. Turning to Solvency II, inconsistencies remain in the way that the market rates are extrapolated to the regulatory **ultimate forward rate** (UFR), reducing comparability and underestimating reserve requirements for euro-denominated business.

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

D- RULES GIVING RISE TO POSSIBLE OTHER UNINTENDED CONSEQUENCES

… and consideration should be given to whether legislation impacts on behaviour in the way that it was intended to…

CRDIV bonus cap

19. The **CRDIV bonus cap** may have the unintended consequence of encouraging higher fixed pay through salary increases. In 2013 the proportion of fixed to total remuneration for material risk takers in the five major UK banks was 28%. In 2014 – the year firms first had to apply the bonus cap – this proportion had increased to 54%. The Bank believes that variable remuneration should constitute a substantial portion of overall pay in order that a meaningful

amount of pay can be deferred for a significant period of time. In the UK, variable pay of senior managers will need to be deferred for up to seven years. If financial risks or poor conduct materialise, deferred variable pay can be reduced through the application of 'malus' by firms. In this way incentives can be better aligned with the longer-term interests of society. The bonus cap is counter-productive as it reduces the scope for this re-alignment of incentives.

Restrictions on maximum distributable amount (MDA) under CRDIV

20. 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 their combined buffer. 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 will seek to avoid these restrictions, particularly on Additional Tier 1 dividends. Some firms are planning to hold 'voluntary' buffers above the combined buffer. They may also seek to deleverage in a stress in order to avoid using the buffer, contrary to its purpose. In effect, banks may act as if buffers are an extension of their minimum capital requirements, meaning that they are not 'usable'. The Bank supports a review of the MDA triggers, including considering to which types of distributions they should apply, how the maximum distributable amounts are calculated and the scale by which they escalate as banks use the buffers.

Design of the Countercyclical Buffer in CRDIV

21. EU legislation currently requires a bank to determine its **Countercyclical Buffer (CCyB)** by multiplying the relevant CCyB rates determined by the authorities in each country by the proportions of its <u>credit exposures</u> to borrowers from each respective country and then applying the buffer rate to its <u>total exposures</u>. In effect this is using credit risk as a proxy to calculate domestic exposures across all exposures classes. This can have unintended consequences if, for example, a bank has small credit risk exposures, concentrated on one country, but large market risk exposures across other countries.

Protected limits under the Deposit Guarantee Schemes Directive (DGSD)

22. Finally, 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. 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.

OTHER ISSUES

Definition of 'financial institutions' under Solvency II

23. **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 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)

24. In addition, the **DGSD** prescribes the text of the main source of disclosure to depositors (the Information Sheet). This is long and has the potential to dilute the message or confuse depositors. There should also be scope to take account of different member circumstances and to provide for transitional arrangements if there is to be a change in the amount of cover provided.

Supplementary supervision under the Financial Conglomerates Directive (FICOD)

25. The **Financial Conglomerates Directive (FICOD)** sets rules in respect of the supplementary supervision of regulated entities that form part of a financial conglomerate. Since its implementation, it has become apparent 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. This allows clients to benefit from life-insurance tax wrappings, but capturing the groups leads to the significance of any life insurers in the group being overstated, which would appear to be an unintended consequence. Although FICOD affords significant flexibility to waive the requirements of FICOD where the PRA deem its application as inappropriate, meaning that this 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.