EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Public consultation

on a draft Addendum to the ECB Guide on options and discretions available in Union law

Explanatory memorandum

Contents

1 Context of the proposed act

1.1 Reasons for and objectives of the proposal

As mentioned in the Explanatory Memorandum published for the first ECB public consultation on the exercise of Options and Discretions available in Union law ("the first Memorandum")[1], a lack of consistency in the exercise of options and discretions ("O&Ds") in the European legislative framework may distort the level playing field and encourage regulatory arbitrage. It adds a layer of complexity in cross-border banking activities under the Single Supervisory Mechanism (SSM). It may also result in inconsistent prudential standards and reduced comparability of the capital adequacy position of significant credit institutions. This in turn may lead to decreased market transparency with respect to the soundness and resilience of specific credit institutions and the banking sector as a whole. Finally, discrepancies in prudential standards may hinder the ECB's exercise of effective supervision with the application of common standards to all significant credit institutions having a similar risk profile.

In this regard, the ECB, as the competent authority for significant credit institutions within the SSM, has initiated a project designed to address these issues and promote the harmonisation of the regulatory and supervisory framework. The goal of the O&D project is to assess how to exercise, in the best interests of the banking union, those O&Ds available under the CRD IV legislative package granted only to competent authorities.

To that end, the O&Ds are divided mainly according to their mode of application, i.e. general or case-by-case. They are exercised by the ECB through two separate instruments: a Regulation for O&Ds of general application and a Guide explaining the policy stance on case-by-case O&Ds[2].

The ECB Regulation and the first version of the ECB Guide on options and discretions available in Union law were the result of the first phase of this project, which began in November 2014 and ended in March 2016. Those instruments were submitted for public consultation from November to December 2015 and finalised, approved and published in March 2016. The ECB Guide (first version) became operational, as a legally non-binding instrument, from its date of publication (24 March 2016). The ECB Regulation (Regulation (EU) 2016/445 of the European Central Bank of 14 March 2016) will enter into force on 1 October 2016[3].

As already announced at the public hearing for the first consultation (Frankfurt am Main, 11 December 2015), the ECB opened a second phase of this project in November 2015, with the aim of concluding the policy work on supervisory O&Ds. Following the same principles and process as in the first phase, the ECB is proposing a general approach regarding eight additional options and discretions

1 See in particular Section 1.1. of the Memorandum.

2 As well as certain general O&Ds where follow-up work is required.

3 See Article 25 of the Regulation. Article 4 becomes applicable on 31 December 2016 and Article 13 becomes applicable on 1 January 2019.

applicable on a case-by-case basis. This approach is described in the Addendum to the ECB Guide on options and discretions available in Union law (Consultation Document), which is now submitted for public consultation. The Addendum will be revised following the assessment of the comments stemming from this consultation. Once the revised version has been approved by the Supervisory Board and the Governing Council, the ECB Guide on Options and Discretions will be amended to take the proposed changes into account.

With this Addendum to the Guide the O&D policy package can be considered, for the time being, concluded. Alongside the other parallel consultation on Institutional Protection Schemes (IPSs), this second consultation on the O&D package completes the list of O&Ds the ECB has identified in European banking legislation (Regulation (EU) 575/2013 of the European Parliament and of the Council[4] (CRR), Directive 2013/36/EU of the European Parliament and of the Council [5](CRD IV) and Delegated Acts) and considers to be of importance for the prudential supervision of significant credit institutions.

At the end of this process, the ECB will publish a consolidated version of the Guide to take into account the amendments to the first version deriving from this consultation and the IPS consultation, carried out between February and April 2016[6].

1.1.1 Issues addressed in the second phase of the O&D project

The ECB project on O&Ds focuses on the provisions of the CRR/CRD IV and Commission Delegated Regulation (EU) 2015/61[7] (LCR Delegated Act (DA))[8], where a clear and explicit discretionary mandate is given to Member States or supervisors (competent authorities). For the first phase of the project, 122 O&Ds granted to the competent authority were prioritised for policy development. In the second phase, the ECB reviewed the CRD IV package to identify additional provisions which were deemed to be consistent with the scope of the first phase, on the basis of the following methodology.

First, the ECB identified those provisions where the legislator had used the typical wording that the competent authority “may” decide on a specific prudential treatment (CRR Articles 93(6), 113(6), 113(7) and 429(7), and Article 108(1) CRD IV).

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

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

6 Consultation on a Draft ECB Guide on the approach for the recognition of institutional protection schemes for prudential purposes. This consultation started in February 2016 and ended on 15 April 2016. The ECB is currently assessing the comments submitted in the consultation process and finalising the policy guidance.

7 Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions (OJ L 11, 17.1.2015, p. 1)

8 The Leverage Ratio Delegated Act (Commission Delegated Regulation (EU) 2015/62), which amends the provisions of the CRR directly, is also included in the scope of the second phase.

Second, the ECB included a number of other O&Ds in the second phase, based on two criteria:

- A policy criterion, i.e. the need, taking into account the experience accumulated in the first year of ECB supervision, to develop policy guidance for cases where the legislative framework is not sufficiently specific and the European Banking Authority (EBA) and the Commission do not have a legislative mandate to develop Regulatory Technical Standards or Guidelines that would guarantee the harmonisation of supervisory practices;

- a logical criterion, i.e. that the discretion embedded in the provisions is interpreted as being, in essence, equivalent to the level of discretion of the O&Ds included in the first phase.

Based on these criteria, O&Ds relating to Articles 30(2) and 33(2) LCR **DA** as well as to Article 88(1)(e) CRD IV have been added.

Of the eight selected provisions, Article 113(7) CRR has been excluded from the present consultation, given that it has already been subject to the ECB public consultation on provisions covering Institutional Protection Schemes.

It is also submitted to public consultation an additional paragraph of the Guide on the option of Article24. (2) CRR, that had already been inserted in the first version of the Guide among the options requiring follow-up analysis in Section III.

It should also be stressed that a lesser degree of discretion is also present in other CRR/CRD IV provisions that have not been included in the list of additional O&Ds. However, the ECB has excluded these provisions from the scope of the present project and has decided instead to focus on provisions that are broadly similar in terms of their prudential significance and the role assigned to the competent authority by the legislator. That said, it should be kept in mind that regardless of whether they are included in the O&D project, many other provisions of the CRR/CRD IV require the exercise of supervisory judgement for the assessment of individual applications submitted by credit institutions.

1.1.2 Objectives of the proposal

The overarching goal of the O&D initiative has always been to foster financial integration through the harmonisation of high standards for prudential requirements, according to the ECB's mandate within the framework of the SSM Regulation and the pursuit of the objectives of the Banking Union. The policy stance introduced with this second phase serves the same goals. The second phase also concludes the mapping of the O&Ds available under the current legal framework, in an effort to achieve stability and predictability of supervisory practices within the SSM and to manage the expectations of significant credit institutions regarding the assessment of specific supervisory applications.

As underscored in the Explanatory Memorandum attached to the first phase of the project, the ECB, in its effort to achieve these objectives, complies with relevant Union law and respects, in particular, the mandate entrusted to the EBA of developing draft technical standards and guidelines and recommendations in order to ensure supervisory convergence and the consistency of supervisory outcomes within the Union.

1.2 Policy principles and processes for the O&D Project

In developing the present policy stance, the ECB has adopted the same guiding principles followed for the first phase. Specifically, in line with the SSM mandate, prudence has been the guiding principle of the ECB's work on O&Ds. The ECB also recognises that financial integration is furthered by equal treatment, thereby ensuring a level playing field where, for the same business and the same risks, the same rules apply.

The ECB has also given special consideration to the international standards and in particular to the work of the Basel Committee on Banking Supervision.

Lastly, the ECB has, as always, taken into account the legitimate expectations of credit institutions, as created by previous decisions of the national competent authorities where the same provisions were applied in the past.

The second phase of the project, like the first, has been executed by the ECB's High Level Group on Options and Discretions ("HLG"), composed of alternate members of the Supervisory Board and chaired by an ECB representative from that Board. The HLG was supported by ECB staff with both legal and supervisory expertise, and benefitted from close cooperation by staff from the National Competent Authorities. As in the first phase, a careful analysis was conducted of the prudential issues underlying each O&D and policy guidance was drawn up. The HLG submitted the proposed policies on the additional O&Ds to the Supervisory Board, where an agreement was reached in March 2016 on the content of the policies. The Supervisory Board also approved the submission of the draft amendments to the Guide to public consultation on 4 May 2016. This decision was ultimately endorsed by the Governing Council of the ECB on 13 May 2016.

2 Impact assessment, monitoring and evaluation

As noted in the first Explanatory Memorandum, for most O&Ds taken individually the harmonisation effort does not result in a material and immediate quantitative impact. The benefits, in terms of the overall consistency, simplification and enhancement of the prudential framework, are, therefore, well worth the potential costs of the introduction, in some cases, of a new and more explicitly detailed policy stance. It should be noted that, as this second phase of the project consists entirely of case-by-case O&Ds, an ex-ante quantification of the impact of their implementation is not possible, as this will depend on applications from the credit institutions themselves. Furthermore, it is difficult to use past experience in applying these provisions to draw conclusions for their current exercise, since several of the provisions in question have only recently been introduced in the European legislative framework.

3 Legal elements of the proposal

The legal framework for the exercise of O&Ds is analysed in the Explanatory Memorandum of the first phase of the project (Section 3, pp. 11-13). It is worth reiterating here that the ECB, as the competent authority for carrying out the tasks entrusted to it by the SSM Regulation, has the power to exercise Options and Discretions, especially pursuant to Article 4(3) of the SSM Regulation (see also Recital 34 of the same Regulation). Such power is immediate and direct in the case of O&Ds granted only to competent authorities and provided for in the CRR, which form the most important part of the O&Ds related to capital adequacy and liquidity requirements for prudential supervision. The O&Ds granted to competent authorities by CRD IV can be exercised by the ECB in accordance with national implementing legislation.

The ECB has already clarified that for the exercise of O&Ds applicable on a case-by-case basis some general guidance should be developed to ensure that supervisory discretion is exercised in a consistent manner by the Joint Supervisory Teams. The addenda to the Guide submitted to public consultation with this document aim not just to provide transparency but also to develop general guidance for a small number of O&Ds that were not included in the first version of the Guide. As already explained for the first phase of the project, case-by-case O&Ds can be subsumed under the SSM supervisory powers and exercised through individual decisions addressed to specific credit institutions, provided that sufficient grounds exist for these decisions.

As already announced in the first public consultation, the ECB has decided to publish the general guidance addressed to the JSTs for the assessment of individual applications in order to foster transparency and shape the expectations of supervised entities and the general public. This will, in turn, also better define the accountability of the ECB in the exercise of its supervisory discretion.

Finally, Regulation (EU) 2016/445, which governs the exercise of general O&Ds, is not affected by this second consultation and will enter into force, as already provided for by Article 25 of the same Regulation, on 1 October 2016.

4 Detailed explanation of the proposal and policy rationale

As mentioned in section 1.2, the ECB has followed a defined set of principles underlying the design of a prudentially consistent framework for the exercise of O&Ds (prudence, rigorous harmonisation and consideration of internationally agreed standards). Taking the approved policy stance for the first phase of the project into account, a consistent policy stance underpins the exercise of the additional O&Ds relating to the treatment of intragroup exposure with regard to exemption from risk weighting, as well as compliance with liquidity requirements. To ensure the overall coherence of the project, further changes have been proposed in order to complement the existing O&D framework for capital waivers with the prudential rationale of the leverage ratio (see section 4.1.2)

4.1 Content of the proposal

4.1.1 Structure of the proposal

The basic structure of the O&D Guide has been preserved. Section I provides an introduction of the purpose, legal framework, scope, content and effect of the Guide, while the other two sections deal with specific O&D provisions.

The amendments now submitted for consultation will mainly be introduced in Section II of the Guide, which lays out the harmonised policy approach adopted by the ECB regarding case-by-case O&Ds. The structure of that section reflects the order of articles in the CRD IV package:

Chapter 1: Consolidated supervision and waivers of prudential requirements.

Chapter 2: Own funds

Chapter 3: Capital requirements

Chapter 4: Large exposures

Chapter 5: Liquidity

Chapter 6: Transitional provisions on capital requirements and reporting

Chapter 7: General requirements for access to the activity of credit institutions

Chapter 8: Acquisition of qualifying holdings

Chapter 9: Governance arrangements and prudential supervision.

One provision, namely Article 93(6) CRR, will be added in Section III of the Guide, which contains a description of the O&Ds requiring follow-up actions.

Following the decision by the Supervisory Board not to exercise the discretion under Article 24(2) CRR (see Section 4. 2 below), chapter 1, paragraph 6 of Section III has been deleted.

4.1.2 Policy rationale underlying the common approach for selected individual O&Ds

- **Assessment of the materiality of outflows in the event of downgrade triggers (Article 30.2 LCR DA)**

Credit institutions are required to calculate and notify to the competent authorities their additional outflows from all contracts containing provisions (such as downgrade triggers) which would lead, within 30 calendar days of a material deterioration of their credit quality (corresponding to a 3-notch downgrade of their external credit assessment), to additional liquidity outflows or collateral needs. The competent authorities are entrusted with the task of assessing these notifications. If they consider such outflows to be material, they will require credit institutions to add them to the total amount of outflows for the purpose of LCR calculations (denominator of the ratio).

According to the data available from supervisory reporting thus far, the ECB suggests that a threshold of 1% of total outflows should be set as an appropriate benchmark for the assessment of materiality of additional outflows, at least for the initial phase of application of this O&D. This threshold would ensure that, even where an institution does not recognise any inflows, non-recognition of outflows below the materiality threshold would only overestimate the LCR figure by, at most, less than 1 percentage point. Given that supervisory data of a higher quality and quantity will be available to the ECB from September 2016 as the new harmonised reporting templates enter into force, a review clause has been introduced in the proposed policy, allowing for a possible new calibration of the threshold.

- **Preferential treatments of the LCR Delegated Act and consistency of the ECB's policy on liquidity requirements (Article 33(2) LCR DA)**

In the first version of the Guide, the ECB designed a policy approach for several liquidity O&Ds included in the CRR and the LCR DA (see, in particular, Section 2, Chapter 5 of the Guide). Most importantly, in Chapter 1 of Section 2 the ECB developed specifications for the liquidity waiver under Article 8 CRR.

In view of the interaction of the Article 8 CRR waiver with certain preferential treatments provided for in the LCR DA, the ECB intends to ensure consistency of the assessment criteria for all of the O&Ds concerning liquidity requirements that from a prudential perspective could present elements of functional equivalence. This objective becomes particularly relevant for the O&D under Article 33(2) LCR DA, which is now being assessed with specific reference to two aspects.

1) First, in certain cases the exercise of this provision could have a comparable effect to the waiver under Article 8 CRR. This concerns, more specifically, the

exercise of the option in such a way that the amount of intragroup inflows to be exempted from the 75% cap on inflows is sufficient to completely offset the total outflows for a particular credit institution. In such a case, the institution in question would no longer be required to maintain its own buffer of High Quality Liquid Assets, as ordinarily required by the LCR DA.
Therefore, at the consolidated level, and especially if this combination of options was granted to multiple subsidiaries, the impact would be very similar to the creation of a liquidity subgroup under Article 8 CRR, as the buffer of liquid assets would be centrally managed. This functional equivalence is reinforced by the fact that the reporting requirements may remain applicable in both cases. In order to not only maintain high supervisory standards, but also comply with the principle of equal treatment, the ECB must ensure that functionally equivalent situations are assessed in accordance with the same prudential framework.
This approach not only avoids inconsistencies within existing ECB policy, but also prevents potential arbitrage between the application of the two sets of provisions (Article 8 waiver versus a combination of Articles 33(2) and (34) LCR DA). Therefore, the ECB intends to examine applications based on Article 33(2) also against the Article 8 CRR specifications, in those cases where such an examination is prudentially warranted due to the functional equivalence of the outcome described above.

2) Second, the exercise of this option for intra-group or intra-IPS deposits should be conditional upon the fulfilment of conditions ensuring that these deposits represent a reliable source of liquidity in times of stress. The ECB therefore considers that these deposits should either be subject to additional requirements as to their availability for the depositor, or exhibit the same features as those required under Article 16(1)(a) LCR DA in terms of liquidity.

- **Intragroup exemptions from the Leverage Ratio exposure measure (Article 429(7) CRR):**

One of the two prudential objectives of the leverage ratio, according to the relevant Basel Standard, is to “restrict the build-up of leverage in the banking sector to avoid destabilising deleveraging processes that can damage the broader financial system and the economy”. This objective is endorsed by the EU legislator and reflected in Recital 90 of the CRR, which states that “the years preceding the financial crisis were characterised by an excessive build up in institutions' exposures in relation to their own funds (leverage). During the financial crisis, losses and the shortage of funding forced institutions to reduce significantly their leverage over a short period of time. This amplified downward pressures on asset prices, causing further losses for institutions which in turn led to further declines in their own funds. The ultimate results of this negative spiral were a reduction in the availability of credit to the real economy and a deeper and longer crisis.” Thus, an important aspect of the policy rationale behind the introduction of this prudential requirement is the need to control the build-up of leverage in credit institutions and the banking system at large in order to avoid abrupt and disruptive deleveraging processes. This policy objective is clearly present in the ECB’s proposed policy stance on the exercise of subparagraphs (a) and (b) of Article 429(7) CRR. As a second objective, the leverage ratio should also represent a backstop to the risk-based capital

requirements. This objective targets potential shortcomings of the risk-based framework and is reflected in Recital 91 of the CRR, which states that “Risk-based own funds requirements are essential to ensure sufficient own funds to cover unexpected losses. However, the crisis has shown that those requirements alone are not sufficient to prevent institutions from taking on excessive and unsustainable leverage risk.” This objective too is clearly reflected in the ECB’s proposed policy on the exercise of Article 429(7)(c) CRR. Finally, point d) of the proposed policy aims to ensure consistency with other intragroup waivers in the CRR, where both the recovery and resolution plans need to be taken into account in order to grant prudential waivers.

In analysing the exercise of the option in Article 429(7) CRR the HLG has also identified a need to review and align the existing O&D policy framework on prudential waivers with prudential considerations related to the leverage ratio.

More specifically, in cases where a credit institution benefits from a capital waiver under Article 7 CRR, a waiver from the requirements related to leverage and included in Part 7 of the CRR is also granted automatically, by virtue of Article 6(5) CRR.

To prevent potential regulatory arbitrage between Articles 7 and 429(7) CRR, the supervisory assessment for granting a capital waiver under Article 7 CRR must also include considerations related to the leverage ratio.

Therefore, Section II of the ECB Guide has been amended not only to include the policy guidance on Article 429(7) CRR, but also to include a reference to leverage considerations for capital waiver decisions.

- **Governance: Combination of the functions of Chairman of the Management Body and Chief Executive Officer (Article 88(1)(e) CRD IV)**

In accordance with Article 88(1)(e) CRD IV, competent authorities may authorise the functions of Chairman of the Management Body and CEO in a credit institution to be combined. The ECB considers that, given the structure and wording of Article 88 CRD IV, this authorisation constitutes an exception to the general rule that the two aforementioned functions should be carried out by two different persons, in order to avoid potential conflicts of interest. This stance is aligned with the approach taken in both international and European best practices and standards. For instance, the EBA Guidelines on Internal Governance (GL 44) state that “the chair of the management body and the chief executive officer of an institution should not be the same person. Where the chair of the management body is also the chief executive officer of the institution, the institution should have measures in place to minimise the potential detriment on its checks and balances”. The rule, therefore, should be that the executive and non-executive functions are separate. Indeed, the Management Body has the task of overseeing the work of the executive arm of the credit institution, which the CEO leads within the system of corporate checks and balances. The performance of this task would be significantly compromised if the same person carried out both functions. Nevertheless, this situation could, in practice, arise in

certain cases where the establishment of a full-scale corporate governance structure would not be deemed feasible or necessary. Therefore, the ECB proposes that such a situation should only be allowed in exceptional cases and should be subject to a specific time limit. When examining an application for this authorisation, the ECB expects not only that a satisfactory justification be provided, but also that effective mitigating measures be put in place to address the potential lack of sufficient checks and balances in the corporate governance framework of the credit institution.

To provide more clarity on the measures which will be considered as acceptable for the purpose of applying this O&D, a dedicated network of the ECB and the NCAs plans to further develop the content of the conditions mentioned in the Guide, taking into account the on-going work of the EBA in this area.

4.2 O&Ds requiring follow-up actions

As mentioned above and explained in detail in the first Memorandum, Section III includes O&D provisions where some follow-up work was or is still necessary.

Only for one of those provisions, namely Article 24(2) CRR, has the follow-up work recently been concluded. In Section III, paragraph 6 of the first version of the Guide, it was announced that the "The ECB intends to determine its policy on the exercise of the option in Article 24(2) of the CRR on the basis of the results of an impact assessment, to be carried out in cooperation with the national competent authorities."

In this regard, the Supervisory Board decided in September 2015 that further technical work was required in order to assess the available policy alternatives and their implications for the exercise of the discretion provided for in Article 24(2) of the CRR. The Supervisory Board also decided that a specific working group would be set up to carry out this analysis. The working group assessed, from a qualitative and quantitative perspective, the impact on the prudential level playing field of the application of different accounting standards across Member States.

The qualitative assessment was based on contributions from working group members and focused on the differences between IFRS and national GAAP. The quantitative analysis entailed data collection from significant institutions applying n-GAAP of a selection of balance sheet and own funds items.

The findings of this working group were submitted first to the High Level Group on O&Ds, which reviewed the results and discussed the pros and cons of the alternative options. The Supervisory Board then discussed the issue formally at its meeting on 16 March 2016. After careful analysis, the Supervisory Board decided not to exercise the discretion under 24(2) CRR. Consequently, credit institutions can continue to use the relevant accounting standards also for the purposes of supervisory reporting. A new paragraph 10 has been added to Section 2, Chapter 1 of the Guide, setting out the procedure to be followed for specific cases of reporting in IFRS by credit institutions required by their national accounting framework to apply n-GAAP.