Section III

Developing its approach to cross-border consolidation in the Euro Area

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Section I. Obstacles to cross-border M&A resulting from the existing EU prudential framework

The EU prudential framework, and its national implementations, contain regulatory obstacles to the cross-border flow of capital and funds within banking groups which constitute an ongoing barrier to cross-border consolidation in the Euro Area.

Absence of meaningful cross-border waivers in the Eurozone: In spite of the existing ECB policy with respect to cross-border LCR waivers, it is well acknowledged that this has been of limited benefit in practice: no such waivers have been granted and the ECB’s existing policy itself is limited to 75% of the HQLA requirement at the parent level, with the review of this approach announced for 2018 not yet having taken place. Moreover, at this stage, there is no clarity on the cross-border waiver policy that will be adopted for the CRR2 NSFR requirement.

We encourage the ECB to update and publish its approach to cross-border liquidity waivers in line with current regulatory framework as soon as possible. We recognise that the situation is exacerbated by the complex approach to large exposure exemptions across the eurozone, which continues to create an unlevel playing field and even if there is no change in the parent company’s head quarter, a transactions are facilitated by the universal succession regime applied to mergers and subsequent cross-border transactions in particular, which originate from EU prudential regulation, as well as from other areas of legislation, at national and European levels.

We understand that these issues are not within the direct remit of the ECB nor are they strictly speaking within the scope of the present consultation. Nevertheless, we consider it important to recall their existence as they continue to act as significant practical impediments to cross-border consolidations.

In this context, we reiterate our strong support for the ECB to continue calling on the EU co-legislators to overcome these obstacles. We also invite the ECB to actively participate in the identification and resolution of issues which may require legislative change. To this end and to the extent the ECB considers that further consolidation in the European banking sector may be desirable, we encourage it to take a pragmatic approach to the evaluation of the consolidation projects, and to make full use of all its existing powers granted under EU regulation.

We hold the view that such a provision hinders banking consolidation and to make full use of its existing powers granted under EU regulation.

Appropriately balancing operational resilience with the benefits of cross-border groups: As recognised in the guide, expected efficiency gains can be a key driver of consolidation, including scale benefits in IT and operations. At the same time, operational resilience is key in mitigating risks associated with a cross-border group. However, resilience cannot mean that each unit should operate in full isolation. We would urge the ECB to look into local initiatives such as the French Preparedness Obligation to ensure that cross-border bankers are intentionally not being built up, particularly within the Banking Union where the ECB is the single supervisor, as this can erode scale benefits and result in demerger rather than mergers. We take this opportunity to recall that this should also apply with respect to the ECB’s supervision of entities belonging to 3rd country groups

Section II. Obstacles to M&A arising from other legal or regulatory requirements

As the ECB is well aware, regulatory obstacles to business combinations also originate outside of the prudential framework. Our members have highlighted the following examples as having created particular difficulties in the context of past experiences.

In general, in the EU, M&A transactions are facilitated by the universal succession regime applied to mergers, demergers and other corporate transactions. However, in some jurisdictions the direct universal succession from one corporate entity to another is not automatic permitted. For example, a cross-border demerger is not explicitly ruled yet in many jurisdictions and thus a similar goal has to be achieved through more complex structures and burdensome processes (e.g. local demerger into a dedicated domestic “newco” which could need a new banking license, and subsequent cross-border merger of the “newco” into another foreign company). More standardised requirements among European countries for cross-border transactions would reduce the complexity and uncertainty originated by the differences in the local legal and prudential requirements.

Another issue which weighs on cross-border consolidation is the difference in tax regimes between Member States. The tax framework is particularly relevant for M&A transactions: in any cross-border transaction, deferred tax assets could be lost (depending on the transaction structure), even if there is no change in the parent company’s headquarter (see also above). An additional tax inefficiency could be represented by taxes triggered by a change of control not only in case of takeover, but also in case of a merger/combination (for example, in Germany a new company would be required to pay the real estate transfer tax (RETT)).

The AML framework in its current directive-format, leaves too much discretion to local regulation, creating an uneven pattern of rules across Europe. This creates both inefficiencies for institutions operating cross-border and opens up vulnerabilities in the joint effort in combating financial crime. The ECB’s support for the EU action plan on AML, improving harmonization, is therefore very welcome.

Section III. Comments on the draft guide - please refer to the detailed Comments worksheet
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<td>1</td>
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<td>Clarification</td>
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<td>For instance, the ECB could clarify that, depending on whether the project only marginally changes the situation of the acquiring entity or is of significant and notable (for example by changing the nature and the perception of the business model), the ECB could act accordingly in its approach.</td>
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<td>The business plan should consider national law and the proportionality principle (as not set out in CRD/CRD II/PISA), and depending on national transactions, the information may be necessary in cases of change of qualifying holding resulting in a change of control (i.e. depending on the likely influence the proposed acquisition may exercise on the target). Moreover, in the context of a combination between entities under direct ECB supervision, it would also be helpful if the guide could highlight that the ECB’s assessment will leverage on the existing information thus as a result of this iterative nature of the early communication process. Finally, given that the ECB will already have a good understanding of the business models and risk profiles of the entities involved, it would seem more appropriate and more proportionate for the emphasis of the assessment to be on the added value of the proposed project. For this same reason, it should be mentioned in the Guide that the ECB will rely on its existing expertise on individual banks in the context of a M&amp;A transaction in order to avoid additional administrative burden where related to M&amp;A indications (such as those related to fit and proper considerations). This should also include cooperation with other EU and non-EU supervisors as we explain further below.</td>
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<td>While we fully appreciate that each assessment will be done on a case-by-case basis, if the objective underlying this guide is to be achieved, we encourage the ECB to go further and develop a more explicit policy stance on possible downward adjustments to the post-P2.</td>
<td>We very much appreciate the principle in paragraph 26 that consideration will be given to the likely empathy in timing of costs (usually upfront) and benefits (achieved) of a transaction when the ECB is assessing the so-called “post P2” PSRs and PSIGs. Nevertheless, we consider that the ECB should go further in explaining how this principle will be applied in practice, particularly as this is not fully apparent in the following paragraph 27 describing the P2 standing point and adjustments.</td>
<td>No ECB could specify in paragraph 27 that it will adjust P2 to reflect the forwarding of costs usually involved in a business combination. We raise this as it would put remuneration resulting from an external acquisition on par with internal remuneration where costs and benefits are highly unbalanced. We would also suggest the ECB give explicit consideration to a paradigm embedded in the so-called “tsa” element when determining PSR “downward adjustments”. While business combinations need a reasonable period of time before utilising their full potential, we would observe the ECB differentiate between “tsa” and cost synergies. While the former could be perceived to some extent as being less certain, previous transactions have shown that cost synergies are recognised certain and, in some cases, “realised” cost synergies can exceed the expected synergies at the date of the announcement of the transaction. The ECB could take from the Supervisory Review and Evaluation Process (SREP) that has been in place over the past few years to further investigate the extent to which cost synergies have been effectively exploited.</td>
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clarification

We understand that the guidance cannot provide exhaustive lists of examples; however, including further examples in the second bullet point of paragraph 37 of situations likely to result in a downward adjustment could be helpful in clarifying the policy stance.


clarification

For instance, we consider that the ECB may still consider a somewhat longer timeframe than 1 year for providing visibility on the future evolution of P2R and P2G of the new entity or phasing in compliance with the existing P2R and P2G over a number of years. This would, of course, be strongly monitored, and adjustments could depend on the evolution of the risk profile and performance of the combined entity.


clarification

We welcome the confirmation of the principle that the ECB will acknowledge fully verified accounting based on a prudent perspective. However, we consider that the reference in paragraph 38 to expecting badwill to be reclassified for the combined entity serves to obscure whether or not the combined entity has a greater capacity to generate future earnings and capital going forward. As the new combined entity has a greater capacity to generate future earnings and capital going forward, we consider a somewhat longer time-frame than 1 year for providing visibility on the future evolution of P2R and P2G for at least a year, all else being equal.


clarification

The ECB could thus have the opportunity to give an SREP decision for the new entity, rather than for the combined entity, which the ECB should then apply only at the highest level of consolidation of the group in question, particularly where entities within the Banking Union are involved.


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We would also like to make some more specific suggestions which could contribute to an efficient implementation of the roll-out plan. To recognize that this may require temporary waivers, from the CBK’s PD & LGD Estimation Guidelines, and, potentially, discrete adaptations of the CRR level test, we would invite the CBK to flag and discuss these within the relevant regulatory forum as far as they would be appropriate for facilitating M&As.

We would welcome guidance from the CBK in this section of the final guide on how to integrate or harmonize data from an acquired entity into the IT infrastructure of the buyer. For example, the CBK should consider how to do this action plan does not unacceptably reduce the potential viability of the integration exercise.

This would require the CBK to consider how to facilitate the implementation of the required representation analysis in Chapter 4.2 of the CBK’s PD and LGD Estimation Guidelines. This should include consideration of, with the focus being first on the most recent data (e.g. 1-3 years) and potentially a temporary wave of, 5 years. The calibration of ABEs parameters which will be applied to consolidated portfolios, while a joint parameter calibration calculation could be an option, to avoid a buyer’s internal models being uniquely impacted by the historical behavior of the acquired portfolio, a specific parameter could be developed for the acquired portfolio with a phased-in joint publication (e.g., 5 years). Where the acquired banks’ portfolio is not representative, this could be subject to a run-off.

The CBK could consider provision for more flexibility on the model to meet the milestones in their integration plan. Firms would not want to allocate a disproportionate amount of time to consulting with and seeking approval from the CBK in adjusting their plans where the adjustments could have been made internally first – which should be considered on an ad-hoc basis.

Finally, such models could be included in the CBK’s monitoring mandate. If the size of the target firm is insufficient for the buyer or the buyer is not significant for the market, the ECB could consider a more proportionate approach compared to the one involving a more significant acquisition for the buyer firm, its group and/or the market. The parameters of an acquisition which would merit a higher level of scrutiny should be explicitly defined by the CBK.

The ECB envisages applying a high level of scrutiny to overseeing the successful integration plan. Widely firms will seek to submit integration plans with the highest level of accuracy and completeness. It is often the case that the plane will be subject to change – as adverse conditions external or internal or an entity which may require firms to adjust their integration plans (for example, COVID-19).

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As mentioned in Section A of our response to the General Information questionnaire, the new inclusion of capital sufficient to cover minority interests in consolidated own funds represents a substantial impediment to MFA. Minority interest “haircuts” can be significant by way of example, when the EBA clarified that AT1/T2 instruments issued by bank operating companies would be subject to a haircut of the bank holding level in November 2017 (see EBA Q&A 2017_3294), several banks reported a significant impact on their own funds. For instance, at year-end 2017, ABN AMRO reported a haircut of approximately 8% on its own funds of T2. It is possible that the haircut would have been even higher if the bank had been in a reduced capital group and held no capital in a subsidiary. More generally, given that AT1 and Tier 2 instruments can typically represent around a quarter of a bank’s regulatory capital mix in the case of CEEs, AT1/T2 could represent at least 0.15% of RWAs.

For example, when Clydesdale Bank acquired Virgin Money in 2019, the AT1 instrument issued out of the Virgin Money Holding company would have been subject to a minority interest haircut as the Clydesdale Group became a consolidated entity. As the holding of Virgin Money ceased to be an intermediate holding company, as a result, the acquisition was finalized, Clydesdale had to undertake a capital injection and repurchase the AT1 instrument issued out of the Virgin Money AT1, to substitute the issuing entity to Clydesdale Bank. As these examples show, the current regulatory framework for minority interests directly impacts banking consolidation.

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Please note, during the assessment process, the SSM could consider an adjustment of the capital requirement of the acquiring entity to allow for the full inclusion of AT1 and T2 in the consolidated own funds. This could be conceived as a pragmatic approach aiming at alleviating the undesirable consequences of the minority interest haircut. However, for the avoidance of doubt, to the extent that such an increase in the “promotora” capital requirements of the acquiring entity would result in an increase of the capital requirement of such entity, the SSM would not increase the target capital requirement at consolidated level, nor at the legal entity or sub-consolidated levels. We also recall our general point that P2R and P2G should only apply at the highest level of consolidation within the Banking Union.

The ECB could also examine whether it could make greater use in practice of the existing waiver of the minority interest haircut foreseen in CRR Art 84.5. Alternatively, the ECB could explicitly note in the guide that acquiring banks will be given flexibility on repurchases of such capital instruments, by allowing them to be repurchased within 5 years of the issuance date on the secondary market, at market prices consistent with the debt of issues, and, in any event, to be repurchased on a pro-rata basis in the event of a M&A, capital increase or reorganisation.

As a part of the envisaged transition, liability management exercises may need to be undertaken in order adapt the MREL structures in the new group resolution plan. For example, this could involve the need to repurchase or redeem existing MREL, issuance of new MREL, redrafting of the group MREL resolution plan. An appropriate implementation period should therefore be provided for any changes to MREL, or other aspects of resolution planning.

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In case of an M&A transaction, the outstanding stock of MREL eligible capital instruments of the target bank holding company would need to be redefined, in particular as to the parent entity. This could be particularly helpful in situations where consent subsidiaries to ratify the MREL of minority interests in consolidated own funds.

We would welcome clarification in the guide that the newly formed entity will receive a revised DEF, taking into account the revised supervisory framework for the new entity arising from the above.

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While MREL is the appropriate tool for the resolution of a bank that is in distress, it is important to consider the need for increased capital in the event of a major acquisition by an existing bank. This would be an important consideration in the case of a critical probability event, such as a major acquisition.

A critical probability event is defined as an event that has a probability of occurrence of 1 in 100,000 or lower. The SSM would need to consider whether the target bank holding company would be able to absorb the costs of the acquisition, including the costs of any changes to MREL (or other aspects of resolution planning).

In case of an M&A transaction, the outstanding stock of MREL eligible capital instruments of the target bank holding company would need to be redefined, in particular as to the parent entity. This could be particularly helpful in situations where consent subsidiaries to ratify the MREL of minority interests in consolidated own funds.