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DIRECTORATE-GENERAL FOR FINANCIAL STABILITY, FINANCIAL SERVICES AND CAPITAL
MARKETS UNION

The Director-General

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**Subject: Draft regulatory technical standards on own funds and eligible liabilities under
Regulation (EU) No 575/2013**

Dear Mr Campa,

On 25 May 2021, the EBA submitted to the Commission the draft regulatory technical standards ('RTS') on own funds and eligible liabilities under Regulation (EU) No 575/2013 ('Capital Requirements Regulation' or 'CRR').

While the Commission agrees with the main substance of the submitted draft RTS, it also considers that the draft RTS would benefit from some amendments. These amendments relate to the definition of 'indirect funding' (Article 9(2) of the draft RTS) and to the permission regime for certain 'liquidation entities', i.e. entities whose minimum requirement for own funds and eligible liabilities ('MREL') has been set at a level equal to their loss absorption amount (Article 32h of the draft RTS).

With regard to the definition of indirect funding, recital 5 of the draft RTS, inter alia, provides that the rules on indirect funding should capture funding chains independently of whether they involve an external investor or not. This rule is essential, as funding must not originate from the entity that has to comply with the requirement – otherwise, losses might come back to that entity. However, the rule that is outlined in recital 5 is not reflected in the relevant enacting provisions. On the contrary, Article 9(2) of the draft RTS sets out that the investor must not be an internal investor in order to consider a funding chain as indirect funding. Hence, it is necessary that the RTS are modified to reflect the rule that is spelled out in recital 5, that is, to ensure that intragroup circular funding is appropriately captured. This change would ensure an appropriate legal basis for the rule provided in that recital and an appropriate application of the notion of indirect funding to internal TLAC/MREL, and to external TLAC/MREL in the context of groups with multiple point of entry resolution strategies.

To facilitate the understanding of the Commission's amendments in this respect, my services developed examples of (undesirable) funding chains within banking and resolution groups, respectively.

With regard to the permission regime for certain liquidation entities, the proposed draft RTS raise substantive concerns in terms of compliance with the Level 1 text, including with the EBA mandate for these RTS (see dedicated annex). It remains our reading of the CRR that the permission regime is an institution-specific regime, in which a resolution authority may grant a permission for a specific institution based on an *assessment* of an *application* submitted by that institution. This implies that input from the institution is a necessary part of the prior permission regime and that the need for an institution to apply for a permission is inherent to that regime. Consequently, it does not seem legally admissible under the current Level 1 text to consider, by means of an RTS, that the submission of information for the purposes of drawing up a resolution plan shall be deemed as an application to redeem eligible liabilities. In this context, we note that the information for resolution planning is submitted by liquidation entities for a different purpose, under a different legal basis, and with a different frequency than the ones relevant under the permission regime.

The Commission nevertheless continues to agree with the EBA that there is merit in ensuring a proportionate treatment of the liquidation entities concerned. The Commission therefore intends to implement a ‘tacit agreement’ mechanism. Under that mechanism, in case the resolution authority does not reply to or opposes the request from the liquidation entity, the prior permission is to be deemed granted. This mechanism strikes a reasonable balance between, on the one hand, the need for liquidation entities to submit a request for prior permission and for resolution authorities to assess that request, as envisaged under the current Level 1 text, and, on the other hand, the desire to ensure a proportionate treatment for the entities concerned. Looking ahead, the upcoming review of Directive 2014/59/EU (‘Bank Recovery and Resolution Directive’ or ‘BRRD’) may be an opportunity to consider in a holistic manner the treatment of liquidation entities in the MREL framework.

In addition, the Commission intends to make some technical adjustments to improve further the consistency and clarity of the legal drafting and to support the translation process. These amendments would be fully in line with the objectives of the draft RTS and intentions of the co-legislators.

I therefore inform you that the Commission, acting in accordance with the procedure set out in Article 10(1), fourth and fifth subparagraphs, of Regulation (EU) No 1093/2010, intends to endorse with amendments the draft RTS submitted by the EBA on own funds and eligible liabilities, as set out in the annex attached. I look forward receiving EBA’s opinion on the proposed changes, hoping that they can be supported based on the explanations being provided with this letter.

Yours sincerely,

John BERRIGAN
(e-signed)

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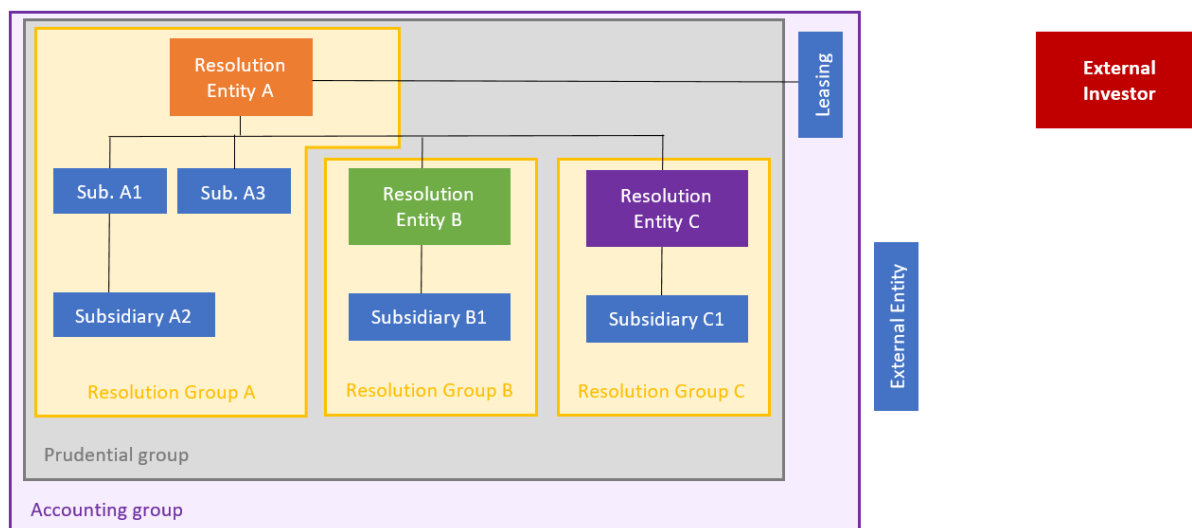
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Enclosure: Annex with examples for (undesirable) funding chains within a group
Annex on legal concerns on the treatment of certain liquidation entities in the prior
permission regime
Intended amendments to draft regulatory technical standards on own funds and
eligible liabilities under Regulation (EU) No 575/2013

Examples for (undesirable) funding chains within a group

The illustration below depicts a banking group with a Multiple Point of Entry (MPE) resolution strategy. That group consists of three resolution groups and, consequently, of three resolution entities (Resolution Entity A, Resolution Entity B, and Resolution Entity C). Resolution Entities B and C are subsidiaries of Resolution Entity A.¹



From a prudential perspective, the following scenarios have to be prevented:

Within a banking group with an MPE resolution strategy:

- Subsidiary B1 gives funds to RE A (or its subsidiaries), and the latter uses those funds to buy external MREL/TLAC of RE B (because RE B controls subsidiary B1);
- RE B gives funds to subsidiaries A1, A2, or to RE C (or its subsidiary), whereby they transfer those funds to RE A who then buys external MREL/TLAC of RE B.

Within a resolution group:

- Subsidiary A2 gives funds to RE A for it to buy internal MREL of subsidiary A1 (because subsidiary A1 controls subsidiary A2);
- Subsidiary A1 gives funds to its sister subsidiary A3 so that it gives funds to RE A, and the latter uses them to buy internal MREL of A1.

However, under the draft RTS submitted by the EBA, the above scenarios would not be prevented. Indeed, according to Article 9(2), point (a), of the draft RTS, an investor would have to be outside the scope of consolidation to allow considering a funding chain as ‘indirect funding’.

¹ For the sake of completeness and to facilitate the understanding of Article 9 of the draft RTS, all subjects and the most relevant scopes of consolidation mentioned in Article 9 have been added to the illustration. This includes an external entity, an external investor, and an entity that is outside the scope of the prudential consolidation but inside the scope of the accounting consolidation (‘leasing’). Evidently, to provide examples on funding chains *within* a group, those aspects are not relevant.

The Commission intends to capture the above scenarios by introducing a new paragraph on intragroup circular funding, i.e. funding granted indirectly by the institution through another group entity to an internal investor. The usage of the word ‘through’ in the proposed amendment should ensure that only those situations are captured where the funding can be traced back to the issuing institution (circular funding, i.e. where, for instance, the institution uses one of its subsidiaries to provide funding to the investor that then buys the instrument of the institution). This avoids impeding daisy chains, where the funding does not come from the subsidiary of the institution but from its parent entity.

The additional safeguards set out in point (b) of the proposed new paragraph should ensure that normal intragroup transactions are not frustrated, unless the funding is explicitly granted to acquire the ownership of the institution’s capital instruments or liabilities. Where the funding is explicitly granted for that purpose, point (a) of the new paragraph, and thus no safeguards, would apply. The wording of point (b) mirrors the wording already used in Article 8(3) of Delegated Regulation (EU) No 241/2014.

The following scenarios do not cause concerns and would still be possible:

- RE C gives funds to RE A and the latter uses them to buy external MREL/TLAC of RE B, because losses of RE B would end up with RE C who is supposed to have its own buffers to absorb them;
- RE A gives funds to subsidiary A1 and A1 uses them to buy internal MREL of A2 (this is the so-called ‘daisy chains’ funding structure which allows RE A to indirectly subscribe the internal MREL of A2, a possibility explicitly provided in the BRRD).

Legal concerns on the treatment of certain liquidation entities in the prior permission regime

1) The mechanism implemented in the draft RTS for the granting of prior permissions to certain liquidation entities does not seem to be compatible with Articles 77(2) and 78a of the CRR

1.1.) A regular submission of information for the purposes of resolution planning cannot be given, through RTS, the status of an application by a liquidation entity for general prior permission

The permission regime laid down in Articles 77(2) and 78a of the CRR is an institution-specific regime, in which a resolution authority may grant a permission (be it a general or an ad-hoc permission) for a specific institution based on an assessment of an application submitted by that institution. This implies that input from the institution is a necessary part of the prior permission regime, regardless of whether it is a general or an ad-hoc permission, and that the need for an institution to apply for such permissions is inherent to that regime.

The need for an application from the institution – in other words, for the institution to convey an explicit will to receive a prior permission to redeem eligible liabilities – is relevant due to the fact that a prior permission has consequences for the institution. Most importantly, any amounts whose redemption has been authorised by the resolution authority have to be deducted from the institution's eligible liabilities instruments from the moment the authorisation is granted, in order to accurately reflect the loss-absorbing capacity of the institution. It would thus not be appropriate for the resolution authority to cause a reduction in an institution's stock of eligible instruments without its prior consent. For reasons of legal certainty, the entity needs to submit a specific application for the granting of a prior permission.

In this context, it does not appear legally acceptable to consider, by means of RTS, that the submission of information for the purposes of drawing up a resolution plan should be deemed as an application for a general prior permission to redeem eligible liabilities. The information for resolution planning is submitted by a liquidation entity for a different purpose than the one intended by the prior permission regime and under a different legal basis (which, unlike the prior permission regime, is not even in the CRR: it is in the Single Resolution Mechanism Regulation and/or the national transpositions of the BRRD). While it is true that the RTS allow the liquidation entity to request an exemption from the general prior permission, the Commission does not agree that the submission of information for drawing up resolution plans should represent an explicit and clear will of the liquidation entity to ask for and receive said general permission. For instance, there may be liquidation entities which must provide information for resolution planning purposes and which do not wish to pursue a prior permission to redeem any instruments.

It should also be noted that the drafting of Article 32h(1) of the draft RTS could be made more precise. Article 32h(1) of the draft RTS says that “*the resolution authority may grant a general prior permission [...] based on the information available to it for the purposes of drawing up the resolution plan which shall be deemed as a complete application*”. Under this draft provision, the complete application should be “the information available to the resolution authority” (which may include information obtained through other sources, e.g. transmitted by the competent authority), and not necessarily the submission of the information by the liquidation entity. Therefore, an action by the liquidation entity does not even appear necessary under the legal construction of the draft RTS – the resolution authority may take the decision on the basis of information already in its power, e.g. submitted by the institution even before the start of application of the RTS.

1.2.) *The automatic renewal of the general prior permissions granted to liquidation entities does not allow the resolution authority to verify whether the respective conditions continue to be met*

Article 78a(1), second subparagraph, of the CRR provides that general prior permissions for the redemption of eligible liabilities must be granted for a specified period of time which may not exceed one year, after which it may be renewed.

In what concerns the normal procedure for granting prior permissions, the content of the application for a renewal and the timing for its submission are set respectively in Article 32f and Article 32g(3) of the draft RTS. The resolution authority is required to take a decision on the renewal of the general prior permission, where it must verify that the requirements for granting that permission continue to be met.

However, for the simplified procedure applicable to liquidation entities, the general prior permission is renewed automatically for the same period and the same predetermined amount, pursuant to Article 32h(2) of the draft RTS, provided that the MREL requirement of the liquidation entity has not changed or that the liquidation entity has not applied for a withdrawal.

This raises the question of whether this automatic renewal appropriately allows the resolution authority to verify whether the conditions set out in Article 78a(1) of the CRR for the granting of general prior permission continue to be met. Article 78a(1), third subparagraph, of the CRR requires resolution authorities to withdraw the general prior permission where the legal criteria are breached, which in turn implies that the general prior permission does not cease to apply *ex lege* by the mere occurrence of those breaches.

It should be noted that, unlike large institutions who submit information for the purposes of resolution planning at least annually, liquidation entities are generally subject to simplified obligations under Article 4 of the BRRD, meaning that they submit that information and have their resolution plans updated with a frequency lower than one year. Liquidation entities are also not subject to MREL monitoring requirements pursuant to Article 45i(4) of the BRRD. This implies a disconnection between the duration of the general prior permission (maximum one year) and the submission of information that would allow resolution authorities to reassess whether the legal conditions continue to be met (with intervals exceeding one year).

The Commission is sensitive to the need to reduce the administrative burden for the resolution authorities and for liquidation entities arising from the need to obtain a permission prior to the redemption of eligible liabilities. Nevertheless, an automatic renewal does not seem to appropriately allow the resolution authority to verify whether the conditions set out in Article 78a(1) of the CRR continue to be met.

2) The draft RTS could better specify the procedure, including the time limits and information requirements, for granting the general prior permission under the simplified regime as per the mandate under Article 78a(3), point (c), of the CRR

2.1.) *On specifying the time limits:*

With respect to the normal procedure for requesting prior permissions (either general or ad hoc), Article 32i, paragraphs 1 to 4, of the draft RTS specify the timing for institutions to transmit the applications to resolution authorities. However, for the simplified procedure for liquidation entities, Article 32h(1) of the draft RTS does not specify at what point in time these entities would submit the application for a general prior permission (e.g. at any time or only when submitting information

for the purposes of resolution planning). It is thus unclear whether liquidation entities may ask for a general prior permission at any time or only when submitting information for the purposes of resolution planning.

As mentioned, liquidation entities are generally subject to simplified obligations and report their information with a frequency lower than one year. If liquidation entities can only (indirectly) ask for a general prior permission through the submission of information for drawing up resolution plans, it may put them at a disadvantage vis-à-vis the other institutions.

Additionally, and more importantly, Article 32h of the draft RTS does not specify the timeline for resolution authorities to decide whether to grant the general prior permission. This may be problematic, as it means that resolution authorities are not bound to take the decision in any timeframe and that liquidation entities may be left without a general prior permission for a longer period than other institutions. If Article 32h of the draft RTS is to be understood as requiring resolution authorities to take that decision when adopting the resolution plans for liquidation entities, then that could mean a delay of almost one year or more between receiving the information and taking the decision. For the normal procedure, the timeframe for decision-taking is set out in Article 32i(5) of the draft RTS.

Therefore, Article 32h of the draft RTS should better specify the time limits for granting a general prior permission to liquidation entities, which are necessary to ensure legal certainty and deliver on the CRR mandate.

2.2.) *On specifying the information requirements:*

For the normal procedures, the content of the application for the purposes of receiving an ad hoc or general prior permission, or for renewing the latter, is spelled out in detail in Articles 32d, 32e and 32f of the draft RTS. Conversely, no such detail is provided for the content of applications for general prior permissions for liquidation entities because, the “*information available to [the resolution authority] for the purposes of drawing up the resolution plan*” is to be deemed a complete application.

As mentioned, liquidation entities are most likely subject to simplified obligations, which means they do not have to transmit to the resolution authority all the information set out in Section B of the Annex to the BRRD. The information requirement is determined through a case-by-case decision of the resolution authority. And, because the information for resolution planning is not submitted for the purposes of requesting a general prior permission, there is no opportunity for the liquidation entity to convey to the resolution authority that it wants to receive a permission (only that it does not want it), for what predetermined amount and for what period.

This also raises the question of the basis on which the resolution authority will decide on the details of the decision to grant a general prior permission, if it cannot be sure that the liquidation entity is interested in receiving it. Under the mechanism proposed in the draft RTS, the resolution authority would know which liquidation entities *do not want* to receive a general prior permission, but it does not know which liquidation entities effectively *want* to receive it. In case the number of entities pursuing the redemption of eligible instruments and requesting a prior permission is lower than the number of entities not pursuing it, this mechanism in fact may create more administrative burden. Article 78a(1), second subparagraph, of the CRR requires general prior permissions to be granted for a specified period and for a certain predetermined amount. Everything considered, the mechanism in the draft RTS clearly implies some informal exchanges between the resolution authority and the liquidation entities still need to take place to set the details of the general prior permission, which should instead be regulated in the draft RTS.

The draft RTS should provide for a self-standing possibility for the liquidation entity to inform the resolution authority that it wants to receive a permission, as well as to indicate for what predetermined amount and for what period, in order for the resolution authority to have sufficient information to grant a general prior permission.