

**Subject : EBA/CP/2012/17**

**Date : 12 July 2013**

## **Société Générale Comments on deductions of indirect and synthetic holdings under article 33 of the CRR**

Société Générale welcomes the opportunity to comment on the consultation on *Regulatory Technical Standards on Own Funds under Articles 33(2), 69a(6) and 79(3) of the Capital Requirements Regulation – Part Three*.

### **Synthesis of the comments**

CRR requires firms to make deductions from capital on investments in the capital of banking, financial and insurance entities that are outside of the scope of consolidation, where the firm does not hold more than 10% of the issued common share capital of that entity. Investment for the purpose of this requirement extends to direct, indirect and synthetic holdings of capital instruments which may be held in either the banking or trading book, excluding underwriting positions held for five working days or less. The deduction is based on calculating the net long position. This is derived by calculating the value of the gross long position less the value of the gross short position in the same underlying exposure. For indirect or synthetic holdings, including index positions, this requires looking through the instrument to the underlying exposure and identifying the specific instrument(s) referenced and its value. Only short positions which match the maturity of a long position or have a residual maturity of more than one year are permitted to be included in the population of short positions.

We also would like to draw your attention to another major issue relating to the scope of financial sector entities that shall be considered for the purpose of deduction according to article 4 (27) of CRR. They include mixed activity holding companies which are “*parent undertaking, other than a financial holding company or an institution or a mixed financial holding company, the subsidiaries of which include at least one institution*” (article 4 (22) of CRR). *Stricto sensu*, that would have the unattended consequence of including in the scope of deduction any corporate entity that would hold an insignificant financial entity (for the purpose of treasury management for instance) with all detrimental consequences of banks reducing investments in such entities. We have the same concern for mixed-activity insurance holding companies (article 4 (27) of CRR).

We do not believe that this is what the regulation aims at when requiring deduction, which is avoiding the systemic risk of interconnection of capital within the financial sector. We are conscious that amending the definition of FSE in the CRR to the Basel 3 text is not part of the mandates of EBA. However considering the potential detrimental impact to the EU economy, we urge EBA to exclude the mixed activity holdings from indirect holdings.

Our comments will focus on two major issues posed by the RTS currently under consultation:

- **Our major concern is that the RTS stipulates that the exposure shall be the notional amount of the relevant instruments. The new restriction does not have any accounting, nor risk rationale and may lead to inconsistent risk management behaviour between financial and non-financial equity markets. Actually, it conflicts with the rules within “Own funds requirements for position risk” and market risks regarding the evaluation of such exposures.**
- Our second concern relates to the **look-through approach** which is operationally almost impracticable for market activities and uncorrelated with the way the risks are actually hedged and monitored. The definition of exposures may be so extensive that it ends up not reaching

the purpose of such deductions, which is avoiding double counting of capital within the financial system.

We believe the current RTS text could:

- Significantly increase costs to financial market end-users, including pension funds and asset managers, who enter into index positions to express an investment view or hedge a risk;
- Unnecessarily restrict market-making activity, potentially resulting in a significant reduction in market liquidity for financial institutions' equity;
- Make investments in financial institutions far less attractive to investors, at a time when policymakers would like banks to raise more capital; and
- Cause banks to use less effective hedges, thereby potentially increasing basis risk and providing a disincentive to prudent risk management.

### **More detailed considerations, including responses to questions**

#### Question 1

*Are the provisions of Article 14a sufficiently clear? Are there issues which need to be elaborated further?*

There are a number of things that need further clarification in Article 14a(1) :

1. The expression 'but not limited to' is superfluous, as the reference to 'any exposure' would already take account of all possible situations where the firm has risk to the intermediate entity.
2. 'Any exposure' may lead to different interpretation and uncertainties. The extension to 'senior exposure' is unclear and need to be clarified as it must not encompass other exposures such as loans, derivative exposures or other various banking transactions with the intermediate entities. Indeed, a creditor of an intermediate entity is not deemed to be treated as a shareholder or a holder of capital instruments, as it will be redeemed in accordance with the relevant contracts. What such deduction aims at, is avoiding the systemic risk of cross-holdings within the financial system.
3. The scope of entities shall also be reviewed and it should be clear, in relation to CRR article 46 and the financial Conglomerate regulation, that insurance entities that are within the financial conglomerate shall be excluded article 14 a.
4. Also, the RTS should specify that it relates to 'direct holdings' by the intermediate entities of the capital instruments of financial sector entities. Where these intermediate entities were to hold shares of financial sector entities indirectly – via an index or synthetically via derivatives, it would be impossible for the firm who tries to look through the intermediate entity, or in case of serial structure – through multiple intermediate entities, to assess the size of its indirect holding.

#### Questions 2 and 3

*Provisions included in paragraph 1 of the following Article 14a refer in particular to pension funds. These provisions have to be read in conjunction with the deductions referred to in Article 33(e) of the CRR. Would you see any cases where there might be an overlap between the two types of deductions? Please describe precisely these situations and the nature of the problem.*

*Please provide also some input on the potential impact? What would be the size of the deduction of defined benefit pension funds under the treatment proposed in the following Article? Would the treatment cause a change in the investment policy of the pension fund with regard to such holdings, or have any other consequences for the operation of the defined benefit pension scheme?*

Actually, we believe that there may be an overlap and that the RTS shall exclude from article 14 (a) any exposure already deducted under Article 33 (e).

We also believe that this clause will certainly lead institutions to prevent pension funds from investing in holdings of financial institutions which will have two damageable consequences:

- Increase the risks of pension funds through limiting the diversification of their assets portfolios;
- Unnecessarily restrict market-making activity, potentially resulting in a significant reduction in market liquidity for financial institutions' equity;

#### Question 4

*Do you agree with the examples of synthetic holdings provided in paragraph 2 of the following Article 14a? Should other examples be added to this list?*

We agree with the example. For the avoidance of doubt, the only additional comment to the list of proposed synthetic holdings would be that a symmetrical recognition of eligible short synthetic positions should apply (i.e. short call, long put options, short TRS or futures / forward contracts on a single name underlying) when calculating the net long position at underlying level in accordance with CRR. A broader wording would be welcome in order to avoid any misunderstanding.

#### Question 5

*Are the provisions contained regarding synthetic holdings in paragraph 2 of the following Article 14a and in Article 14e sufficiently clear? Do you agree that the amount to be deducted shall be the notional amount? Would you see any situations where another amount shall be used?*

We strongly disagree with the use of the notional amount, which does not reflect the way that trading books are currently managed: when an institution enters into a transaction referred to in art a.2 of the proposal (call, put options, forwards indexed on shares issued by the financial sector..), it immediately hedges the market risk through adjusted opposite positions in the relevant shares (ie: taking a short position when the institution purchases call options or sells put options, or taking long positions when the institution is selling call options or purchasing put options).

Above all, the market risk is managed globally, taking into account all the synthetic holdings incurred through derivative transactions, and the net synthetic long or short position is actively managed through opposite short or long positions in the relevant shares issued by the financial sector.

The potential long position serves as a perfect hedge of the net short position incurred through the derivatives instruments and is not considered as a holding that can create an additional risk for the institution, as it is covered by the opposite short position. This is currently the way that market risks are managed in the financial institutions, and we do not understand why the notional amount method should be preferred for the deduction of holdings.

This is why, in our view, the net delta method must be used for the calculation of exposures. **Such notional amount method would result in the credit institution deducting an artificially high net exposure, in total contradiction with the fact that the trading activities are delta neutral (no directional position).**

The net position, calculated in accordance with existing position risk requirements, should be the basis of any deduction. We believe this will be in line with the original intention of the rule: to reduce interconnectedness and promote equity financing of financial institutions from outside the financial sector.

#### Question 6

*Are the provisions relating to the deduction of serial or parallel holdings through intermediate entities sufficiently clear? Do you see any unexpected consequences? Are there issues which need to be elaborated further?*

From a practical standpoint, this clause is operationally unrealistic and seems to be achievable only in two realistic scenarios:

1. in the case of exchange traded funds
2. when institutions and intermediate entities specified in Art.14a are part of the same groups in the sense of accounting consolidation.

#### Question 7

*Are the provisions of Article 14d relating to a structure-based approach sufficiently clear? Are there issues which need to be elaborated further?*

As an alternative and upon determination by the competent authority, the draft RTS allows using the structure-based approach to estimate the value of the indirect holdings. Structure-based approach requires taking into account separately the amount that the intermediate entities hold in own CET1 instruments and the amount that the intermediate entities hold in the CET1 instruments of other financial sector entities on an aggregate basis. Such information is not readily available. If the institution does not know these two amounts, they may be estimated as the maximum amounts that the intermediate entities are able to hold on the basis of their investment mandates. The latter is not available information as funds do not publish it. When the institution is not able to determine on the basis of the investment mandate the maximum amount, the draft RTS requires a full deduction in the same way as the institution's own shares, which is the most punitive approach in terms of capital charge. We do not understand the rationale of this proposal that mixes up different kind of risks and exposures (exposures to own shares with exposures to financial sector entities).