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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

on the rules governing the levels of application of banking prudential requirement

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1. INTRODUCTION

The supervision of a banking group which is composed of several credit institutions or investment firms (hereafter 'institutions') is carried out at two levels, the level of the entire banking group and the level of each institution of the group. The first level corresponds to the supervision on a consolidated basis and the second level corresponds to the supervision on an individual basis. According to this principle of dual-level supervision, the banking prudential rules set out in Directive 2013/36/EU[1] (hereafter 'CRD') and Regulation (EU) No 575/2013[2] (hereafter 'CRR') shall apply at both individual and consolidated levels. However, this principle is subject to a number of exceptions.

The purpose of this report is to assess the appropriateness of the rules governing the levels of application of the prudential requirements set out in CRD and CRR, in particular the exemption regime. This report jointly covers two mandates given to the Commission by the European Parliament and the Council as specified in Article 161(4) of CRD and Article 508(1) of CRR:

– the first mandate requires the Commission to review and report by 31 December 2014 to the European Parliament and the Council, together with any appropriate legislative proposals, on the application of Articles 108 and 109 of CRD; these two articles specify the levels of application of the prudential requirements laid down in Articles 73 to 96 of CRD, as regards the internal capital adequacy assessment process (ICAAP), governance arrangements, risk management and remuneration policies;

– the second mandate requires the Commission to review and report on the application of Part One, Title II and Article 113(6) and (7) of CRR. Part One, Title II of CRR specifies the rules for applying on an individual or a consolidated basis all the other prudential requirements set out in CRD and CRR to institutions, including those in cooperative networks and institutional protection schemes (IPS). Article 113(6) and (7) of CRR specifies the conditions to be satisfied to exempt from liquidity requirements on an individual basis institutions which are members of the same IPS or institutions which are linked by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC[3].

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[1] 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, 27.06.2013, p. 338).

[2] 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).

[3] Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts (OJ L 193, 18.07.1983, p.1).

The report is based on the opinion delivered by the European Banking Authority (EBA) in consultation with national competent authorities on 31 October 2014[4].

The next section gives an overview of the various rules governing the levels of application of prudential requirements, to begin with a clear appreciation of the issues at stake. The third section identifies differences, inconsistencies, and interpretation issues in these rules. The conclusion proposes a way forward to address the issues identified.

2. OVERVIEW OF THE RULES GOVERNING THE LEVELS OF APPLICATION OF PRUDENTIAL REQUIREMENTS SET OUT IN CRD AND CRR

2.1. The general rule of dual-level supervision

As a general rule, a banking group which is composed of one or more institutions is subject to prudential requirements on both individual and consolidated bases. At the individual level, each institution within the banking group shall comply with the prudential requirements on the basis of its own situation in accordance with Article 6 of CRR. At the consolidated level, the entity at the head of the banking group is required to abide by the prudential requirements on the basis of the consolidated situation of the banking group in accordance with Article 11 of CRR.

2.1.1. A general rule consistent with the BCBS standards

The rule of dual-level supervision is a key element of the Core Principles for Effective Banking Supervision revised by the Basel Committee on Banking supervision (BCBS) in September 2012. These principles stress the importance for supervisory authorities to supervise each bank in the group on a stand-alone basis, in addition to supervision on a consolidated basis.

The general rule of dual-level supervision is also consistent with the June 2006 BCBS framework[5] which recommends that prudential rules should apply to any internationally active banking group on a consolidated basis and at the level of each internationally active banking subsidiary within such a banking group.

2.1.2. Both levels of application complement each other

The levels of application are complementary. The application on an individual basis enables competent authorities to focus on the institution itself while the application on a consolidated basis allows an overall assessment of the whole group to which the institution belongs. The consolidated supervision helps competent authorities to better identify and monitor the threats that other group entities may pose to each institution within the group, which in turn strengthens the supervision of institutions on an individual basis.

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[4] Opinion of the EBA on *the application of Articles 108 and 109 of Directive 2013/36/EU and of Part One, Title II and Article 113(6) and (7) of Regulation (EU) No 575/2013*, 29 October 2013.

[5] June 2006 BCBS framework - *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version.*

The application on an individual basis is consistent with the fact that liabilities have to be repaid by legal entities, meaning that parent entities are in general not legally responsible for liabilities incurred by subsidiaries. On the other hand, the application on a consolidated basis helps to avoid double counting of capital where an entity holds capital issued by another entity within the same group. Application at individual level in turn helps supervisors to ensure that own funds are appropriately distributed within the banking group and available to protect savings or investments.

The consolidated application enables competent authorities to supervise financial entities that are not directly supervised on an individual basis. The scope of consolidation includes all entities carrying out activities of banking or financial nature, including those that are not qualified as institutions such as asset management companies, payment institutions, or financial holding companies. On the other hand, the application of prudential requirements on an individual basis helps competent authorities to better detect intra-group risks that cannot be detected by the consolidated application alone.

2.2. Exceptions to the general rule

The principle of dual-level supervision is subject to the following exceptions:

– competent authorities in a Member State may exempt a subsidiary or its parent from solvency requirements on an individual basis where the subsidiary and its parent are established in that Member State, are supervised on a consolidated basis and subject to the same risk management framework without obstacles to the transfer of funds pursuant to the conditions set out in Article 7 of CRR; this exemption may be extended to the prudential requirements set out in Articles 74 to 96 of CRD pursuant to Article 109(1) of CRD;

– competent authorities in a Member State may exempt a central body and credit institutions permanently affiliated to that central body from compliance with all prudential requirements on an individual basis where the conditions set out in Article 10 of CRR are met; this exemption may be extended to internal capital requirements pursuant to Article 108(1) of CRD;

– competent authorities may exempt a parent institution and its subsidiary from disclosure and solvency requirements (with the exception of leverage requirements) on an individual basis by allowing the parent to incorporate its subsidiary in the calculation of its solvency requirements where the conditions set out in Article 9 of CRR are fulfilled;

– competent authorities may exempt a group of institutions from liquidity requirements on an individual basis and supervise them as a single liquidity subgroup where the conditions set out in Article 8 of CRR are met[6]; this exemption can also apply to institutions which are members of the same IPS and institutions which are linked by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC, provided that they meet the conditions laid down in paragraphs 6 or 7 of Article 113 of CRR;

[6] Where the institutions are authorised in several Member States, the competent authorities of the various Member States need to reach a common agreement pursuant to Articles 8(3) and 21 of CRR.

– Pursuant to paragraphs 4 and 5 of Article 6 of CRR, investment firms with limited authorisations to provide investment services are not subject to liquidity and leverage requirements on an individual basis; competent authorities may also exempt any investment firm from compliance with liquidity requirements on an individual basis taking into account the nature, scale and complexity of its activities; Article 11(3) of CRR extends this exemption to liquidity requirements on a consolidated basis where the group comprises only investment firms;

– Pursuant to Article 16 of CRR, a group of investment firms is allowed not to comply with leverage requirements on a consolidated basis, provided that all group entities are investment firms that are not subject to leverage requirements on an individual basis;

– Pursuant to Article 15 of CRR and Article 108(1) of CRD, the consolidating supervisor may exempt a group of investment firms from capital and ICAAP requirements on a consolidated basis, provided that the group does not include credit institutions, and all investment firms in the group carry out limited investment activities or services;

– Pursuant to Article 6(3) or 13 of CRR, no institution included in a prudential consolidation, except for significant subsidiaries, is required to comply with disclosure requirements on an individual basis; institutions are exempted from disclosure requirements on a consolidated basis where equivalent consolidated disclosures are provided by a parent undertaking established in a third country;

– Pursuant to Article 6(2) of CRR, no institution included in a prudential consolidation is required to apply on an individual basis the prudential treatments laid down in Articles 89, 90 and 91 of CRR to qualifying holdings in undertakings carrying out non-financial activities;

– entities of a banking group may be excluded from the scope of prudential consolidation under certain circumstances as described in Article 19 of CRR.

2.3. Justifications to the exceptions

Exempting institutions belonging to a banking group from solvency requirements on an individual basis under Articles 7, 9 and 10 of CRR is justified where these institutions can be regarded as a single entity. This may happen where all group entities are linked together through strong control relationships and where they are supervised on a consolidated basis by the same authority while being subject to a group-wide risk management framework with robust intra-group commitments and without obstacles to capital movements. In such situation, the application of prudential requirements on an individual basis does not add value to the supervision on a consolidated basis.

Exempting institutions belonging to a banking group from liquidity requirements on an individual basis under Article 8 of CRR helps facilitate group-wide liquidity risk management and avoids trapped pools of liquidity due to restrictions of the group’s internal liquidity transfers which would result from the application of liquidity requirements to each institution within the banking group.

Excluding entities of a banking group from prudential consolidation under Article 19 of CRR is deemed appropriate, where parent entities face restrictions which substantially hinder the exercise of the parents' rights over subsidiaries, or where the activities carried out by a group entity are so different from those of other group entities that its inclusion does not give supervisors a correct view of the banking group.

The exemptions under Article 6(3) and 13 of CRR are based on the principle that requiring non-significant subsidiaries to disclose prudential information at individual level does not contribute significantly to market discipline, given the prudential information already-disclosed at group level.

The exemptions under paragraphs 4 and 5 of Article 6 and Article 16 of CRR are due to the fact that the liquidity and leverage ratios were originally developed by the BCBS with a view to applying to credit institutions and not to investment firms and without taking account of the specificities of the activities and services provided by investment firms.

The exemption under Article 15 of CRR aims at avoiding that groups of investment firms with limited investment services or activities are disproportionately burdened by capital requirements. However, to preserve the solvency of these financial groups, the granting of this exemption is coupled with additional conditions to fulfil in terms of the calculation of capital requirements, own funds and internal control.

2.4. Use of the waivers in the EU

The use of some waivers appears relatively limited across the EU:

– only 5 of 28 Member States grant the waiver under Article 7 of CRR;

– only three Member States allow parent institutions to consolidate subsidiaries in accordance with Article 9 of CRR;

– only a small number of group entities are excluded from the scope of prudential consolidation pursuant to Article 19 of CRR;

– only two Member States exempt institutions from requirements on governance, remuneration and risk management pursuant to Article 109(1) of CRD.

The waiver under Article 8 of CRR applies in a cross-border context only since 1 January 2015.

Conversely, the application of the derogation under Article 10 of CRR for cooperative networks is relatively extensive since a large number of central bodies and affiliated credit institutions in at least six Member States benefit from this exemption, which may in turn allow them to be exempted from ICAAP requirements pursuant to Article 108(1) of CRD.

While appearing of lesser material importance, waivers may strongly influence the structure and internal organisation of EU banking groups and the way competent authorities supervise banking groups. Changes to the existing rules might result in potentially far-reaching adjustments and costs for institutions, competent authorities, and EBA. However, there may be some merit in reviewing the derogation regime in the future to take account of the lessons

learnt from the application of the liquidity coverage requirement and the Single Supervisory Mechanism (SSM).

3. ISSUES IDENTIFIED IN THE RULES GOVERNING THE LEVELS OF APPLICATION OF PRUDENTIAL REQUIREMENTS

The analysis of the rules governing the levels of application of prudential requirements raises the following differences, inconsistencies and interpretation issues that merit further consideration.

3.1. Differences in the derogations applied to credit institutions and investments firms

Credit institutions and investment firms are subject to prudential requirements on both individual and consolidated bases unless exempted. However, the derogation regime is not similar for both types of institutions. Unlike credit institutions, investment firms may be exempted from compliance with liquidity or leverage requirements on an individual basis pursuant to Article 6 of CRR, without being required to meet specific conditions. Unlike groups of credit institutions, competent authorities may waive groups of investment firms to comply with prudential requirements on a consolidated basis in accordance with Article 11(3), 15 or 16 of CRR.

There may be some merit in maintaining less stringent rules for investment firms, given their size, the nature of their activities or their risk profiles. It will be therefore important to understand whether such differentiated treatment could give rise to negative effects. The Commission will review the derogation regime applicable to investment firms as part of the overall review of the whole prudential regime applicable to investment firms that the Commission has to carry out in 2015 pursuant to Article 508(2) and (3) of CRR.

3.2. No integration of resolution aspects in the rules

The conditions for exempting institutions from prudential requirements on an individual basis do not take resolution aspects into consideration. These conditions could be reviewed in light of the new requirements introduced in Directive 2014/59/EU[7] (hereafter 'BRRD') to maintain coherence between banking resolution and the way banking groups are supervised. In particular, the existence of a group financial support agreement as specified in Chapter III, Title II of BRRD could be taken into account when assessing whether there are impediments to the free movement of funds within the banking group.

3.3. Existence of derogations with inappropriate scope of application

Competent authorities may exempt institutions from the prudential requirements set out in Articles 74 to 96 of CRD on an individual basis in accordance with Article 109(1) of CRD. However, Articles 74 to 96 cover fundamental prudential requirements, for example, the

[7] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council **(**OJ L 173, 12.6.2014, p. 190).

implementation of robust governance arrangements, effective risk management processes and robust internal control mechanisms. Competent authorities are therefore reluctant to grant this exemption because these requirements are considered essential for effective prudential supervision. It is therefore more prudent to limit the scope of this exemption where the application of these requirements on an individual basis is not essential and can be adequately replaced with an application on consolidated basis.

In addition, Article 9 of CRR does not allow for exempting institutions from leverage requirements, which is permitted under Article 7 of CRR. It might be worth considering the possibility of better aligning these two articles.

3.4. Incomplete conditions for the application of waivers

Parent institutions and their subsidiaries may be exempted from prudential requirements on an individual basis under Article 7 of CRR, provided that certain conditions specified in that Article are met. However, there might be some merit to supplement the current conditions with further specifications as follows:

– Control relationships between the parent undertaking and the subsidiaries should be assumed where the parent undertaking has the power to issue binding instructions to its subsidiaries; such a condition already exists under Article 10 of CRR;

– The implementation of the risk management framework of the parent undertaking in the subsidiaries could be assumed where a uniform and integrated risk management framework is established in both the parent undertaking and subsidiaries.

3.5. Misalignment of exemption rules between CRD and CRR

The supervisory review and evaluation process (SREP) applies at the same level as the level of application of prudential requirements set out in CRR. As the ICAAP under Article 73 of CRD is the starting point of the SREP and the latter covers the obligations set out in Articles 74 to 96 of CRD, the levels of application of the prudential requirements specified in Articles 108 and 109 of CRD may lead to the following inconsistencies:

– The ICAAP and prudential requirements set out in Articles 74 to 96 of CRD may not apply at the same level where institutions are exempted under Article 108(1) or 109(1) of CRD;

– Institutions benefitting from the derogations provided for in Article 8 or 9 of CRR may be required to apply the prudential rules set out in Articles 73 to 96 on an individual basis;

– The granting of the exemption under Article 108(1) of CRD is not determined by the granting of the exemption under Article 10 of CRR, meaning that credit institutions permanently affiliated to a central body may be exempted from capital requirements on an individual basis while being subject to internal capital requirements;

– Institutions belonging to banking groups are not required to implement the ICAAP on an individual basis whereas they are subject to solvency requirements at this level.

The levels of application of the ICAAP and the prudential rules on governance arrangements, risk management and remuneration policies as set out in Articles 108 and 109 of CRD could therefore be made consistent with the levels of application of the other prudential requirements set out in CRR and CRD. Requiring an ICAAP for every institution in a large banking group might, however, be considered excessively burdensome, particularly for those institutions which are not significant in relation to the rest of the group. Jointly with ICAAP requirements on a consolidated basis, where applicable, the ICAAP could therefore apply on an individual basis to any institution, including those belonging to banking groups, except where competent authorities make use of the derogations under Article 7, 9 or 10 of CRR, taking account of the significance of the institution in relation to the rest of the group.

3.6. Insufficient monitoring of the entities excluded from the scope of prudential requirements

Banking groups are allowed to exclude group entities from the scope of prudential consolidation pursuant to Article 19(1) of CRR without referring to their competent authorities. However, it could be worth assessing the costs and benefits of requiring banking groups to notify the use of the waiver under that Article to their competent authorities so that the latter could grant permission to banks before undertaking exclusions and monitor the number of entities and volume of assets covered by the waiver.

3.7. Interpretation issues identified

3.7.1. Risk of divergent interpretation on how to apply remuneration rules on a consolidated basis

Article 92 (1) of CRD requires competent authorities to ensure that the principles and rules on remuneration laid down in Articles 92 to 95 of CRD apply to institutions at group, parent company and subsidiary levels, including those established in offshore financial centres. Recital 67 of CRD clarifies that this is to protect and foster financial stability within the Union and to address any possible avoidance of the requirements laid down in CRD.

A number of the remuneration requirements in Article 92 of CRD apply only to staff whose activities have a material impact on an institution's risk profile. The Commission Delegated Regulation (EU) No 604/2014[8] set out criteria to identify such staff at group, parent company and subsidiary levels.

Moreover, pursuant to Article 92 (2) of CRD the remuneration requirements are to be applied in a manner and to an extent that is appropriate to the institutions' size, internal organization and the nature, scope and complexity of their activities. The updated EBA guidelines on the application of the remuneration rules will contain further guidance on the scope of the concept of ‘group’ and the application of the proportionality principle, which will help address risks of divergent interpretation and application of the remuneration rules.

[8] See Article 1 of Commission Delegated Regulation (EU) No 604/2014 of 4 March 2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile (OJ L 167, 6.6.2014, p. 30).

It should also be noted that Article 161(2) of CRD provides for the Commission, in close cooperation with EBA, to review the provisions on remuneration by 30 June 2016. This review will, amongst other elements, assess efficiency, implementation and enforcement of remuneration provisions, including the identification of any lacunae arising from the application of the principle of proportionality.

3.7.2. Risk of diverging interpretation of the conditions to the application of waivers

Institutions may be exempted from solvency or liquidity requirements in accordance with Articles 7, 8 or 9 of CRR, provided that there is no impediment to funds movements. However, supervisors may face difficulties in identifying impediments. Clarifying this could help enhance the convergence of supervisory practices on the application of the waivers. More broadly, the conditions set out in those three Articles, especially in Article 8 of CRR, might benefit from further specifying how to reduce risk of diverging interpretation from authority to authority.

3.7.3. Unclear treatment of institutions holding participations in financial entities established in third countries

Article 22 of CRR and Article 108(4) of CRD stipulate that a subsidiary institution which holds participations in a financial entity established in a third country shall apply on a sub-consolidated basis the capital and large exposure requirements as well as the rules related to qualifying holdings and those related to ICAAP. However, the purpose of these two Articles is open to several possible interpretations. Consequently, the treatment applicable to institutions holding participations in financial entities established in third countries could be clarified.

4. CONCLUSION

It does not appear suitable to propose amendments to the existing rules in the wake of the report as the Commission needs to continue to reflect further on whether and how these exceptions and conditions for their application should be maintained. Some of these considerations will be particularly apposite in the context of SSM. Moreover, since some rules are new or have not been used extensively yet, experience in their application must still be gained so that the Commission could carefully assess the feasibility of amending the existing rules.

It also appears particularly important to take account of the conclusions of the report on the prudential regime for European investment firms that the Commission shall issue in accordance with Article 508(2) and (3) of CRR before considering the possibility of changing the rules applicable to investment firms.

Finally, the experience gained by competent authorities in the implementation of the liquidity coverage requirement and the application of the provisions laid down in the BRRD will contribute to the reflection of the Commission on whether amendments to the application regime for banking prudential requirements would be appropriate.