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COMMUNICATION TO THE COMMISSION

on the intention not to endorse the draft Regulatory Technical Standards submitted by the European Banking Authority on additional collateral outflows for derivative contracts according to Article 423(3) of Regulation (EU) No 575/2013

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Article 10(1) of Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) provides that where the Authority is required to develop regulatory technical standards, it shall submit the draft thereof to the Commission for endorsement. Where the Commission intends not to endorse the draft regulatory technical standards, it should send it back to the Authority explaining why it does not endorse it.

Regulation No 575/2013 ('Capital Requirements Regulation' or 'CRR') seeks to strengthen the resilience of the EU banking sector and to establish a European single rulebook applicable to all financial institutions in the Single Market in accordance with the European Council conclusions of June 2009. To fully take effect, a number of provisions in the CRR need to be complemented by Regulatory Technical Standards (RTS) and / or Implementing Technical Standards (ITS). The CRR takes into account the Basel standards for banking supervision. The processing of this RTS has been delayed pending the delegated act[1] adopted by the Commission on the Liquidity Coverage Ratio (LCR) in accordance with Article 460 CRR.

The LCR delegated act (DA) sets out the detailed rules under which banks are obliged to hold sufficient liquid assets to cover their expected net cash outflows over a 30 day stressed period. During the financial crisis many banks experienced substantial liquidity strains because they had to provide extra collateral, in the form of cash or high quality securities, to cover changes in the market value of the bank's derivative transactions. Since these outflows could be significant, the LCR DA requires banks to hold provisions against these outflows. The RTS in question defines the extra liquidity reserves that a bank should hold against any additional outflows for collateral pledged against its exposures on derivative contracts. The draft RTS was submitted by EBA on 27th March 2014 following difficult discussions in EBA.

The basic HLBA (Historical Look Back Approach) method as proposed by EBA establishes a floor methodology where the estimated outflow for extra collateral on derivative transactions is based on the largest gross difference in collateral posted for derivative contracts over any 30 day period in the last 2 years. In contrast, the Basel HLBA approach uses the largest net difference in collateral posted. The EBA method is more conservative because it does not allow banks to offset collateral received from other banks. In the documentation to the draft RTS, EBA noted that it was unable to estimate precisely the additional impact of its method but it did note that *"for institutions with significant derivative portfolios the calibration of the methods could have a material impact"*.

EBA consulted industry on the basis of a wider range of methods, of which only 2 were retained in the final RTS, including the HLBA approach. Many respondents to the EBA consultation indicated their preference for close alignment with the Basel approach and

[1] Commission Delegated Regulation (EU) 2015/61, OJ L11/1, 17.1.2015

emphasised the importance of a level-playing field. The recommended EBA methodology based on the largest gross difference in collateral was not subject to the normal EBA impact assessment process because it was introduced as a compromise solution at a late stage to replace other approaches that did not command consensus. Although EBA has proposed to carry out a comprehensive review within two years, the lack of the normal EBA impact assessment process raises concern, particularly in the specific circumstances of this RTS.

Furthermore, leaving aside the procedural aspect, the substantive issues identified below also raise concern.

First, the liquidity outflows under the EBA HLBA as compared to the Basel HLBA approach are much higher, perhaps 3-4 times higher for major players in derivative markets. Second, 80% or more of collateral received by banks is cash, the rest is principally very high quality sovereign debt and banks have a valid self-interest to only accept high quality collateral. Therefore, there would seem to be good arguments to allow netting as permitted under the Basel HLBA approach[2]. Third, from a broader market perspective, the EBA HLBA method could have a significant impact on the level-playing field in international derivative markets[3].

In the light of the above analysis and in accordance with the sixth paragraph of Article 10(1) of Regulation 1093/2010, the Commission is recommended not to endorse this RTS. This should be communicated to EBA explaining the reasons for non-endorsement. Procedurally, this would take the form of a letter to EBA indicating the Commission's intention not to endorse the draft RTS and authorising the Director-General of DG FISMA to sign and transmit this letter to EBA on behalf of the Commission (Annex). In the letter to EBA, it is suggested that the Commission also communicate that it is open to considering endorsement of an amended RTS based on the Basel approach.

EBA then has a six-week period during which it may amend the draft RTS and re-submit it in the form of a formal opinion (with a copy to the Parliament and the Council).

Should EBA not amend the RTS in line with the above comments, the Commission may then formally reject it in accordance with the seventh paragraph of Article 10(1) of Regulation 1093/2010 by a second Commission decision.

The submitted RTS does not raise other significant issues.

The Commission is therefore invited to:

– decide not to endorse the draft Regulatory Technical Standards submitted by the European Banking Authority on additional collateral outflows for derivative contracts according to Article 423(3) of Regulation (EU) No 575/2013,

– decide to invite EBA to submit an amended draft RTS based on the Basel approach,

and

- approve the enclosed letter to the EBA, to be signed and transmitted by the Director General of the Directorate General for Financial Stability, Financial Services and Capital Markets Union to EBA on behalf of the Commission.

[2] In fairness to EBA it should be recognised that the Basel Committee only clarified in April 2014, after the deadline for the submission of the RTS by EBA, that the additional collateral outflows should be calculated at a portfolio level (i.e. on a net basis).

[3] The EBA HLBA approach is super-equivalent to the Basel HLBA approach which other leading jurisdictions including the US, Switzerland, Canada and Australia are adopting.