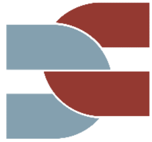

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# EACB Comments

# EU COMMISSION EXPLORATORY CONSULTATION ON THE FINALISATION OF BASEL III

Brussels, 12th April 2018


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## General comments

The members of the EACB welcome the opportunity to comment on the Commission exploratory consultation on the finalised Basel III framework. We appreciate the intention to open a first channel for feedback even before launching the data collection and the process of drafting a legislative proposal.

Given the complexity of the revisions and the far reaching consequences of the proposed changes, we would very much welcome if the Commission maintained an open and continued exchange with the industry. In particular, the institutions will be assessing the impacts of the Basel deal over the coming months and criticalities in connection with EU specificities may be identified at any stage.

We would also like to recall that the EBA already indicated in its first assessment from 20th December 2017 an increase in capital requirements resulting from the final deal of roughly 13% on average (almost 15% for IRB banks). This is not only above the long stated objective of an average capital increase not greater than 10%, but also suffers from a number of data limitations and does not reflect the situation of Member States where the increase is likely to be even above 20%. In this context we encourage the Commission and the EBA to proceed to a careful and wide ranging data collection and impact assessment that is not the mere result of the transposition of Basel templates. It should take into account, for instance, targeted sectoral (real estate, SMEs, agricultural lending, corporate lending, trade and commodity finance) and regional analysis of impacts and provide sufficient time to allow the largest possible number of banks to participate in the exercise.

## Answers to section "general questions"

a) What are your views on the impact of the revisions on financial stability?

b) What are your views on the impact of the revisions on the financing of the economy?

Since the onset of the crisis in 2008, a lot has been achieved in tackling the overall level of risk in the financial sector. In particular, fundamental areas of criticality such as securitizations, minimum leverage, liquidity and funding ratios, resolution frameworks and capital requirements have been successfully addressed with wide ranging reforms. Banks show much greater levels of capitalisation and also thanks to the reforms have better aligned incentives with customer interests and improved transparency. It should also be remembered that in 2008, Basel II had been barely introduced in January when the build-up of asset bubbles burst, and some banks were already reporting losses. Thus, many elements of the crisis cannot simply be reduced to flaws of the Basel II framework for credit risk.

Moreover, following the implementation of a harmonised SREP framework, all banks operate clearly above the regulatory minimum capital requirements, capital add-ons following SREP decisions can be very significant.

The overall idea of the output floor and the revised-SA penalise in particular the least risky exposures. The BCBS package could lead to unintended consequences on the EU economy (e.g. credit squeezes) and society.

We believe that the final BCBS agreement does not take sufficiently into account certain aspects, for instance collateralisation or differences in markets and legal systems that exist across Member States, which instead are currently well reflected in the CRR and CRD. This may result in capital constraints for banks and in turn in less lending volume, or more

expensive lending than otherwise would have been the case.

The output floor constitutes a serious problem for loans with relatively 'secure' collateral and for banks with a low risk profile.

For instance, the floor will have disproportionate consequences for European banks with low risk mortgage portfolios and for instance agricultural exposures with strong collateral security and low loss ratios. Regarding mortgages, there is also no account taken of the existence of a (statutory or otherwise) maximum loan principal for households in a country or the presence of a good social security system. In this case the financing risk of mortgages would be lower than the international average risk as assessed by the Basel Committee.

Apart from mortgages and agricultural loans, Basel 3.5 will also increase the minimum capital requirements for trade and project finance. Given the social and economic importance of these activities, there needs to be further consideration of whether this is indeed the right approach.

Also, although this may not have been the intention of the policy makers, the reforms negatively affect the inverse pyramid structure of cooperative banking groups, where local and regional banks own their central body. The revised SA provides an increase from the current 100% risk weight for equity holdings to 250%. This increase of risk weights would have serious negative consequences in terms of capital requirements for the local banks for which the equity stake in their central body is a sizeable asset. This issue has to be carefully taken into account when implementing the deal. Also the increase for other equity holdings may have important consequences for industrial financing. This would also be in contradiction with the aim of developing a capital market union to encourage equity financing in Europe.

Furthermore, and probably unintentionally, the package might have damaging effects on operations of banks in developing countries and emerging markets. The proposals do not make sufficient distinction between different situations. For project and trade finance, in practice it makes a great deal of difference that a bank has many years of expertise in a market segment and is a large professional party compared to, for example, a bank that only recently started such activities and which still has a small portfolio. This is why banks have invested for years in increasing their expertise, knowledge of sectors and in risk modelling. This needs to be better reflected in the proposals than currently is the case. In the same vein, a common practice for financing companies in developing countries is the joined participation of international commercial banks, development banks, export credit agencies, and local banks. The complementary expertise and due diligence of the several financing parties ensure all parties feel comfortable with their respective risks, and borrowers can tailor their financing needs with the sources of financing. This common practice is hampered by different elements of the final Basel III reforms. We believe that the EU impact assessment should look into this as well, as European international trade is an important factor to be considered[1].

Moreover, the requirements could lead to incentives for making an incorrect evaluation of risk and return. As was the case after Basel I, it will become attractive to dispose of low credit risks that are affected by the minimum floor to external investors and keep high risk loans on the book. If the regulator's calibration is not correct, the markets will arbitrage

[1] See also the comments on the potential impact of Basel proposals on trade finance and emerging markets and possible improvements of risk weighting by Organizations such as the International Finance Corporation, Institute of International Finance, the European Development Finance Institution, development bank FMO, Rabobank, and the International Chamber of Commerce.

this. Impact assessments and consequent decision making should factor this in as well.

**Answers to section "Standardised approach for credit risk (SA-CR)"**

What are your views on the revisions? Please provide details.

We appreciate the recognition of elements such as the loan-splitting approach and a dedicated treatment for SMEs. However, the reforms still carry numerous criticalities with regard for instance real estate, retail exposures, equity holdings that might strongly impair real economy financing.

As an example, collateral is a very important risk mitigating element in lending to corporates. The extremely narrow approach taken in this respect effectively penalises sound business models such as Commodity Finance and Project Finance, which are all important for the real economy.

How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. How does the revised SA-CR compare to the current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

ii. Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

- *Mortgage lending*

In the EU there is much less evidence of risk capture problems for residential real estate, and in any case not at generalised level. Moreover, competent authorities in the EU are already entitled to set higher risk weights based on the loss experience and forward looking market developments of exposures secured by immovable property according to specific CRR powers (e.g. macroprudential tools). Indeed, the proposals for a revised SA residential real estate do not seem relevant for all markets (not only when comparing the EU and US, but also within the EU).

For mortgage markets the impact of Basel reforms could be severe if no account is taken of specificities of the markets. A one-size-fits-all approach may lead to unintended consequences especially for residential real estate markets characterized strongly by domestic specificities in particular in the areas of insolvency laws; social welfare system; legal system regarding mortgages; country specific mitigating factors (guarantee systems, mandatory building of savings); predominance in some Member States of use of fixed rate mortgages with a connected reduction of the risk of the counterparty as the bank fully controls the interest rate and can manage it via its ALM; specific market dynamics (e.g. high LTV markets with scarce history of losses, or markets where LTV is not a key driver for lending).

In addition, some of the rules on the calculation of the LTV and the recognition of collateral have very asymmetric effects on individual jurisdictions. For example, the LTV calculation cannot be adjusted if the loan is not amortising, as in some jurisdictions mortgage loans are not amortized (or only to a small extent), but cash is instead invested in

savings/pension plans linked to the mortgage (which cannot be touched other than to repay the loan at maturity). This is largely driven by the tax laws in the country in question. The proposed treatment discriminates against mortgages in these countries as these are classified as high risk (high LTV), while the effective LTV (and the actual real estate exposure) are reducing through the accumulated savings.

According to the Basel agreement, institutions should be using the original property value measured at the time of loan origination or downward (footnote 37). In our opinion, LTVs should be calculated on the basis of the current debt outstanding as well as the current property value. The original valuation may create perverse incentives where the borrower is considering refinancing. The rule would in fact encourage repeated switches of lender: for the same loan (monetary amount) and the same property, the risk weight (and thus the pricing) applied by a new lender could be lower if there has been an increase in property value since the original loan was made, as the new lender will use the latest valuation, while the original lender cannot. The risk, of course, is the same. Thus, this feature incentivises the unnecessary churning of mortgages, i.e. the opposite of "originate to hold". The present proposal creates an incentive to change lenders, as customers would be able to obtain a lower risk weighting as prices increase.

We therefore believe that institutions should be allowed to monitor the value of the collateral, and also to recalculate the LTV according to the outstanding loan amount. We would thus propose to include an annual intrinsic value adjustments as this is in line with current risk management and underlying risk.

Finally, it should be considered that current Articles 124–126 CRR (and other macroprudential tools) already provide a legal basis for competent authorities to increase risk weights for exposures that are secured by real estates if loss figures which are based on empiric data and alarming developments in the real estate sector justify such a measure.

- *Commercial real estate*

According to the Basel package when repayment of the loan is not materially dependent on the cash flow generated by the property and the LTV ratio is less or equal 60%, a 60% RW shall apply, and if LTV is higher than 60%, the risk weight of the counterparty shall apply. In all other cases, if the repayment of the loan is materially dependent on the cash flow generated by the property RWs from 70% to 110% shall apply and other criteria (finished property, legal enforceability, claims over the property, ability of the borrower to repay, prudent value of property, documentation) have to be met for assigning these risk weights. Otherwise RWs would go up to 150%.

However, these exposures are currently assigned a risk weight of 50% under Art. 126(1) and (2) CRR, which clearly shows the remarkable capital increase these exposures face. In addition, there seems to be a poor recognition of security (i.e. collateral) as commercial real estate exposures can even be assigned risk weights higher than unrated (unsecured) corporate exposures. Secured exposures risk weights should be at least below the risk weights of unsecured exposures.

- *Land acquisition, development and construction (ADC) exposures*

This category of exposures would be assigned the same risk weight as 'defaulted exposures'. A risk weight of 100% for ADC exposures shall only apply if certain criteria are

met (Para 75 in the SA chapter). However, small scale home builders deserve a distinct treatment as their risk profile is usually lower than that of speculative building development. The unintended consequences of this proposal would negatively affect the financing of such real economy players. Risk weights of ADC exposures should be below the risk weights of defaulted exposures.

Also, in addition to agricultural land and one-to-four family residential housing units that will be the primary residence of the borrower, also property development financing should be exempted from the finished property criterion.

- *Equities*

Under the CRR equity exposures in banks and companies in the non-financial sector shall be assigned a risk weight of 100%. In the view of the Committee these equity exposures should have a risk weighting of 250% under the new SA within 5 years.

This provision is extremely dangerous for cooperative banks due to their inverse pyramid structure, where local and regional banks own their central body. The equity stakes in the central body are a sizeable asset (for the smallest banks the most sizeable) for cooperative banks. Under the final Basel agreement these assets will get such a steep increase in the RWs, that it would result in tremendous consequences in terms of capital impact and would not be justified from a risk perspective as those holdings are neither held for speculative purposes, nor are they listed and subject to market volatility. This increase of risk weights would practically result in a discrimination of cooperative groups and should be carefully addressed when implementing the deal.

The proposal has consequences also for the equity investments that many banks have in local businesses. The BCBS has included a provision (para. 52) for national supervisors to allow banks to assign a risk weight of 100% to equity holdings made pursuant to national legislated programmes that provide significant subsidies for the investment to the bank and involve government oversight and restrictions on the equity investments. However, such treatment can only be accorded to equity holdings up to an aggregate of 10% of the bank’s combined Tier 1 and Tier 2 capital. This does not reflect business reality where equity holdings are not acquired in connection to a public/government supported scheme and rather sets a number of further restrictions that would largely affect business relationship and the real economy.

Reasonable equity holdings of banks in successful European enterprises would be punished. It is a crucial moment to decide whether to facilitate capital investments for EU investors or not, especially as we are aiming to establish a capital markets’ union. Inevitably, the increase of risk weights will force banks to sell existing equity holdings in the non-financial sector. Some members reported that international investors are already inquiring when certain industrial holdings will be sold due to the pressure of the Basel reforms. This would lead to major disruptions in the economies of Member States with potential labour market losses.

The further proposed five-year linear phase-in arrangement for existing equity investments from the date of implementation of the Basel standard (Footnote 29) in order to avoid a rapid, exorbitant increase of capital requirements is not sufficient to avoid negative consequences in the long run. The provision will inevitably lead to sales of equities in strategic important companies.

In addition, the IRB framework (i.e. para. 34 of the IRB section) would shift equities portfolios entirely under the SA. The increase of these risk weights will lead to sales of equity holdings by credit institutions. This seems hardly in line with the demand not to impair the financing of the real economy. Many institutions have broad and well-diversified investment portfolios and see equity holdings also as a tool to put into practice their role and responsibility for the economic development of their region. Banks may hold participations in enterprises of different industrial sectors, e.g. enterprises and industrial holdings in the areas of construction, medias and agricultural companies (including diaries, mills and the processing sector). These holdings have often been acquired several decades ago and are of high social interests for the overall economy as they are not hold for profit purposes only but rather to safeguard added value, head offices and jobs in local regions.

➢ *Risk weighting of MREL instruments*

The package also includes a requirement to apply a risk weight of 150% to all positions, that are considered eligible as TLAC (Para. 53 in the SA chapter). This requirement should not be extended to positions qualifying as "minimum requirement for eligible liabilities" (MREL).

➢ *Retail exposures*

In the area of retail exposures we appreciated the recognition of the BCBS on a dedicated treatment of SME exposures, nevertheless the SME supporting factor included in Art. 501 CRR is a much better instrument to safeguard continued financing to this category of exposures.

We also welcome the fact that the overall approach of the current Art. 123 CRR for a treatment as retail exposure with 75% RW has been maintained for exposures to SMEs not exceeding an absolute threshold of EUR 1 million (Para. 55 SA chapter). This safeguards the ability of the institutions to grant loans to SMEs as the backbone of the European economy. However, this element is overshadowed by the shift of wording on the granularity criterion, as it becomes binding as an additional prerequisite for a treatment as regulatory retail. According to this criterion no aggregated exposure to one counterparty shall exceed 0.2% of the overall regulatory retail portfolio.

This requirement particularly places at a disadvantage smaller banks, as to take full advantage of the retail RW of 75% for an SME with a € 1mn loan an institution needs a retail portfolio of at least € 500mn. This amount can hardly be achieved by smaller banks many of which may have the entire balance sheet summing € 500mn.

*Granularity criterion*

The granularity criterion due to which no aggregate exposure to any single counterparty shall exceed 0.2% of the overall regulatory retail portfolio in particular discriminates smaller banks. Although the Committee has introduced a discretion for competent authorities to deviate from the granularity measure when another method to ensure satisfactory diversification is determined, we still see no need and no justification to enforce a hard granularity criterion. A proportional approach could be envisaged for credit institutions with a retail portfolio (without taking account of granularity criterion) below a certain threshold (e.g. €500 million (0.2%=1/500)) to be subject only to the loan size criterion removing 0.2% granularity criteria.

The BCBS rightly considers the diversification criterion to be one of the primary justifications for the current preferential treatment. However, adopting a 'one-size-fits-all' approach in this area, and setting a very low threshold, is likely to result in unintended negative consequences. Indeed, for institutions with small portfolios the proposed thresholds can be reached very easily. Therefore, small business-retail customers of smaller banks would be strongly discriminated and competition within the banking sector is likely to be distorted via the prudential regulation. This can entail significant drawbacks; in particular the specific business model of local banks (informally-intensive and traditional lending activity, i.e. so called relationship lending) might be negatively affected by the prudential regulation, mainly for two reasons:

- The 'too-small-to-survive/succeed problem' would be exacerbated due to regulatory-induced incentives to grow in size (while in some cases merger operations are the principal way to increase efficiency and strengthen the resilience of very small banks this principle cannot hold true for every case);
- The commitment of the bank towards the SMEs-borrower would be weakened and in turn the typical benefits of the relationship lending would be jeopardized.

It is imperative for the growth of regional economies to maintain the availability of credit to retail individuals by smaller credit institutions. In some cases, the market area of credit institutions is even restricted to a very limited number of municipalities. The proposed 0.2% of granularity criteria would impose harsh constraints on credit availability, and raise pressure on supervisors and policy makers to ensure that local economy is unharmed by imposing unnecessarily rigid diversification rules. In this context we encourage the Commission to explore the landscape of existing practices and availability of more suitable alternatives to ensure diversification of the retail portfolio.

- *Exposures to banks*

Due Diligence

In general, we support the use of external ratings when calculating the risk weights for exposures to banks as this approach reflects the nature of the SA for credit risk. Given the simplified character of the SA, the additional due diligence process to calculate the 'correct' risk weight is redundant. As a result, all institutions (also very small banks) would have to draw up an internal process for the calculation of risk weights – similarly to what done at a more complex level with IRB.

In addition, the description of the overall due diligence process is too vague to have a concrete grasp of supervisory expectations. The requirement to perform an additional due diligence process contradicts the fundamental principles of a standardised approach and should not be included in the transposition. Or at least non-complex banks should not be obliged to implement such a process.

External Credit Risk Assessment Approach (ECRA)

The revised Basel framework outlines two techniques for determining the capital requirements for interbank exposures. According to Para 18-20 (in the SA chapter) the banks are required to use for rated bank exposures the ECRA. However, according to Para.

18 the ratings must not incorporate assumptions of implicit government support. There are only some exemptions for public banks which are owned by their respective government.

We see the point that probability of government support for banks has considerably decreased within the new resolution frameworks. Nevertheless, for instance the BRRD still includes a possibility for the governments to support the banks under certain specific conditions. The recent changes in the rating methodologies of the rating agencies reflect these changes in the probability of support very well.

The requirement not to reflect the implicit government support should not be explicitly introduced as moreover ratings without the implicit government support are not available on the market.

<u>Standardised Credit Risk Assessment Approach (SCRA)</u>

According to Para 21-31 banks are required to use the SCRA for unrated bank exposures. SCRA completely removes without good justification the possibility to derive the risk weight of the obligor bank from the risk weight of the jurisdiction in which it is incorporated. This leads to potentially much higher risk weights compared to current treatment.

It should be at least possible to assign lower risk weights to unrated bank exposures in countries/areas where recorded losses are demonstrably lower.

According to Footnote 18 exposures to banks without an external credit rating may receive a risk weight of 30%, provided that the counterparty bank has a CET1 ratio which meets or exceeds 14% and a Tier 1 leverage ratio which meets or exceeds 5%. We support the general idea to significantly reduce the risk weights if the bank is a financially sound institution. Nevertheless the proposed threshold of a CET1 ratio of more than 14% is way too high. It has to be borne in mind that current Article 92(1)(a) CRR stipulates a minimum CET1 ratio of 4.5%. 14% would be more than three times the regulatory minimum CET1.

- *Exposures to corporates*

Similarly to bank exposures, institutions can make use of external ratings when calculating the risk weights for exposures to corporates. Institutions also have to perform a due diligence process in order to calculate the 'correct' risk weight in this exposure class. We reiterate that the requirement to perform an additional due diligence process contradicts the fundamental principles of a standardised approach and should not be included in the transposition.

In addition, while we appreciate that the BCBS recognizes a dedicated treatment for corporate SMEs (85% RW) we believe that the current CRR framework and its ongoing review are addressing SME financing and its incentives in a much more targeted and appropriate manner, the EU SME treatment should be reinforced and not watered down.

- *Specialised lending*

Corporate exposures are to be treated as a specialised lending if such they possess certain characteristics, either in legal form or economic substance. We would emphasize that promoting viable infrastructure projects in domains like transport, energy, innovation, education, research is of vital importance for Europe's competitiveness, the economic growth of the Union and to stimulate job creation. Thus, we support the elements

introduced in the ongoing CRR review for a preferential treatment for specialised lending exposures if certain criteria are met. We believe that such preferential treatment for certain specialised lending exposures should become part of the regulatory framework.

- *Risk weight multiplier to certain exposures with currency mismatch*

For unhedged retail and residential real estate exposures to individuals where the lending currency differs from the currency of the borrower's source of income, the BCBS foresees that institutions apply a 1.5 multiplier to the applicable risk weight. However, the risk weight for unhedged retail and residential real estate exposures to individuals where the lending currency differs from the currency of the borrower's source of income is limited as it shall not exceed 150%. The proposed add-on for certain exposures with currency mismatch is inappropriate as such kind of credit risk is already included in an external rating. The risk weight multiplier for exposures with currency mismatch would lead to a double counting of risks. Hence, it should be avoided.

- *Off-balance sheet items*

The decision to significantly increase the requirements of certain off-balance sheet commitments (Para. 79 SA chapter and Para. 102 IRB chapter) will also have a negative impact on lending activities of banks.

Currently a 0% credit conversion factor (CCF) is included in Article 166(8)(a) CRR. According to this provision for credit lines that are unconditionally cancellable at any time by the institution without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness, a CCF of 0% shall apply.

The removal of 0% CCF for unconditionally cancellable commitments is unduly punitive and does not give an adequate view of underlying risks. It also does not necessarily reflect actual usage ratios of such credit lines.

| Where do you expect particular implementation challenges and why? Please specify. |
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**Answers to section "Internal ratings-based (IRB) approaches for credit risk"**

| What are your views on the revisions? Please provide details. |
| --- |

Following Basel II, European banks were encouraged to implement IRB approaches, and had to produce "roll out programs" with the aim to reach 100% of coverage for assets to be treated under IRB and as stipulated in article 149 CRR. As of today, it can be estimated that only a relatively small amount of RWA for large EU banking groups are treated under the SA (usually for foreign subsidiaries and/or recent acquisitions) with most of exposures falling within the IRB methods.

The finalised reforms represent a step backwards and a fundamental shift in the philosophy compared to the elements introduced in Basel II, which constituted a key moment to increase institutions' ability to assess risk and develop risk sensitivity. The BCBS approach is instead a full "U turn" of the regulatory framework and for instance not even in line with the manner the accounting standard setters look at expected losses. For significant

portfolios the risk sensitive internal approaches will be largely affected by the one size fits all SA.

The advancements of Basel II have been integrated in the risk management and capital planning over the past years and can only now be fully assessed. Lack of risk sensitivity will likely lead to the inappropriate pricing of risk, less lending in low-risk asset classes due to excessively high capital requirements for these exposures in relation to the actual risks and return, perverse search for yield incentives for some market participants, less diversification across banks' credit portfolios, a shift of risks to the unregulated sector and a corresponding increase in risk to the financial system as a whole. We do not believe that the Committee' agreement of 7th December 2017 puts forward the appropriate solution to fix the use of internal models. In addition to the general consequences of higher capital requirements, we like to highlight that the BCBS proposals would have the effect of a double penalisation for the assets today treated under IRB and that would have either to be shifted under the SA or be limited by input and output floors. For instance, assets that will continue to be treated under the IRB (e.g. retail, including residential real estate) would be impacted by the increase generated by input floors of about 10-20%. In addition to this increase in capital requirements, the SA output floor effect is then still to be considered and would push the capital increase even higher, in some cases even above 35%. All in all, and knowing that the banking sector contributes to 70% of the lending in the Union, transposing the BCBS agreement without necessary adjustments would in turn lead to disintermediation, reduction of lending capacity and ultimately credit constraints in the EU despite the expansionary efforts of central banks.

The stated aims of restoring trust in internal models and reducing variability of results, are better addressed by targeted actions such as the review being conducted for instance by the ECB (Targeted Review of Internal Models or TRIM project), the EBA work on consistency and use of harmonized definitions (for instance differing definitions of default already explain large parts of RWAs' variability) and reducing the national discretions related to regulatory capital. The ECB case-by-case assessment could bring advanced and more conclusive basis for decisions. Supervisors have built up the capacity and the expertise to reduce excess variation in risk weighted assets using the tools at hand. Removing some portfolios from IRB treatment is a dramatic short cut.

How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. How do the revised IRB approaches compare to the current approaches in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

ii. Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

The measures may have a substantial effect on banks and on their role in provision of financing to the economy, at least the on balance financing will be affected (more finance will be shifted off balance). Making credit intermediation by banks less attractive also contradicts the expansionary stance of Central Banks and the efforts to increase liquidity in the market. Furthermore, non-bank institutions are not governed by the same capital requirements and supervision and they will gain an unfair competitive advantage in the

financing landscape. This will not be beneficial to the continuity of financial institutions, and it will also not be helpful for stability and for the economy at large.

It should also be avoided that increased capital requirements do not result in a self-amplifying loss of confidence in banks: while nothing has changed in the real economy, nor in the banks' credit portfolio, it would appear that capitalization has deteriorated. Instead, proposals relate to very general measures not linked to the development of underlying risk and not adequately recognizing the value and role of collateral.

The proposals should be carefully assessed in all their consequences, such as reduced incentives for accurate risk measurement, excessive risk taking, shift of significant parts of lending towards the shadow bank system, increased lending cost (e.g. for the commercial real estate sector and specialised lending).

It should also be recalled that while accounting standards for credit risk will use models to estimate future losses in the IFRS 9, the use of models for prudential purposes would be largely scrapped reinforcing the hiatus between the two perspectives.

Also, European banks have invested heavily in internal models and integrated them in their management, limits, allocation of own funds, EVA and Raroc tools, etc., and would see their competitivity impaired.

It should finally be considered that a backstop is already envisaged in the form of the leverage ratio, thus making an output floor redundant and adding a further layer of complexity.

- *LGD floors for real estate exposures*

With respect to secured, retail mortgages (both residential owner occupied and residential retail IPRE) the proposed LGD floors are a very blunt instrument to managing potential underestimation risk, in particular for low LTVs. The input floors do not take into account the naturally existing differences across residential mortgage markets, and this creates issues that can only partially be remedied by further refining the floor calibration.

For instance, residential real estate RWAs in France would increase by a factor of 2 or 3 while the real rate of arrears/non performing exposures has remained very low (between 0.89% and 1.45% from 2001 to 2013), and also the Dutch, German and Danish markets would be negatively affected. Specific concerns and proposals were put forward during the SA consultation but were not taken into account by the BCBS, while a differentiated treatment was envisaged for jurisdictions that forbid the use of external ratings to allow banks to weigh under the SA corporates 'investment grade' at 75% versus 100% in Europe (BBB + client).

- *Agri lending*

The proposed exposure level input floors do not contribute to increase comparability and transparency, and instead are likely to increase RWs variation due to a missing link with the underlying risk. Generic LGD input floors will negatively affect strong collateralized lending. One of the sectors where this will be visible is in agri lending in the EU, which is characterized by a consistently low risk profile and highly collateralized positions, which are very easily liquidated. The underwriting criteria are more conservative than applied in commercial/residential real estate financing, with moderate Loan to Values. The portfolios

have performed very well historically compared to non-agri portfolios and multi-year historic impairments are low.

➢ *Unrated corporates*

The new rules of the standardized approach for corporates would potentially penalize banks in jurisdictions that allow the use of external ratings for regulatory purposes e.g. Europe as opposed to jurisdictions where external ratings are not allowed for regulatory purposes (e.g. US). In the latter case banks can assign a 65% risk weight to exposures to "investment grade" corporates, whereas in the former, they need to apply 100% RW for externally unrated corporate exposure.

➢ *Equities*

The removal of internal models for equities is not justified from a risk perspective. The use of the PD/LGD approach goes hand-in-hand with applied rating models. In principle there are no convincing arguments against using PDs/LGDs in case of equities. Reverting to the standardised approach would only strongly penalize the equities compared to other asset classes.

➢ *Methodology for recognition of eligible collateral under the foundation approach*

We welcome the decrease of the LGD for senior claims on other corporates that are not secured by recognized collateral (Para. 70 IRB chapter).

Nevertheless, there are some uncertainties arising from the table in Para. 75 with regard to the proposed haircuts. It is unclear, if the haircuts included in the table replace the level of minimum collateralisation as mentioned in the second BCBS consultation paper (BCBS 362; chapter 4.2.2). It should be clarified if haircuts replace the level of minimum collateralisation.

| Where do you expect particular implementation challenges and why? Please specify. |
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Overall, in the context of credit risk the revised SA and the connected output floor will represent a specific challenge for IRB banks. Just to calculate the new output floor it will be necessary to perform a complete implementation of the SA, compared to the current partial use-approach under article 149 CRR. In order to be able to calculate RWA in parallel under the IRB and the SA approach as also required under the BCBS Pillar 3 requirements, automated solutions could be preferable and even required but still have to be developed, tested and implemented.

Given the CRR structure, where Art. 111-141 are related to SA and the articles following SA are related to IRB, it is envisioned that banks applying SA can opt to use the IRB approach following supervisory approval. However, there is no provision foreseeing that IRB banks can revert to a full application of the SA. For example, the SA Art. 112 CRR provides for 17 exposure classes, while Art. 147 CRR aggregates these in only 7 asset classes. In other words, banks will need to go in detail through all their credit portfolios in order to allocate exposures from 7 to 17 assets classes. This is only one example of the hurdle that IRB banks face when implementing the SA. Numerous other issues are for instance related to the way exposures secured by real estate, exposures in securitization

and trading books portfolio's will have to be calculated and reported and several new data-points (e.g. company revenues p.a., LTV data, data for exposures secured by real estate, CVA etc.) have to be identified, collected and linked to software solutions through new interfaces.

This makes the implementation of the SA extremely complex. Besides IT consequences, IRB banks will also need to decide upon several discretionary options under the SA approach like for example what credit risk mitigation methods to apply.

When the EU implementation comes due, at least processual relief should be ensured for IRB-banks with regard to the SA calculation, e.g. no due diligence process for exposures because of the already existing internal rating processes. Additionally, for the purpose of calculating the output floor the different ways of recognition of valuation adjustments between standardised approach (valuation adjustments reduce RWA) and IRB approach (include RWA before valuation adjustments) have to be reflected as well as the different approaches themselves (SA: RWA include EL+UL; IRB: RWA include exclusively UL) and the related link to double counting of credit risk when applying the IFRS 9 expected loss model.

**<u>Answers to section "CVA risk framework"</u>**

| What are your views on the revisions? Please provide details. |
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When the BCBS released its consultation d325 (2015) the discussions on the Standardised Approach for the Credit Risk (SA-CR) revolved around making the SA mostly independent from ECAI's credit assessments. Accordingly, the revised CVA risk charge comprised an approach, which also was almost independent from ECAI's credit assessments, apart from a rough differentiation between investment grade and others. Even though the Basel committee has discarded the centrality of rating independent approach in SA-CR in its final version, it did not adapt the CVA risk charge in this point.

The "Basis Approach for CVA" according to BCBS d424 leads to a significant increase in the applicable weighting factors, and consequent capital charge, if compared to the standard method currently provided for in Art. 384. When using the Basic Approach from BCBS d424, on the transactions subject to the CVA charge as of 31.12.2017, one of our members estimated an 80% increase in own funds for CVA risk compared to the current standard method. On the other hand, we do not see a solid reason for such an extremely conservative calibration of the "Basic Approach for CVA".

Within the CRR scope the most material sector for counterparties is the "financial" ones. There is no empirical reason why the weights of investment grade counterparties are set to 5%, which is significantly higher than the weight 3%, which is currently used for counterparties with a low credit quality step of 5. Additionally, it is still a fact that a high counterparty credit quality induces a low market price volatility due to credit risk and vice versa.

Therefore, we strongly support that the rating based approach of the current Standardised Method according to table 1 in article 384 CRR should be retained for the Basic Approach.

| How would the revisions impact you/your business? Please specify and provide relevant evidence. |
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More specifically:

i. How does the current CVA framework compare to the revised one in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

Test calculations reported by one of our members reported that a change from the current Standardized Approach to the new Basic Approach would increase the CVA risk charge roughly by a 2.5 factor.

More in general, the revised CVA framework cannot be considered detached from other Basel reforms. The design of the new standard method for counterparty credit risk (SA-CCR) has a direct impact on the resulting CVA charge. We expect the application of the SA-CCR (as also laid down in the current CRR II revision draft) to lead to a slight decline in exposures to derivative positions, which could counter the effect of increased risk weights (RWc) of the Basis Approach for CVA. However, the overall tightening of the CVA charge described increases per se the costs of hedging interest rate risks, which in turn can set perverse incentives (interest rate risk hedging will be more costly).

Theoretically, the Basis Approach for CVA includes the possibility of incorporating the hedging effects of suitable hedging transactions. However, in our view, this is of no practical relevance due to the associated costs for such hedging transactions. The overall additional burden to be expected (whether from increased own funds requirements or costs for hedging transactions) is a disproportionate readjustment of the CVA charge.

Where do you expect particular implementation challenges and why? Please specify.

The Basic Approach is quite similar to the current Standardised Approach. Thus, in that respect no particular implementation efforts are expected as such. Software customization per se would not be a significant expense driver in this context.

However, the fact that the Basic Approach will generate a significant rise of CVA risk charge will give banks a strong incentive to move towards the new FRTB-based Standardised approach. The rollout of this new standardized approach will instead cause significant implementation costs, followed by material regulatory costs, not least because of the approval process for the Standardised Method.

Instead, it is essential to maintain the exemption for dealings with counterparties that intragroup or intra-IPS. A significant portion of the derivative business of cooperative banks is attributable to intragroup or intra-IPS transactions.

What are your views on the revised CVA framework to capture CVA risks arising from counterparties currently exempted from the own fund requirements for CVA risks under Article 382 of the CRR?

The introduction of the CVA risk charge was a consequence of the financial crisis, which highlighted that OTC derivatives carry a significant risk for own funds due to a credit rating decline of counterparties. The counterparties concerned were almost exclusively part of the financial sector. As non-financial counterparties (NFCP) bear no financial systemic risk, as far as they do not execute a significant OTC derivative transaction volume (measured by

EMIR clearing threshold), the exemption was introduced into article 382(4)(a) CRR for good reasons and should be maintained.

Additionally, NFCP normally use derivative transactions for hedging market risks. A CVA risk charge would make hedging costs for these counterparties more expensive and will make hedge accounting under Directive 2013/34/EU extremely complex. Because these OTC derivative transactions are mostly tailor-made for counterparties' requirements, central clearing usually cannot be used to reduce these hedging costs.

Article 382(4)(d) CRR stipulates the exemption for central and regional governments, local authorities and supranational institutions, which receive a 0% risk weight in credit risk. This makes sure that the CVA risk charge is in line with the treatment under credit risk: risk positions against these counterparties generate no capital requirements and this provision should be maintained. Additionally these counterparties are not part of the financial sector that was mainly involved in the financial crisis. Thus, the exemption from the CVA risk charge should not be reviewed before any reform is made on the credit risk profile of such counterparties.

Intragroup transactions with a 0% RW, which comply with the strict conditions pursuant to Art. 113(6) and intra-IPS transactions which receive a 0% RW according to Art. 113(7) CRR, should not be made subject to an own fund requirement through the back door. To make the CVA risk charge consistent to article 107 et seqq. CRR the reference to Regulation (EU) No 648/2012 should be replaced by a reference to Articles 113(6) and 113(7) CRR.

**Answers to section "Operational risk framework"**

| What are your views on the revisions? Please provide details. |
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We believe that scrapping at once the formerly established Basic Indicator Approach (BIA), the Standardised Approach (TSA) and the Advanced Measurement Approach (AMA) was a rather shortsighted decision. There is a big uncertainty on what to expect with regard to the requirements of the regulators in Pillar 2 but also with regard to many aspects relevant for Pillar 1, which are currently not addressed in the SMA (eg. accounting date for ILM). The chosen course of action and the rather erratic genesis of the SMA, will weaken the position of operational risk as a risk discipline and may lead to a deficit of focus from a management perspective for a material risk category. Consequently, the quality of operational risk management as such will not be improved by this new framework (e.g. for cyber risk, legal risk etc.).

The goal of implementing one easy approach that captures all aspects of operational risk and generates global and industry wide comparable results was a noble idea but neglected the well-known complexity of the problem (conduct risk, model risk, legal risk, cyber-risk and all other aspects of operational risk). The calibration of the SMA is based on the idea of a global "joint liability community" ignoring regional risks (e.g. legal risks). To capture operational risk business model and market environment specific features have to be taken into account. Certain business types like Asset Management (fee income/expenses in the SMA formula) are not the main drivers of operational risk but will be hit hard by the new SMA.

The derivation of a capital charge based on balance sheet figures is neither risk sensitive nor correct nor stable (changes in accounting standards will have an impact in risk capital too, e.g. IFRS 15, accounting rules are not always distinct). The idea of the loss component was to take into account the economic risk profile of an institution, but the impact of the

component was wiggled down and can now be "deactivated" completely based on discretion of the competent authority (which is a grave contradiction to the idea of one approach fitting for all). Moreover, loss data only covers operational risk from an ex-post perspective. It is a well-known fact that forward-looking elements have to be taken into account for operational risk measurement (e.g. risk scenarios).

Consequently, the SMA is flawed from the start, as neither the regulatory community nor the industry is convinced that the generated capital charges do sufficiently reflect operational risk on the targeted confidence level. Due to the well-known weaknesses of the Pillar 1 approach, the pressure on Pillar 2 will increase. Institutions will have a hard time to "prove" that the regulatory stipulated SMA figure does reflect their OpRisk adequately. This may lead to the situation that SMA figures are considered pure floor data, and the industry has to convince the regulator that this floor is sufficient and no additional capital charge has to be defined (with internal models). So banks will use an internal model to derive the proper Pillar 1 charge (the approach formerly known as AMA), but without any proper regulation.

How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. Which approach for the calculation of the operational risk requirement do you use at the moment?

ii. How does the new approach compare to your current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

Our members reported as approaches currently in use a variety of solutions:

- Pillar I: STA but also BIA and AMA;

- Pillar II (incl. Stress test): internal OpVaR Model.

Overall our members expect an increase in capital requirements for OpRisk.

Some members see that with regard to the calculation of the BI there is a lack of clarity (Para. 6 in the chapter related to operational risk):

- Expenses related to any preventive actions are not supposed to be captured in BI items. Otherwise it would be penalizing banks' investments in good risk management.
- There is no indication that for the consolidated reporting only the group composition at the end of each financial year is relevant and has to be taken into account in the calculation of the BI. Otherwise restatements could be possible.
- It has to be mentioned that the BI has to be calculated by only using the figures available at the end of each financial year: audited results, where available, otherwise business estimates.
- It has to be specified that in case an institution has been in operation for less than three years (the data is not available for the entire reference period) it may use forward looking business estimates for BI items unless the institution can prove to its competent authority that due to a merger or acquisition using a three years average would lead to a biased estimation for the capital requirement for operational risk.

Where do you expect particular implementation challenges and why? Please specify.

One of the big challenges will be the implementation of accounting logic (and information) in the loss data collection process. Linking loss data to specific accounting transactions is tricky, as many losses due to operational risk are not linked to one specific transaction.

Moreover differing approaches with regard to the reflection of loss data in COREP reporting, EBA Stress Testing, SMA (Pillar 1) and Pillar 2 will increase the complexity of loss data processing and will cause the need to explain the differences between these views.

In general, the unclear future with regard to reliable standards for Pillar 2, the vagueness of Pillar 1 requirements and conflicting principles between Pillar 2 and Pillar 1 will be a constant challenge in the upcoming years.

**Answers to section "Output floor"**

What are your views on the revisions? Please provide details.

The finalised reforms represent a step backwards and a fundamental shift in the philosophy compared to the elements introduced in Basel II, which constituted a key moment to increase institutions' ability to assess risk and develop risk sensitivity. The BCBS approach is instead a full "U turn" of the regulatory framework. For significant portfolios the risk sensitive internal approaches will be largely affected by the one size fits all SA.

The advancements of Basel II have been integrated in the risk management and capital planning over the past years and can only now be fully assessed. Lack of risk sensitivity will likely lead to the inappropriate pricing of risk, less lending in low-risk asset classes due to perverse search for yield incentives, less diversification across banks' portfolios, a shift of risks to the unregulated sector and a corresponding increase in risk to the financial system as a whole. We do not believe that the proposals of the Committee are the appropriate solution to fix the internal models.

Assets that will continue to be treated under the IRB (e.g. retail, including residential real estate) would be impacted by the increase generated by input floors of about 10-20% and the effect would be amplified by the output floor.

All in all, a strong increase of the RWA is to be expected and could be even above 35%. This would in turn lead to disintermediation, reduction of RWAs and ultimately a credit crunch despite the expansionary efforts of central banks.

The stated aims of restoring trust in internal models and reducing variability of results, are better addressed by targeted actions such as the review being conducted for instance by the ECB (Targeted Review of Internal Models or TRIM project) and the EBA work on consistency and use of harmonized definitions (for instance differing definitions of default already explain large parts of RWAs' variability). The ECB case-by-case assessment could bring advanced and more conclusive basis for decisions. Supervisors have built up the capacity and the expertise to reduce excess variation in risk weighted assets using the tools at hand. An output floor is a blunt and questionable shortcut to address RWAs variability.

Even if an output floor would eventually be introduced, it should at least be calculated only at the level of the consolidated group and only at the aggregate RWA level.

In addition, if an implementation of the Basel output floor is decided this cannot be done without its homogenous implementation on a global perspective as a precondition.

| How would the revisions impact you/your business? Please specify and provide relevant evidence.<br>More specifically:<br>i. What would be the impact of the revised output floor in terms of capital requirements when compared to the application of the revised internally modelled approaches? Please provide an estimate, if the impact is significant in your view, and specify the relevant driver.<br>ii. Does the application of the revised output floor affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible. |
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| Where do you expect particular implementation challenges and why? Please specify. |
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