European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

EACB Comments on Commission's DG FISMA consultation paper on the possible impact of the CRR and CRD IV on bank financing of the economy

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The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 31 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4.200 locally operating banks and 68.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 205 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 78 million members and 860.000 employees and have a total average market share of about 20%.

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Introduction

The Members of EACB welcome this initiative of the Commission to consult stakeholders on the impacts of the regulatory changes brought by the CRR-CRD IV framework.

Answers to selected questions

Q.1 What role has been played by the CRR and CRD IV requirements in the recapitalisation process, in terms of the timing and overall effect on the levels and quality of capital held by banks? How have market, supervisory and regulatory capitalisation demands interacted to make banks adjust the level of capital they hold to the current level? Whilst these three factors may be interlinked, is it possible to identify which has/have played the most important role?

These three sources of capitalisation demands overlap in time and post an unprecedented cost burden for institutions, and substantial placement efforts, in particular for smaller banks. This could also be a source of negative impacts on the financing of other kinds of long term exposures.

In addition, in the current scenario of low interest rates the demand of the market for subordinated instruments with higher yields should grow. However, investors perceive institutions as more exposed also to marginal hikes in the interest rate curve and thus request even higher compensation for risks that would normally be priced at a lower level, e.g. higher distributions or higher interest-rates. This results into higher costs for new issued capital instruments considering the very low interest rate level.

With regard to the supervisory capitalisation demand, many institutions have already received SREP decisions. We would like to point out that the periods within which the institutions have to comply with the SREP ratios are usually very short. Contrarily to the Pillar I requirements in CRR and CRD IV, institutions cannot anticipate the content of the decisions and therefore will start with setting adequate actions to comply with the SREP requirements after delivery of the decision. Depending on the requirements in the decision it may be necessary to issue new CET1 and AT1 instruments. Therefore the issuer will regularly have to prepare a prospectus which usually takes up to six months. The placement process will not start after the prospectus has been approved. Additionally, if a vast distribution of capital instruments is mandated by statutes or law it will usually take a certain period of time for selling a relevant volume of instruments, which may exceed the implementation period of the SREP decision.

In this light we would propose to provide institutions with sufficiently long periods of time for the implementation of the requirements in the SREP decisions.

Banks provided with a SREP decision regarding a capital add-on have to fulfil more severe capital requirements, thus the regulatory capitalisation demand may not even be the main incentive for capitalization.

The impact of SREP decisions is likely to increase within the next few years. Although the transitional periods of the CRR will continue for more than seven years, many institutions have already been forced to strengthen their own funds due to SREP decisions. At the same time the markets seem still sceptical regarding the placement of CET1 and AT1. For that reason banks have to reduce their risk weighted assets to achieve higher capital ratios. The supervisory capitalisation demand plays a prominent role in funds' attraction.

Regarding the quality of capital the CRR determines on the one hand new and on the other hand more detailed qualitative requirements for the eligibility of own funds. Many instruments have been issued before the CRR entered into force and for that reason did not meet the required conditions. This was for example the case with many hybrid instruments. As a result, these instruments are either grandfathered or not eligible at all.

Additionally, the CRR and CRD IV determined higher quantitative requirements for own funds, especially regarding CET1. These qualitative and quantitative requirements already obliged banks to recapitalise with capital of higher quality.

Q. 2 If you consider that capital levels go significantly beyond what is necessary in light of the level of risk incurred and posed by banking activities in certain areas, please specify those areas and back up your view with specific evidence.

Q. 3 What role have the additional capital requirements and buffers exceeding the harmonised requirements set out in the CRR played in the capitalisation process? Are such additional micro- and macroprudential capital requirements and buffers commensurate to the level of risk incurred and posed by banks? Please back up your view with specific evidence.

The rationale of the new capital requirements concerning scope and quality of Tier 1 as well as additional capital buffers was to strengthen the resilience of banks. However, it is not fully clear why the new conservation buffer could not be a part of Tier 1 capital requirement. Also, with regard to the countercyclical capital buffer, cooperative banks and joint stock companies calculate the requirement in the same manner while locality, group structure of cooperative banks and their focus on serving Members make them already countercyclical by themselves in contrast with joint stock institutions.

In addition, the ECB Methodology on the SREP process remains quite unclear, as a transparent process has not yet been not provided. This makes it difficult for institutions to appeal against the SREP decision. It seems that ECB defines the current own fund situation of the credit institution as the new SREP ratio. However, this SREP ratio is by far exceeding all minimum requirements and the CRR and CRD IV requirements fully loaded. These supervisory requirements do not seem commensurate to the level of the risk actually incurred in the current context. Furthermore capital requirements in connection to the systemic risk buffer, which is tool in the hands of national competent authorities,

may lead to a distortion of EU-wide competition. Some member states may introduce a systemic risk buffer, while others may not. Also, the SREP-ratio and the systemic risk buffer seem to double count certain risks, and it is unclear whether competent authorities take this into account when determining the ratios. Finally, it seems that the SSM approach in determining the SREP-Ratio intends to cover all capital requirements including the capital conservation buffer and the anticyclical buffer, only excluding the systemic risk buffer. This approach does not seem consistent with the provisions indicating that the SREP ratio has to exclude all kind of buffers.

Q. 4 Have increased capital requirements influenced the overall capacity of banks to lend? Which factors, including demand-side factors, regulatory changes and other supply-side factors (such as the volatility of interbank and capital markets), contributed most significantly to the change in the volume of loans? How do you think bank lending would have developed had regulatory changes to capital requirements not been introduced?

Due to higher regulatory and supervisory capital requirements reductions of risk weighted assets are necessary. This may lead to a restriction of future lending decisions since the placement of own funds is currently difficult. Additionally the development of new technologies may suffer from the new requirements, e.g. the lending for the purpose of the development of intangible assets. The introduction numerous pieces of new regulations increased complexity and compliance cost, draining resources away from front office activities. Simplifying the existing regulatory landscape and making it easier to understand and manage for all stakeholders involved is a necessity.

In this context, also the monetary policy in a low interest rates environment plays a critical role, compressing margins and profitability for financing real economy, and in particular small businesses on which cooperative banks traditionally have a fundamental focus.

Also the role and approach of the new supervisory framework may push institutions to keep on hold their lending activities, in particular while the new supervisory practices are yet to be fully known and implemented.

Also uncertainty regarding the impact of BRRD, with the mechanics of the bail-in tool and the future level of MREL which may impact the costs of retail funding have to be considered.

Additionally, the recession has strongly curbed the demand of credit on the business side, as new funds would be mostly devoted to restructuring purposes, liquidity and working capital, rather than growth itself as the prospects remain sluggish.

That is why systematic and systemic impact assessments should be provided before any new initiative is launched. Issues to be addressed could be: regulatory overlaps, consistency between different pieces of legislation, enormous amount of related costs, which add on top of the new requirements and buffers.

Finally, since the implementation of the CRR and CRD IV banks are faced with many surveys and data requests which cause additional costs.

Q. 5 Are the effects of increased capital requirements, such as they are, generally temporary and transitional or have structural changes been seen? Has the requirement to hold higher levels of capital increased the cost of funding banks? Has the per-unit cost of bank capital decreased as banks have become less risky?

The changes resulting from higher capital requirements are mainly structural and have a serious long term impact on business models. Non secured lending will generally be avoided. The per unit cost of capital has not decreased.

It should also be considered that cooperative banks have a tradition of high capitalisation and soundness, given their “natural” vocation to build up capital with profits. However, an excessive push for higher capital levels may limit the capacity to expand credit to the local economy if on the demand side there are consistent surges. In fact, the SMEs and retail segment which is in the focus of local banks is witnessing a reduction of margins in a low interest environment. In addition, the possibility to raise new capital to face such sudden increases in credit demand may create a challenge to respond over the short term for cooperative banks, which have a mechanism for steady and prudent automatic capitalization over time, but which do not traditionally rely on equity instruments traded on a broad market.

Q. 6 Have increased capital requirements affected the market for some categories of assets more than others? If so, which ones and how? Which of the provisions contained in the CRR, apart from those establishing capital ratios, are likely to have created the effects experienced by specific markets and/or exposures?

Generally, the more subordinated an instrument is the more difficult the placement results. In some jurisdictions (e.g. UK) AT1 instruments are also regarded as not being suitable for retail investors. The terms and conditions of AT1 instruments have to include provisions regarding the write down or conversion of their principal amount when a trigger event occurs. Some competent authorities believe that these provisions may be too complex for retail investors. Since the terms and conditions of former hybrid instruments did not have to contain similar provisions they were less complex and their selling to retail investors was not restricted.

Additionally, the new provisions regarding the bail-in have also a negative impact on the placement of senior unsecured issuances.

Q. 7 Do you think the phase-out of the transitional provisions under CRR could have an incremental impact on future lending decisions? If so, please explain how.

The phase-out and the approaching higher capital requirements may have a significant impact on the lending policies. Many banks will for example avoid future lending without eligible collateral.

Q. 8 To what extent has this provision been effective in supporting lending to SMEs? Could you provide any evidence, preferably quantitative, of the change in lending to SMEs due to the introduction of the supporting factor as from 2014?

SMEs need to be enabled to perform necessary investments to adopt new technologies, equipment and processes that will increase their competitiveness. SMEs In Europe depend heavily upon bank loans, alternative sources of funding (such as those open to listed companies) are usually not available for SMEs. It is for this reason that the SME SF retains a central role in the regulatory framework.

SMEs In Europe depend heavily upon bank loans, alternative sources of funding (such as those open to listed companies) are usually not available for SMEs. It is for this reason that the SME Support Factor retains a central role in the regulatory framework. More time is needed to have a better overview of what are the long-term effects of the supporting factor in SME lending provision. In any case, the use of the supporting factor could hardly have a negative impact on credit supply to SMEs. Overall, it is too early to tell whether the supporting factor is fulfilling its objective, as institutions have had little time to apply it.

It is difficult to prove that the SME lending volume has increased or decreased due to one single factor since there are many other elements that are relevant for this evaluation. A key point concerns the demand side. A still sluggish economic seems in fact to play a determining role in the overall supply of credit. Cooperative banks, due to their governance and business model, are committed to lending to local economy and small businesses. Capital savings are very likely to be addressed to such clients, provided that there is sufficient demand. This is a further reason to test the SF also in a context of full economic recovery. Moreover, as pointed out by the EBA, there is no consistent EU SME lending dataset over the cycle (COREP started in 2014).

In addition, as already mentioned, the SF has only been in place for one budgeting cycle and one credit lending policies cycle. Thus, there has not been sufficient time to institutionalize the change. Business appetite has not changed since the introduction of the SF and risk appetite is constant over time.

The EACB supports the maintenance of the SME factor. Repealing the SF after such a short implementation period would not allow a full and complete evaluation of the actual impact and benefits of the measure, and could instead have detrimental impacts on funding of the real economy in a time of yet weak recovery. In certain instances even up to 50% of SMEs are rejected when approaching banks for finance for the first time, and many turn to more expensive credit cards or overdrafts to cover the funding shortfall.

For more details please refer to the EACB Comments on the EBA DP and Call for Evidence on SMEs and the SME Supporting Factor (EBA/DP/2015/02).

http://www.globalcube.net/clients/eacb/content/medias/publications/position_papers/banking_legislation/BRWG_2015/151001_EACB_Comments_on_EBA_DP_on_SMEs_fin.pdf

Q. 9 What specific difficulties do banks face when lending to SMEs, compared to when lending to larger corporates? Are these related to the CRR? How could the CRR and other prudential regulations contribute to addressing some of these difficulties in other ways than by adjusting rules for SMEs, or do they need to be resolved by some other means? If so, what other means would be adequate?

The costs involved in issuing bonds or promissory note loans are higher, and more difficult and complex to anticipate, than for bank loans. Providing extensive data for the capital markets requires significant efforts. Small businesses often do not have the requisite IT environment or risk management platform at their disposal, in particular in the case of family-owned, owner-operated businesses. While for young, start-up businesses, such disclosure may also be unwelcome for competitive reasons. In this context, banks often play a decisive role acting as a facilitator, raising finance for the enterprise, as well as identifying potential providers of debt capital more easily, functions difficult to fulfil for the capital markets.

Capital market financings cannot be a substitute for bank financing but rather a supplement in individual cases.

Maintaining the SME Support Factor is key to avoid an increased cost of borrowing, as well as an increase in rejection rates for SME loans. Otherwise there might be a push towards the unregulated financial sector at a time when a European Capital Markets Union is yet to be established. Such a shift would entail a loss of the unique expertise and intimate knowledge of customers provided by bank staff who carry out a differentiated assessment of each financing request, where the lending decision depends upon the borrower's business model, and on market conditions.

For more details please refer to the EACB Comments on the EBA DP and Call for Evidence on SMEs and the SME Supporting Factor (EBA/DP/2015/02).

http://www.globalcube.net/clients/eacb/content/medias/publications/position_papers/banking_legislation/BRWG_2015/151001_EACB_Comments_on_EBA_DP_on_SMEs_fin.pdf

Q. 10 Has the CRR influenced the capacity of banks to provide loans to infrastructure projects? Which provisions are most relevant?

Yes it did. Moreover, the flexibility to lend to infrastructure projects could be jeopardized by current discussions on BCBS proposals for a global floor between IRBA and standardized approach. Banks would be pushed to calculate the capital relative to infrastructure financings based on borrowers' turnover and leverage, thus disregarding the quality of income (long-term commitments with governments or local authorities), the quality of the contracts (commitments with big corporations), the financing conditions. Moreover, all specialized lending, including infrastructure projects, could be subject to a high floor of 120%. This would clearly trigger a steep increase in capital requirements for these projects and reduce banks' investments in these projects.

Q. 11 What are the specific difficulties that banks face when lending to infrastructure projects? Are they related to the CRR? How could the CRR and other prudential regulations contribute to addressing some of these difficulties or do they need to be resolved by some other means? If so, what other means would be adequate?

The European financial sector has been strengthened by the regulatory overhaul. However, the new requirements have also resulted in a huge drain of resources (capital, liquidity) for banks. These efforts have been absorbed and mitigated by the low interest rates monetary policy, the development of alternative financings (bond market) and huge cost-cutting policies, including a reduction in IT investments. Any further regulatory constraint will certainly not be sustainable for the banking sector once interest rates are back to more usual levels and alternative financings are withdrawn from the market.

It is essential to slow down the pace of change of prudential requirements, as it limits a clear view on the environment, dampens investment strategy, makes actors (investors and banks) sceptical on long term investment decisions. Furthermore, to meet its long term infrastructure needs, Europe should keep its independent financing capacity. Therefore, any additional regulatory requirement on lending activities (capital floor, TLAC, MREL, revised IRB) may severely affect the competitive position of the European banking sector, which is among the worldwide leaders in long term infrastructure lending. This will reduce its ability to support the Juncker Plan and more generally to contribute to sustainable long term investments programs. For example, the lending capacity of banks using IRBA model will be reduced in a range comprised from 4 – 8 if the BCBS proposals to introduce a capital floor based on a revised SA were implemented.

These difficulties need to be resolved by other means.

Preserving the risk sensitive approach of IRB is fundamental to meet the challenges of infrastructure financing and answer efficiently to the market demand. Only those risks sensitive approaches are able to select the most suitable lending activities, contributing to the stability of the banking sector. For credit risk, the implementation of simplistic risk drivers, as proposed in the BCBS's revised SA, will reduce sensitivity and capital requirements will materially increase for low risk and good quality portfolios. Contrary to its goals, new regulatory reform under discussion will lead to non-risk sensitive capital framework and to increasing risk and uncertainty on the banking sector balance-sheets.

Q. 12 Should infrastructure projects continue to be treated as loans to corporate borrowers? If not, why? What common features of infrastructure projects or their subsets would justify a separate treatment from loans to corporate borrowers?

Infrastructure investments significantly influence growth rate. Regulatory supporting of infrastructure investment could stimulate growth. The supporting factor for SME loans is a good example of regulatory support. The same approach to infrastructure loans could ease capital requirements and thus stimulate growth rate.

Infrastructure projects should not continue to be treated as loans to corporate borrowers. Given their low risk profile in nature, infrastructure specialized lending (such as projects

and object finance) are typically the financing tools useful in supporting productive investment and infrastructure financing. Infrastructure investments are substantial (in 2014: 259 billion dollars worldwide and 70 billion in Europe, source: Project Finance International, 14/01/2015). They require a dedicated prudential treatment maintaining this risk sensitive approach and the particular characteristics of their financing structure. It is fundamental that the new regulations reflect the underlying risk profile of the specialized lending exposures, and do not increase their risk weight.

While corporate financing has a short to medium time horizon, infrastructure financings, thanks to the long asset life and their strategic nature for the economic growth are considered over the long term. Their specific features need an expertise to coordinate the various stakeholders involved (contractors, public parties, operators, suppliers, off takers) and to assess the technological and economical complexity. It should be noted that while corporate financing largely relies on historical financials and perspectives, infrastructure project risk analysis is based on contractual structure, cash flow projections and assets value as appropriate.

Q. 13 Should the provisions contained in the CRR allow for more differentiation in how they are applied to banks of different sizes or with different risk-profiles? How can they do this without compromising the objective of achieving financial stability and creating a level playing field within the single banking market? Are there any provisions that could potentially be applied with greater differentiation? If so, what are these provisions? Provided application on a differentiated basis is desirable, what considerations could be relevant to make such a differentiated application? Are any concrete changes desirable in this context? If so, what are these changes and the associated costs and benefits?

The banking industry is characterised by both a variety of business models, and extreme differences in terms of scale of operations and size of activities among banks. While the largest banking group in Europe has total assets for nearly 2 trillions Euros, the smallest local cooperative banks may well be under 20 millions. It is a factor of roughly 100.000. Moreover, there is a large variety of business models and legal forms. Especially cooperative banks dispose of features that differ from many other institutions, especially regarding capital, group structure and governance. This variety is recognised by the Commission as something positive that needs to be maintained.

The practical declination of the proportionality principle should be undertaken within a structured approach, with clear objectives and scope already from the design of level 1 legislation. This would allow the EBA to indicate effectively how concrete measures can be applied to different categories of institutions.

Applying proportionality in regulation does not mean carve outs and exemptions. A positive approach to proportionality means designing options for rules that are easy to implement and that do not require disproportionate amounts of resources for institutions of all sizes and complexity. It is a fact that compliance costs hit, in proportion, smaller institutions to a larger extent than larger and more sophisticated banks.

It would be appropriate to put in place specific processes to take into account the specificities of business models and institutions, and the fact that compliance resources are limited, if an impact on other areas of business is to be avoided (i.e. reduction of lending). Also, a more comprehensive approach for the evaluation of the impact of new pieces regulation should be considered. The regulatory overhaul (in addition to CRR/CRD IV, other elements came in the picture such as BRRD, EMIR etc.), changes in the supervisory practices and perspective, indications of upcoming further interventions (e.g. the BCBS work on a review of the SA for credit risk and on sovereign exposures), create an uncertainty that can push banks to stand still instead of financing growth, lead to mergers not grounded on economic basis, or even change the nature of their business model. Thus it is extremely important that each new rule is thoroughly assessed ex ante in the context of the existing framework, taking into account the additional complexity and compliance costs that it would trigger.

For instance, it should be reconsidered if the quite complex SREP process for less significant institutions is to be maintained. Competent authorities should not apply the full SREP process to every single institution and should have the possibility to start the procedure only if certain conditions are triggered. This approach would avoid unnecessary burdens for smaller credit institutions and facilitate the supervisory day to day business.

We appreciate the attention of the regulator for the cooperative banking business model in the CRR and in EBA standards, for instance regarding the full recognition of cooperative shares as CET1 instruments, or the detailed and comprehensive provisions on cooperative liquidity systems in the LCR. However, it should be noted, that the rules for the redemption of cooperative shares, introduced by the CRR and detailed in the EBA standards on own funds, are still likely to create unnecessary rigidities to perform reimbursement to Members, especially taking into account the nature of cooperative banks as entities with variable capital.

Another good example of sensible differentiation and application of proportionality comes from the provisions of the LCR delegated act regarding the classification of other retail deposits subject to higher outflows (Art. 25 delegated act). Such deposits must be classified by credit institutions into two risk buckets: the first with an outflow from 10 to 15% and the second with an outflow from 15 to 20%, depending on a detailed assessment of a number of criteria. However, as a fall-back approach, the deposits can be classified directly in the second bucket if the assessment cannot be performed. This might surely support less sophisticated institutions to assign their outflow rates.

In addition, the definition of a Pillar 1 measure for the leverage ratio will constitute a crucial factor impacting the asset-side structure of banks, and consequently the credit provision. We believe that it is essential that the leverage ratio is implemented in a way that properly reflects European specificities. Europe’s economy relies more heavily than other economies on banking intermediation for financing. The retail banking model would be strongly impaired by a measure that would limit lending to the real economy without justification in terms of risk. A rigid and unresponsive calibration may seriously harm economic prospects in the Union.

CRD IV contains provisions regarding variable remuneration. Recital 66 stipulates that the provisions of the CRD IV on remuneration should reflect differences between different types of institutions in a proportionate manner, taking into account their size, internal organisation and the nature, scope and complexity of their activities. Article 94(1)(l) determines that at least 50% of any variable remuneration shall consist of a balance of shares or equivalent ownership interests and where possible, other instruments within the meaning of Article 52 or 63 of the CRR.

The purchase of cooperative shares is usually limited by their statutes or legal provisions. Therefore in many cases it may be almost impossible for cooperatives to fulfil this requirement. Additionally, in many cases smaller banks don't even issue AT1 or Tier 2 instruments themselves. If banks were forced to issue such instruments just for variable remuneration purposes, it would lead to a disproportionate burden since the necessary documentation and administration of such instruments is costly.

Also, with regard to the EBA draft GL on principles for variable remuneration, according to the legal reading of the EBA's and the Commission's legal services, the non-application of certain remuneration provisions would not be allowed, irrespective of the size, internal organisation, scope and complexity of the activities of the institutions. As a consequence, even small and less complex institutions would be under the obligation to comply with all CRD IV remuneration rules. Likewise, rules would apply also to individuals receiving very low amounts of variable remuneration. The costs and practical difficulties to implement the new rules in such a way is most likely to outweigh the benefits expected. This confirms the need for an overarching approach to proportionality in the design of legislation, to allow the detailed technical rules to implement the proportionality principle effectively.

We see a strong need of adapting these provisions and providing tailored rules for banks of a small size or structured along a specific organisational or business model, such as cooperative banks.

Q.14 Which areas of the CRR could be simplified without compromising the regulation's objective of ensuring prudence, legal certainty and a level playing field? Are there areas that could be simplified, but only for specific types of bank or business models? Would it be useful to consider an approach where banks that are capitalised well above minimum requirements or that are less exposed to certain risks could be subject to simplified obligations? What would be the risks with such an approach?

As a general remark, we believe that Regulations and Directives result more and more complex due to too many cross references. For that reason we strongly call for the avoidance of references and rather the use of keywords for an easier readability and comprehension of the provisions.

We would suggest to implement simplified obligations for simple and sound business models devoted to the financing of the real economy, e.g. when addressing credit spread risk, three levels of complexity could be provided for:

- A: Very low complexity – no calculation necessary (e.g. only HQLA)

- B: Medium complexity – simplified calculation accepted (e.g. only HQLA + investment grade straight bonds without optional components)
- C: High complexity – fully calibrated model necessary

Banks could then choose, which level of complexity to choose accounting for the increased expected earnings and the higher cost of meeting regulatory standards when using products of higher complexity.

Q.15 What additional measures could be taken in the area of prudential regulation to further promote integration and enhance a level playing field? Can you indicate specific examples and evidence of discretions that affect the cost and availability of bank lending?

Optional Templates for AT 1 instruments

Article 52 CRR determines a catalogue of requirements which has to be fulfilled to achieve eligibility of these instruments. Since AT1 is a new category of instruments which has been established by the CRR there are no templates for issuances of these instruments. If an issuer decides to issue AT1 while reducing legal risks usually the terms and conditions will be prepared by or in consultation with legal consultants. This will lead to additional consultation fees which may cause disproportionate financial burden depending on the size of the institution and the issuance. Therefore we would welcome the availability of templates, to be used optionally, to reduce legal risks.