EAPB Position on Exploratory consultation on the finalisation of Basel III

General questions:

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

In the aftermath of the financial crisis, regulation has become not only more intensive and extensive, but also more complex. Standards of the Basel committee are intended for, and tailored to, large, complex, and internationally active financial institutions. As a result, the rules themselves have become large and extremely complex, and the "Finalization of Basel III" (Basel IV) is no exception.

Improving RWA comparability is a valid objective that needs to be achieved. But it is important to be aware that in the search of comparability of capital ratios across banks and jurisdictions there may be a loss in risk sensitivity in bank's capital framework. It is necessary to evaluate if the adequate risk sensitivity of capital requirements has been preserved and to continue reinforcing the use of internal models as a management tool.

The implementation of the new standards are likely to be challenging. These new standards imply significant changes in bank's internal processes that will now need to be adjusted. Moreover, the introduction of the aggregate output capital floor, with the need to disclose capital requirements under the standardised approach also introduce significant compliance costs. Combining restrictions to parameters estimations, input floors and output floors can also end up introducing undue complexity to the framework.

Several impact assessments executed by the Basel Committee, audit and consultancy firms, associations and by EBA have come to the conclusion that the proposals will on average lead to a significant increase of European capital requirements. In individual cases the increase may even be more than significant. Additionally, it will come on top of a European capital base which has been already meaningfully augmented due to various post crisis reforms. According to ECB, in the 3rd quarter of 2017 significant institutions in Europe experienced an average CET 1 ratio of 14.74% as a consequence of pillar I, P2G and P2R and management puffer requirements. This figure shows that the current capital base represents a solid pillar of European financial stability which does not need further enhancement. Any capital requirement on top will rather lead to less investor attractiveness due to low RoEs with the resulting consequences of capital inflows in the banking sector.

All available data so far indicate that the strongest impact of the reform will be triggered by the output floor of 72.5%. The European industry has strongly criticized the output floor for not being a suitable supervisory tool. In comparison to model-based capital calculation the floor increases the capital requirements of low risk portfolios since the supervisory standardized approaches cannot distinguish between lower and higher risks. Thus, it creates an incentive to invest in riskier assets since they promise higher yields as portfolios with a lower risk profile while

requiring the same amount of regulatory capital. Therefore, the output floor will very likely have a negative impact on financial stability in the end.

In order to achieve the BCBS' aim of not significantly increasing the capital requirements for European banks, it is of high importance that the European Commission, together with the EBA, conducts a comprehensive impact assessment which will take into account all of the new standards. Based on the result, it is crucial that European specificities will be taken into account when implementing the new standards into EU Law. This especially concerns the fact that the EU unlike other jurisdictions is characterized by very different bank business models, including public and promotional banks. Against this background, not all of the newly revised rules are appropriate and thus, need to be modified or not applied to certain banks, at all.

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

Even though it was agreed on a political level, that the finalisation of Basel III results in no significant increase in overall capital requirements, i.a. the recent EBA assessment which came to the conclusion that the new standards will on average lead to a significant increase of European capital requirements. This can have a negative impact on the banking industry's lending capacity.

1. Standardised approach for credit risk (SA-CR)

Question 1.1) What are your views on the revisions to the SA-CR?

We generally welcome that the revisions introduce a more granular treatment of exposures, such as a more granular look-up table for exposures to corporates. Nevertheless, we have observed that the goal originally set by the Basel Committee to keep the capital requirements stable compared to the current SA-CR is not achieved to a large extent. For example, the capital requirements seem to increase altogether, for exposures secured by real estate and for off-balance sheet exposures. Hence, this is no longer just a shift of the capital requirements within the individual exposure classes but affects all exposure classes.
That having said, we feel that a more granular approach should be applied more equally to the different exposures. In specific, while a granular approach is available for unrated bank exposures, only a very limited approach is available for unrated corporate exposures. Given the fact that most exposures are to unrated corporates, the difference in granularity is amplified.
Next, the changes in the proposed credit conversion factors result in a significant increase in capital requirements for off-balance sheet exposures such as credit facilities. The RWA effectively doubles. Especially accounts used by clients for payments are affected as the ccf changes from 0% to 10%. We would also like to highlight the knock-on effect of changing ccf's on the leverage ratio. Finally, the due diligence requirement on ratings are formulated rather broad potentially creating a disproportionate burden.

Question 1.2) How would the revisions to the SA-CR impact you/your business and, if applicable, your lending/borrowing behaviour?

The complexity of the envisaged standardised approach will raise significantly due to the increased granularity requirements. Since it is also used as a calculation basis for the floors for the Internal-Rating Based Approach (IRBA), this will lead to higher IT and compliance cost for banks which are using internal models.

Question 1.2.1) How does the revised SA-CR compare to the current approach in terms of capital requirements?

Whereas it is difficult to predict the impact for the entire public banks' sector, there are certain aspects which will altogether lead to increases in capital requirements. This applies to the new requirements for equity investments in particular. Moreover, the fact that under the new approach, exposures to public and promotional banks can continue to be treated as exposures to national sovereigns, is over high importance in avoiding undue increases in capital requirements for EAPB-members.

Question 1.2.1.b) Please provide an estimate if the positive or negative difference between the revised SA-CR and the current approach is significant in your view:

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Question 1.2.2) Do the revisions to the SA-CR affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects?

Exposures to corporates: We appreciate that two important European features have been introduced in the Basel accord: the recognition of the low risk of SME and covered bonds exposures. When it comes to SMEs the Basel framework allows a preferential risk weight of 85% to be applied to unrated exposures to corporate SMEs. Basel has not opted for the current European solution on this issue. We welcome the Basel Committee's recognition of the fact that such exposures carry less risk than do "normal" exposures to corporates. We nevertheless believe the reduction in the risk weight does not yet go far enough compared to the equivalent requirement in the EU, for example.

Off-balance sheet items: The introduction of a CCF of 10% on commitments unconditionally cancellable at any time has to be analyzed closely. Based on current evidence unconditionally cancellable commitments are a very wide-spread form of financing of private persons and enterprises of all sizes in Europe. As already stated during the Basel consultation we do not consider this element justified.

Question 1.3) Where do you expect particular implementation challenges in the revisions to the SA-CR and why?

The increased requirements for due diligence when using external ratings will confront institutions with new administrative burden which could sometimes draw significant internal resources. Therefore, we would welcome if third parties could be used for supporting this process.

2. Internal ratings-based (IRB) approaches for credit risk

Question 2.1) What are your views on the revisions to the IRB approaches?

The restricted use of the A-IRBA will lead to the fact that collateral of high quality will not be taken into account anymore for some portfolios. This will lead to higher capital requirements and generally, less risk sensitivity.

For exposures to the public sector that are not treated as sovereign risk under the standardised approach, we understand that it will no longer be possible for banks to use the A-IRB approach (as exposures to the public sector will be included in the "Institutions" category - the same category as for exposures to banks) and that the F-IRB approach will be the new method from 2022 onwards. A 45% LGD would be applied, that is not at all consistent with the low risk business of lending to local governments. A much lower LGD (0% to 5%, consistent with the almost zero real credit losses incurred in this business) should be applied to exposures to local governments that are not assimilated to their central governments. Another option would be to keep A-IRB allowed for such exposures.

Question 2.2) How would the revisions to the IRB approaches impact you/your business and, if applicable, your lending/borrowing behaviour?

Regarding public sector exposures that are not assimilated to their central governments, we would expect these changes to have a significant impact on banks' public-sector lending and undermine the mission of public development banks to lend to local governments.

Question 2.2.1) How does the revised IRB approaches compare to the current approach in terms of capital requirements?

-For banks using internal models, changing from A-IRB to F-IRB with a LGD of 45% would lead to a significant and totally inconsistent rise in capital requirement applied to exposures to local governments

Question 2.2.1.b) Please provide an estimate if the positive or negative difference between the revised IRB approaches and the current one is significant in your view:

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Question 2.2.2) Do the revisions to the IRB approaches affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects?

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Question 2.3) Where do you expect particular implementation challenges in the revisions to the IRB approaches and why?

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3. CVA risk framework

Question 3.1) What are your views on the revisions to the CVA framework?

The impact of the revision to the framework is significant. For many of our institutions, the current standardized approach is replaced by the basic approach. While being conceptually the same, the capital requirement more than doubles due to the increased risk weights. The increase in risk weights is caused by a less granular approach (IG/non-IG versus credit rating steps), impacting especially derivative exposures from financial counterparties (non-clearable derivatives such as currency swaps). We would be in favor of a more granular approach, such as the current framework as the proposed less granular approach introduces two undesired issues. There is a significant cliff effect once a counterparty deteriorates from investment grade to high yield, while the incremental risk can be marginal. On the other hand, a significant deterioration but still within the range of investment grade will not lead to additional capital.

We would welcome an option for supervisory partial use in order to allow a larger number of institutions to use the more risk-sensitive and more advanced method. This is already provided for in paragraph 6 of the BCBS document, under which any number of netting sets can be carved out from the SA-CVA and then calculated using the BA-CVA. A realistic ability to implement an SA-CVA approach for medium-sized institutions as well would create incentives for better management and hedging of CVA risks, as only these risks are fully eligible in the SA-CVA and are in line with economic CVA management.

Question 3.2) How would the revisions to the CVA framework impact you/your business business and, if applicable, your provision of/access to services in the derivatives market?

The revised CVA framework cannot be viewed in isolation from other Basel proposals or decisions. The new Standardised Approach for Counterparty Credit Risk (SA-CCR) directly affects the resulting CVA charge.

The general tightening of the CVA charge per se increases the costs of hedging interest rate risk, which in turn can trigger undesirable incentives (interest rate hedges become more expensive).

There is a theoretical option in the BA-CVA to include hedging effects of suitable hedging transactions. However, because of the associated costs of such hedges, we believe this will be made considerably more complicated in practice.

In our view, the overall expected additional burden (whether from increased own funds requirements or costs of hedges) is a disproportionate realignment of the CVA charge.

Question 3.2.1) How does the current CVA framework compare to the revised one in terms of capital requirements?

The revised risk weights will lead to significant increases in capital requirements under the Basic Approach for CVA. This especially applies to financial institutions which receive the highest risk weights.

Question 3.2.1.b) Please provide an estimate if the positive or negative difference between the current CVA framework and the revised one is significant in your view:

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Question 3.3) Where do you expect particular implementation challenges in the revisions to the CVA framework and why?

The implementation will mostly affect the necessary adjustment of software. Apart from that problems will arise due to the high amount of sensitivities which will have to be calculated.

Question 3.4) 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 exemptions under Article 382 were incorporated after due deliberation and for valid reasons. We do not see why these reasons should have become obsolete.

4. Operational risk framework

Question 4.1) What are your views on the revisions to the operational risk framework?

Capital requirements calculated using the SMA consider only information about the past, both in the BI and in the ILM. As a result, the present design of the loss component is loss sensitive rather than risk sensitive. Steps taken by management to reduce the bank's operational risk are not directly taken into account. Moreover, the final standard reduced the BI-Buckets from 5 to 3, which leads to a capital increase especially for medium sized banks.

The new Basel framework includes several national discretions and optionalities for supervisory approvals that have to be decided on or specified on European level, respectively. In general, it is crucial to undertake an extensive European impact study and take its results into close consideration before determining whether to make use of the national discretions and how to concretize potential supervisory approval processes.

In our view, the suggested possibility of supervisory approvals to exclude certain past losses from the loss component and certain divested businesses from the business indicator is very reasonable as there is no reason to include events or positions in the calculations that have become irrelevant for the institution's risk profile. In this matter, we would favour a rather flexible approval process enabling case by case decisions over an all too mechanistic solution. In particular, in the case of exempting past losses, AMA banks and their supervisors have already established good practices and it should be ensured that these practices can be retained in the future.

Question 4.2) How would the revisions to the operational risk framework impact you/your business?

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Question 4.2.1) Which approach for the calculation of the operational risk requirement do you use at the moment?

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Question 4.2.2) How does the new operational risk approach compare to your current approach in terms of capital requirements?

When it comes to capital requirements, it has become apparent that especially banks currently using the AMA will face significant increases in own funds requirements. For the European implementation of the new Basel rules it is important to note that they hit European AMA banks much harder than particularly their US American peers. Banks using the AMA are usually larger institutions and would therefore have to include the loss component in their calculations. Thus, in order to avert a competitive disadvantage for European banks, the internal loss multiplier should be set to 1. However, it is important that this national discretion is understood as a European discretion. It should be used consistently throughout the EU to ensure a level playing field.

Furthermore, not only current AMA banks but also banks now using simpler approaches will be confronted with increased capital requirements. First and foremost institutions rather focused on commission business than on interest-bearing business will be negatively affected by the new rules. In times of ultra-low interest rates, however, for some banks the only option to be profitable is to rely on fees and commissions instead of interest income. Consequently, profitability is going to be penalized under the new framework. As profitability is one major keystone for financial stability this adverse effect is very undesirable. Therefore, the calculation methodology of the business indicator should be re-evaluated before its implementation into European law.

Question 4.2.2.b) Please provide an estimate if the positive or negative difference between the new operational risk approach and the current one is significant in your view:

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Question 4.3) Where do you expect particular implementation challenges in the revisions to the operational risk framework and why?

Implementation challenges are especially expected for the loss multiplier, as the standards for the loss data are not in line with the current standards. However, in order to calculate the loss multiplier a 10 year data history is needed.

5. Output floor

Question 5.1) What are your views on the revisions to the output floor?

The output floor also has a direct impact on internal capital management: changes in the RWA for a single risk type or exposure class do not necessarily lead to identical changes in total capital requirements. This complicates the capital requirements planning and also the causal allocation of the (net) impact on the total capital. Equally, a risk-adjusted pricing of transactions is made more difficult.´

While the introduction of a floor at the total RWA level is better than a floor at the level of risk types or exposure classes, we believe that introducing this floor restricts the generally sensible risk sensitivity of internal models. If the floor materialises, this also generally reduces the incentives to introduce internal models for calculating own funds requirements.

As pointed out above, we do not consider the output floor to be a suitable supervisory tool. It disincentivises investments in low risk exposures because it raises the capital requirement of such exposures.

Question 5.2) How would the revisions to the output floor impact you/your business and, if applicable, your provision of/access to (bank) financing?

The application of a floor applicable to all total RWAs will significantly increase the RWAs of institutions that use internal models. Among other things, this will mean that it is no longer worthwhile to use an internal market risk model.

It can also be assumed that the floor – in the same way as the leverage ratio – will significantly reduce the risk sensitivity of the own funds requirements. In consequence, in particular long-term business and low-risk business will be prudentially disadvantaged and penalised.

Moreover, the output floor methodology represents a challenge for managing RWAs and calculating transactions because overall own funds requirements are linked to the standardised approaches.

Last but not least, we assume that, despite the long transition period, the floor will also negatively impact the existing business because financing arrangements are entered into as long-term transactions.

In the case of the few institutions at which the floor will not impact RWAs at consolidated level, one of the reasons for this is the fact that the scope of the A-IRB approach will be restricted for large parts of the portfolio and hence recoverable collateral will no longer be eligible for risk mitigation. This will increase the capital requirements in the IRB approach, with the result that the floor no longer increases total RWAs.

Question 5.2.1) 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?

There is strong evidence from member institution that the output floor raises the capital requirements of model banks significantly. In order to have a clear picture a European QIS needs to be executed. It is important to point out that a reliable estimate of the consequences of the output floor will only be achieved by including the effects of the Fundamental Review of the Trading Book. There is no sense in analysing the market risk requirements based on current rules as the ongoing CRR reform will change the final outcome significantly.

Question 5.2.1.b) Please provide an estimate if the positive or negative difference between the revised output floor and the application of the revised internally modelled approaches is significant in your view:

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Question 5.2.2) 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?

We expect the output floor to have consequences on all model based portfolios as long as banks operate in a low risk environment. This will vary from bank to bank. However, as a result of earlier impact studies we consider it highly likely that specialized lending portfolios will be especially affected since the proposals of the standardized approach are not risk-sensitive enough.

Question 5.3) Where do you expect particular implementation challenges in the revisions to the output floor and why?

The implementation effort can be regarded as very high. Based on the prudential standardised approaches, the output floor defines a lower limit for RWAs that have to be backed by own funds. Institutions that use internal models for calculating own funds requirements for credit or market risk must also calculate the capital requirements in these areas using the relevant standardised approaches. The institutions are therefore forced to implement the relevant standardised approaches for the entire portfolio alongside the internal models. In addition, the standardised approaches also have to be included and monitored in internal management and risk management.