

EAPB Position Paper on the Leverage Ratio

General Comments

5 September 2016

In view of the publication of the updated leverage ratio (LR) framework in delegated regulation 2015/62¹, the ongoing LR monitoring period at the European Banking Authority (EBA) and the Basel Committee on Banking Supervision (BCBS), and a LR legislative proposal expected to be published by the European Commission towards the end of 2016, the EAPB would like to express its views on the current LR framework emphasising the adverse effects that the introduction of a LR may have on promotional business in the European Union (EU).

Promotional banks or entities as represented by the EAPB and defined along the lines of delegated regulation 2015/63 article 3 (27)² or (dependent on the context) the EU Council presidency compromise on the recent amendment proposal to CRR article 242 (23)³, are institutions set up by public authorities either at national, regional or municipal level. Promotional banks can also be legally dependent but economically and organisationally independent institutions within regional business banks which were integrated in the business banks as separate promotional entities by their respective regional government. Regardless of their set-up, promotional banks and entities implement investment projects aimed at fostering growth and social development and engage actively in financing activities that serve public policy objectives identified by public authorities. As was shown during the global financial crisis, promotional banks act as lender of last resort with promotional loans fulfilling a unique countercyclical role in support of the real economy. This was explicitly recognised by the EU Commission's communication *"Working together for jobs and growth: The role of National Promotional Banks in supporting the Investment Plan for Europe"*⁴.

For several reasons linked to their institutional frameworks, promotional banks are to a much lesser extent exposed to the risk of excessive leverage. Among other aspects,

¹ http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2015.011.01.0037.01.ENG&toc=OJ:L:2015:011:TOC

² promotional bank means any undertaking or entity set up by a Member State, central or regional government, which grants promotional loans on a non-competitive, not for profit basis in order to promote that government's public policy objectives, provided that that government has an obligation to protect the economic basis of the undertaking or entity and maintain its viability throughout its lifetime, or that at least 90 % of its original funding or the promotional loan it grants is directly or indirectly guaranteed by the Member State's central or regional government

³ promotional entity means any undertaking or entity set up by a Member State's central or regional government, which grants promotional loans or grants promotional guarantees, whose primary goal is not to make profit or maximise market share but to promote that government's public policy objectives, provided that that government has an obligation to protect the economic basis of the undertaking or entity and maintain its viability throughout its lifetime, or that at least 90 % of its original capital or funding or the promotional loan it grants is directly or indirectly guaranteed by the Member State's central or regional government.

⁴ <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1438075411849&uri=COM:2015:361:FIN>

promotional banks do not face the market pressure to reach a certain level of profitability. Furthermore, promotional banks operate in specific business areas and are constrained by legal or statutory provisions to diversify their activities towards riskier areas. Promotional banks have direct or indirect, explicit or implicit guarantees from their public owners and in view of the customer types they are exposed to, their level of credit losses is very low. However, despite these specific aspects, the majority of promotional banks in Europe has a banking licence and is subject to EU banking regulation with only very few promotional banks being exempted from the Capital Requirements Regulation and Directive (CRR/CRD IV). With regards to the updated leverage framework, promotional banks would be heavily affected by the introduction of a binding LR which does neither take into account the principle of proportionality, nor the low risk inherent to promotional banks' assets.

Therefore, promotional banks should obtain a differentiated treatment which respects the specificities of promotional loans and promotional business models. Such a differentiation could be achieved by rectifying the LR framework. EAPB would like to make proposals on how it could be rectified in a way that safeguards lending policy and distribution mechanisms of promotional loans preserving the business models of promotional banks across the EU.

Main Proposals

2 Deduction of promotional loans from exposure measure in LR calculation

In the European Union, promotional loans granted by promotional banks are fundamentally important instruments for the improvement of long-term financing provided to the economy as they support the achievement of public policy objectives of either the European Union, or its national, regional or municipal governments. Across the EU, promotional loans can either be issued directly or indirectly to the final customer via an intermediary institution (e.g. commercial bank). Unlike other regulatory frameworks such as on liquidity coverage (delegated regulation 2015/61)⁵ or on ex-ante contributions to resolution financing (delegated regulation 2015/63)⁶, the LR delegated act 2015/62 neither offers an exemption nor a differential treatment for promotional loans in the calculation of the LR. More precisely, this implies a contradiction in the regulatory framework for banks in the European Union. While promotional loans are recognised as low-risk for the purpose of the ex-ante contribution to resolution financing enabling a deduction of these loans from the contribution's calculation base, the LR calculation does not retain the deductibility of promotional loans. However, an exemption or differential treatment of promotional loans for the LR calculation is necessary in order to uphold the welfare effects that are linked to

⁵ http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2015.011.01.0001.01.ENG&toc=OJ:L:2015:011:TOC

⁶ http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2015.011.01.0044.01.ENG&toc=OJ:L:2015:011:TOC

promotional loans and their focal role in stabilising an economy's lending capacity over business cycles.⁷

Although in the LR framework regulators allowed for differential treatment of certain promotional loans, the given scope is very narrow and only viable for two cases; either if the promotional loans are fiduciary assets that meet the criteria for non-recognition and non-consolidation in accordance with CRR article 429 (13), or if national competent authorities allow to exclude certain exposures to public-sector entities from the LR exposure measure, provided such exposures arise from deposits that the institution is legally obliged to transfer to the public-sector entity in order to finance investments for purposes of general interest (CRR article 429 (14)).

At present however, most promotional loans issued in the EU do not fulfil the criteria from article 429 (13) and may not benefit from the exemption in article 429 (14). The exemption pursuant to article 429 (14) is tailored to specific promotional financing schemes which only prevail in a few EU member states⁸. Similar schemes however also exist in other EU member states. Despite of being structured differently, for example as is the case for promotional loan schemes as laid down in the definition of delegated regulation 2015/63 article 3 (28)⁹, they serve the same purpose. In spite of being highly regulated and generally guaranteed by a member states' central, regional or local governments, such promotional loans are currently not exempted from the LR even if they do not contribute to additional risk of excessive leverage due to the underlying guarantee structures. In many cases, promotional loans are collateralised by separate guarantees issued by the central, regional or local governments, which induces a substitution of the debtor's risk weight by the risk weight of the respective government – i.e. a risk weight of 100% by 0%. Hence, the collateralised promotional loans do not require any equity under the risk-based capital framework. This mechanism of collateralisation will be abolished by the LR. Thus, cross-collateralised loans (collaterals of the debtor and the guarantee of the respective government) might require an equity charge in the future. In order to avoid harmful consequences and unnecessary regulatory constraints on funding of social housing, infrastructure projects and municipalities as well as start-ups, innovation, SMEs and business transfers, promotional banks and promotional loan should have a differential treatment in the LR framework.

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Therefore, EAPB would like to highlight the importance of rectifying the current LR framework towards a broader recognition of promotional loans in line with the provisions from delegated regulations 2015/61 and 2015/63. By doing so, a more consistent

⁷ See Bertray, Ata Can, Demirgüç-Kunt, Asli and Harry Huizinga (2012). Bank Ownership and Credit over the Business Cycle. World Bank Policy Research Working Paper No.6110, World Bank, Washington D.C.

⁸ Reference is taken to the French vehicle Livret A that provides favorable funding for investments in social housing and infrastructure and similar vehicles such as the postal deposits in Italy.

⁹ promotional loan means a loan granted by a promotional bank or through an intermediate bank (...) in order to promote the public policy objectives of central or regional governments in a Member State

regulatory treatment of promotional loans could be reached. More specifically, EAPB would welcome if directly and indirectly granted promotional loans in accordance with the definition of delegated regulation 2015/63 article 3 (28) and together with the eligible promotional financing schemes under CRR article 429 (14) would be deductible from the LR exposure measure, consistently across all EU member states. Such a harmonised approach would be in line with the proceedings in delegated regulation 2015/63 article 5 (1) (f) and would also ensure that in cases in which promotional loans are granted indirectly to the final customer (via intermediary institutions), these loans would not be debited multiple times in the LR calculation of the institutions along the loan transmission chain. This would guarantee a frictionless continuation of promotional lending policy in Europe and reflect all existing promotional loan disbursement schemes enhancing a European level playing field.

Prudent LR calibration for all promotional bank business models in Europe

In the European Union, promotional banks can be set up on a national, regional or municipal level where each national, regional or municipal government is adapting itself to specific legal and market framework conditions in its own way. This degree of flexibility is essential in order to implement the model that works best for the country, region or municipality in question. Nevertheless, all promotional banks – be it municipal funding agencies, public long-term investors, export funding banks or agencies and promotional banks as legally dependent but economically and organisationally independent entities within regional business banks – are characterised by exceptionally low-risk and low-margin businesses which would be severely affected by an improperly calibrated LR (also acknowledged by EBA's LR calibration report from August 2016). This is linked to the fact that the intended use of the LR as a back stop for risk-weighted capital requirements is based on the assumption of consistency between the LR and the risk-weighted capital requirements which however may not prevail for the case of promotional banks. Assuming fully-loaded Basel III requirements with a LR at currently 3%, a capital conservation buffer of 2.5%, and a minimal risk-based Tier 1 capital ratio of 6%, the LR will become a binding constraint for most promotional banks holding very low risk-weighted assets. Consequently, the LR would act as front stop and thus contradict its original intention by penalising the business models of promotional banks.

The current LR level set at 3% is punitively high for promotional banks and would imply a much higher capital requirement as opposed to the requirement based on the risk-weighted capital charge. In consequence, promotional banks would be forced to hold inefficient capital due to mismatched LR provisions and such excessive LR requirements could trigger a drastic cost increase or lead up to a credit crunch for the financing of public policy objectives. These unintended consequences would be contradictory to the European Commission's goal of reviving growth with the "Investment Plan for Europe" and would result in inefficient regulation.

Furthermore, promotional banks in the EU should not be punished by additional LR requirements linked to their possible status as “other systemically important institution (O-SII)”. While promotional banks with an O-SII status may be considered by regulators as systemically important to their domestic market, their risk profiles remain equally as low as the risk profile of any other promotional bank as they equally focus on business activities that support key policy goals of their respective national, regional or municipal government.

EAPB would welcome a differentiated and proportional treatment of promotional loans and promotional banks in their variety of forms by exempting promotional loans from the LR calibration and by introducing lower LR requirements for promotional banks. Since there are already exemptions for promotional loans in line with the proceeding of delegated regulation 2015/63 article 5 (1) (f), promotional loans pursuant to the definition of delegated regulation 2015/63 should also be deducted from the LR calculation base with according amendments made to CRR article 429 (14). This would be consistent with previous legislation and already existing exemptions in the CRR ensuring a sound and equal treatment of comparable subjects within the EU.

Background on EAPB

The European Association of Public Banks (EAPB) gathers over 30 member organisations (promotional banks, funding agencies, public financial institutions, associations of public banks and banks with similar interests) from 17 European Member States and countries, representing directly and indirectly the interests of over 90 financial institutions towards the EU and other European stakeholders. With a combined balance sheet total of EUR 3,500 billion and a market share of around 15%, EAPB members constitute an essential part of the European financial sector.