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# EBF response to Commission exploratory consultation on the finalisation of Basel III

The EBF welcomes the Commission's intention to consult with stakeholders about the potential impact of the finalisation of Basel III and on the implementation challenges involved.

The Commission's clarity about the order of the legislative packages adds transparency to the process and is appreciated by the industry. It is reassuring that any legislative proposal to implement the outstanding Basel III reforms would be independent from the Risk Reduction Measures package currently under negotiation by the European Parliament and the Council. We would like to avail of this opportunity to remind the Commission that the Fundamental Review of the Trading Book (FRTB) has been placed in the same timeline as the finalisation of Basel III, therefore, it should be aligned accordingly.

Nevertheless, we have been surprised about the extremely short timeline for consultation. As stated in the EBF letter to Vice-President Dombrovskis (ref. EBF_031619), sent on 19 March 2018, these proposals will have long term effects on the EU banking system and the EU economy. They would therefore deserve a normal period for consultation ranging from 2 to 3 months. Interested parties should be given sufficient time to conduct analyses from their respective viewpoints if the Commission aims at receiving well-informed assessments. In particular, the Commission requests *evidence on the potential impacts of those reforms on the EU banking sector and the wider economy*. This cannot possibly be done in a few days.

In view of this situation, the present response of the EBF on behalf of the European banking industry, cannot be considered as comprehensive. It merely indicates a non-exhaustive list of areas that would deserve further analysis before a legislative proposal is devised. Given the abovementioned insufficient time for proper consultation, the EBF may probably raise further relevant issues or develop more in-depth the matters presented in this document. We look forward to a long and deep engagement on this dossier.

## General remarks

The objective of financial stability has been largely achieved in the decade following the financial crisis of 2007. The core equity capital ratio of the EU banking system stands at 13.8%, about three times that of the pre-crisis period; the short-term liquidity ratio, which first calculation back in 2011 showed a poor 70%, is now more than double that figure; the question now is whether the EU banking system has too much liquidity in the form of regulatory defined high-quality liquid assets. In addition, a new recovery and resolution framework has been implemented and other improvements in risk management practices and incentives are commonplace.

Against this background, the EBF would like to restate its view that the regulatory reform has largely met its objectives in terms of financial stability. Further revisions can add very little, if anything, to the degree of stability reached. Quite the opposite, they could undermine the capacity of banks to finance the economy and, indirectly, create financial instability.

We advocate for a truly comprehensive impact assessment of not only Basel III measures in Europe but also their interactions with other European policies. European regulation should ensure an appropriate implementation of on-going or upcoming existing frameworks and reflections (e.g. the EBA Future of IRB Approach) and capitalise on them. In our view, it is of utmost importance to gain an in-depth understanding of how the specific rules are going to affect the European banking sector and to adjust them appropriately in order to avoid any undesired outcomes.

## On the Standardised Approach for Credit Risk (SA-CR)

### Impact on business

The revised SA-CR raises several issues for the following asset classes:

Corporate:

We think that given the very low coverage of external ratings on corporates (particularly on middle-market firms and SMEs), a large majority of corporate exposures will receive by default a 85% or 100% risk weight in jurisdictions that allow the use of external ratings (such as the EU).

With equivalent credit analysis and risk profile, a non-SME investment grade firm, but not rated with agencies recognized by regulators, will be less well regarded in the standardised method in the European regime (ECRA, 100% weighting) than in the American alternative regime (SCRA, weighting 65%). We suggest aligning the treatment of ECRA and SCRA for unrated Corporate with a unique weighting of 65%. It may have an impact on the cost of credit to corporates and, hence, to the financing of the economy.

Regarding SME exposures, the SME supporting factor should be maintained in order to promote the financing of these exposures.

Specialised lending:

The proposed risk weights are a missed opportunity to introduce some risk sensitivity, which would enable a differentiation between widely-varying risk-levels among specialised lending transactions. We call on the Commission to introduce simple criteria which would enable most banks to use various levels of risk weights in their specialised lending exposures.

Real estate exposures:

Regarding the Real estate exposures, we are very much in favour of keeping the several possibilities (whole loan approach, loan-splitting approach). Also, under the loan-splitting approach, a supervisory specified risk weight is applied to the portion of the exposure that is below 55% of the property value and the risk weight of the counterparty is applied to the remainder of the exposure. In cases where the criteria are not met, the risk weight of the counterparty is applied to the entire exposure. This option should be kept in the transposition. The loan splitting approach takes adequately into account the low risk situation of residential real estate in several countries and should therefore remain available.

The loan-to-value (LTV) could only be relevant as a risk indicator if calculated on the basis of the property current value and not the origination value which is outdated with the pass of time especially in long term loans.

Furthermore, in our opinion the LTV-approach is not risk sensitive enough in the lower LTV-buckets, especially in commercial real estate lending. Evidence of loss rates suggests that the provided risk weights are too high. In the course of the European implementation it should therefore be examined whether the LTV-approach could be applied in a more granular and risk-sensitive way. Loss rates are being collected in the COREP reporting. Hence, there is sufficient evidence on this issue in Europe. We recommend analyzing these data in the coming month in order to possibly complement the Basel proposal.

Leasing activities:

A study regarding leasing activities (*Capital Requirements for Leasing: A Proposal Adjusting for Low Risk*, by the University of Cologne), has explored the impacts on these activities and has suggested that a leasing factor could be multiplied to the Standardised Approach risk weights in order to more accurately reflect leasing risk. A leasing factor of 0.6177 ensures capital requirements that are sufficiently conservative and still above the A-IRB Approach capital requirements.

Equity exposures:

The impact of the risk weight of 400% for "speculative unlisted equity" may cover wide exposures depending on the clarification on the definition of "speculative unlisted equity"; this perimeter should be cautiously monitored in the impact assessment. Moreover, this requirement does not seem to be in line with the risk weight applicable to private equity exposures in CRR, which was deemed to help the financing of the economy. The notion of private equity with a specific risk-weight of 190% shall remain in CRR.

Credit Conversion Factor (CCF):

The notion of "Unconditionally Cancellable Commitments" should be reviewed and clarified (in accordance with accounting standards). The current possibility in CRR to use a 0% CCF should be maintained upon balanced level of justification to be provided to the European supervisor. Also, we advocate that some low-risk items of CRR should benefit from the current 20% CCF such as certain type of non-financial guarantees (bid bonds, advanced payments, retention money, performance bonds…).

## On the Internal Rating Based (IRB) approaches for credit risk

### Views

The proposal on Large Corporate raises several issues:

- By including the subsidiaries of Large Corporate groups, the Committee makes the assumption that such entities benefit from an implicit support of the group which makes them "low default", which is not proven;
- Moreover, for a counterparty of identical credit quality, the applicable approach to a medium sized company will be different (SA, F-IRB or A-IRB) if the entity belongs to a large group or not: in the absence of parent guarantee there is no rationale

for such a different capital treatment, plus it creates a discontinuity in risk weighting.

As regards the introduction of 40/45% LGD risk parameters, the Commission should also closely consider the impact for banks required to move from the IRBA to the IRBF. Any adoption of such parameters should be done alongside with a detailed impact analysis on these asset classes for institutions moving from IRBA to IRBF. LGD parameters undermine the principle of risk-sensitivity built up through years of investment in IRB models and do not reflect experienced distribution of LGDs, as well as the wide variety of activities which are central to the financing of financial institutions and large corporates. Moreover, such granular IRBF LGD parameters should concern all asset classes in CRR, not just those applicable to financial institutions and large corporates.

One additional point deals with the recognition of collateral which differs between IRBF and IRBA approach. The recognition and applicability of collateral mitigation should be aligned with IRBA approaches as they are the most adequate methodologies to take into account guarantees and securities in the transaction as opposed to fully unsecured loans (therefore with no guarantee). More thorough studies involving the industry shall be led to improve the current framework (see EBA Report on Credit Risk Mitigation framework).

We advocate for a framework which does not penalise the European jurisdiction for which internal models are under close scrutiny. In Europe, the regulator and supervisor treat the modelling choices with the TRIM exercise and the regulatory requirements related to the EBA Future of IRB approach. The outcome of these actions will definitely adjust any deviation to an adequate regulatory framework by end 2020 at the latest. The application of some Basel measures from 2021 onwards seems redundant: we suggest that any input floors on risk parameters and floors on haircuts to be removed from the European's perspective, in order to avoid any double effects.

The application of the IRBF approach envisages a fixed maturity at 2.5 years. This will imply, for a given PD and LGD, a unique risk weight whatever the maturity of the exposure and thus reduce the risk sensitivity of the IRB formula. We think that the removal of the actual maturity for those exposure classes subject to the foundation approach will not solve the variation in risk weighted assets; given the absence of any internal model for the calculation of the maturity we suggest that the Commission exercise the national discretion and maintain the use of the cashflow maturity for portfolios treated under the IRBF, as it is possible in CRR Also, the SME supporting factor should be maintained in Europe. This factor allows the reduction of capital requirements on SME loans with the aim of freeing up regulatory capital to deploy for further SME lending and to improve SME lending conditions.

## Impact on business

The impact of the increase in risk-weighted assets (RWA) as a result of the changes to IRB approaches for credit risk will be significant in the European banking system and much bigger than in other jurisdictions. The Pillar 2 add-on is today roughly 4% over risk-weighted assets on average in the EU, and it is up to 6% in some countries. This represents around one third of the total requirement. The increase of RWA will not only increase the Pillar 1 requirement but also the Pillar 2 requirement which is also based on RWA. When it comes to estimate the impact, the Commission should include the Pillar 2; otherwise, a significant part of the impact would be left out.

Most impacted activities relate to:

- Exposures to Large Corporate and Financial Institutions: application of an IRBF LGD instead of an IRBA LGD (45% or 40% instead of internal LGD values);
- Limited recognition of collateral in IRBF approach;
- Increase of the exposure due to modification of CCFs and their application on UCCs;
- The application of a fixed maturity in IRBF instead of the actual maturity; The application of input floors on an overall basis and floors on haircuts, especially for Specialised Lending.

The impact is also driven by the output floor (see section below).

### Implementation challenges

- The detection of consolidated revenues above 500M€ for Large Corporate requests better clarification and will be an issue for corporates which revenues are not available on a regular basis (SME, funds….);
- Regarding CRM framework, it remains unclear how institutions should handle the mix of regulatory approaches they will be faced with. For instance, for bank guarantees which are a common type of CRM, often provided in support of midcap corporate, we understand that the use of IRBF approach will mean that CRM cannot be reflected in a modelled LGD on a corporate exposure under the IRBA.

## On the CVA risk framework

### Views

First of all, we should point out that the Basel Committee has only conducted one consultation on the revised CVA framework. The final standard removes the use of any internal model, which is regrettable. We recommend undertaking additional impact studies to reliably assess the calibration of the final framework. Regarding the adopted approaches, we recognize that the final text adopted by the BCBS introduces some improvements, notably regarding the eligibility of the hedges, the cap of the maturity adjustment factor to 1 in CCR under IRB for netting sets contributing to CVA capital which removes the double counting that currently exists between CCR and CVA and the recalibration of some regulatory multipliers for both SA-CVA and BA-CVA. However, we would like to share our views on the following key concerns:

A. Gap between accounting CVA and regulatory CVA:

   We believe that capitalizing a hypothetical regulatory CVA which differs from the true accounting CVA distorts the essential link between economic risk and capital requirement. We acknowledge that there is a need for more uniform and prudent CVA practices. However, the Prudent Valuation is a more suitable framework to impose high quality standards on accounting CVA than the CVA risk charge. In that respect, we note that CVA remains the only market risk in the Basel framework for which the accounting measure is not used as an input for capital requirement calculations.

The main sources of divergence between accounting CVA and regulatory CVA are due to:

1. The calibration of parameters
   a. LGDs: The Basel Committee imposes a regulatory CVA based on market-implied LGDs. However, banks should be able to use different LGDs for certain specific type of exposures such as secured ones for example.
   b. Margin Period of Risks (MPoR): the MPoR used to compute the regulatory CVA is overly conservative, not commensurate with the risk truly incurred and not consistent with accounting CVA practices.

2. The definition of the perimeter
   a. Securities Financing Transactions (SFTs): SFTs and other forms of collateralized borrowing should not be incorporated in the CVA regulatory framework since these instruments are not necessarily captured in accounting CVA.
   b. Counterparties with perfect CSAs: It is expected that calculating SA-CVA sensitivities for such counterparties will be computationally very intensive; yet accounting CVA on such counterparties is immaterial. The generalization of mandatory initial margin (IM) requirements on bilateral OTC derivative netting sets will further accentuate this trend. We therefore advocate that netting sets subject to perfect CSA and IM requirements should be excluded from the revised CVA capital charge.
   c. Materiality threshold: we welcome the possibility for a credit institution with an aggregate notional amount of non-centrally-cleared derivatives less than or equal to EUR100 billion to calculate its CVA capital requirements as a simple multiplier of its counterparty credit risk charge. Indeed, this allows banks with simpler business models not to be penalized by excessive capital requirements.

B. Calibration of the new framework

1. SA-CVA: The risk sensitivity of the SA-CVA should be improved. Index hedging is poorly recognized.
   The removal of the internal model approach is not appropriate at least until that index hedging is properly recognized. Under the new CVA framework, a credit exposure hedged by a cross-sectorial index (such as iTraxx Main) will pile up the risks instead of reducing them This treatment is too conservative and will lead to a further disconnection between CVA risk management and CVA capital charge. Under the current internal model approach (A-CVA), this hedge relationship is better recognized. However, we do not believe this was the intention of the BCBS, as hedging reduces the systematic credit risk a bank is exposed to. This issue can be addressed by permitting mapping of illiquid counterparty sensitivities to proxy entities and using the R factor to account for the degree of proxy hedging.

2. BA-CVA: The Basic approach "BA-CVA" should be appropriately calibrated.
   Risk weights are too conservative. In addition, should SFTs be maintained in the CVA charge computation perimeter, the 1-year maturity floor under BA-CVA would not be fit to the short-term nature of SFTs portfolios.

C. Synthetic split of netting sets

The final Basel standard grants the possibility for "SA-CVA approved" banks to carve out any number of netting sets and capitalize them under BA-CVA. However, the text does not explicitly grant the possibility to break a given netting set into 2 synthetic netting sets: one containing transactions that can be managed under SA-CVA and one containing transactions that cannot be managed under SA-CVA and therefore needs to be capitalized under BA-CVA. It is essential that such flexibility is granted to banks. Indeed, the calculation of SA-CVA sensitivities on the full scope of covered positions constitutes a major computational challenge for banks. Credit institutions may need to restrict such capacities to material SA-CVA sensitivities depending on their portfolio compositions.

## Impact on business

It is worth noting that the Basel Committee performed a quantitative impact study on full banks' portfolios in February 2016 prior to the finalisation of the revised CVA framework. The impact study concludes that the revised framework would lead to a significant increase in CVA RWAs. Credit institutions are in the course of assessing the impact of the revised Basel standard as part of the December 2017 Basel 3 Monitoring exercise. Preliminary results indicate that the revised own fund requirements for CVA risk would still be a multiple of current own funds requirements despite improvements compared to February 2016 proposal.

It should be considered that the current Basel consultation on the "revisions to the minimum capital requirements for market risk"1 propose a revision of risk weights and could lead to an alignment of risk weights used in the standardised approach to credit valuation adjustment risk (SA-CVA). The international framework is not finalised on risk weights applying to the standardised approach used for market and CVA risks.

The European Commission should assess the capital impacts of all the latest regulatory reforms before introducing those requirements in Europe.

In addition, we anticipate a potential increase in capital consumption which would increase the cost of hedging for clients along with a substantial increase in operational and infrastructure costs required to comply with the rules, through for instance having to include SFTs which are fair-valued in the computation. We also expect that the requirement to hedge non-linear trades with an external counterparty would increase the cost of hedging for an institution as a whole.

Regarding SA-CVA specifically, we reiterate that usual accounting CVA CCR proxy hedges are overall inefficient and can even lead to an increase in capital requirements.

[1] Basel standard d436 (https://www.bis.org/bcbs/publ/d436.pdf)

### Implementation challenges

We expect the following implementation challenges:

A. Implementation calendar

We are concerned that time constraints could jeopardize the building of a sound and consistent framework. The target deadline set by the Basel Committee (i.e. January 2022) seems extremely challenging, especially in a context where the transposition calendar in Europe is unknown and the European Central Bank has not yet disclosed its expectations in terms of SA-CVA approval process (i.e. validation of internal measures of SA-CVA).

We recommend regulator to define a sustainable transposition calendar for the revised CVA capital charge.

B. Computation of CVA sensitivities

The bumping approach requirement to compute CVA sensitivities on at least a monthly basis is time consuming and computation intensive. Market practices include other numerical approaches should be allowed for credit institutions in order to compute CVA sensitivities. (for example, please see the Basel FAQ on market risk capital requirements, answer to question 1, on paragraph « 1.1 Sensitivities-based method overview »).

C. Need for flexibility to carve out netting set transactions

We reiterate the need to grant bank the flexibility to carve out from a given netting set transactions

(please see our paragraph "C. Synthetic split of netting sets" about our views on the revisions).

D. Inclusion of SFTs & eligible CVA hedges under the new scope

Significant implementation challenges are likely to arise from the requirement to include SFTs in the computation and in identifying eligible CVA hedges under the new scope. While the selection of credit risk hedges (CDS/Index) is already in practice, selecting Rates/FX/Commodities or other type of market risk hedges will be challenging for XVA desks that manage these risks holistically at portfolio level across multiple Valuation Adjustments (FVA, CVA, DVA, CTDVA and others).

### Views (article 382 of CRR)

The exemptions authorized under article 382 of the CRR, have been introduced in Europe to fix the shortcomings of the calibration of the CVA framework as defined in the Basel II standard and should be maintained. The shortcomings of the international standard include the misalignment between the "true" risk managed by the credit institution and the capital charge, that is to say the misalignment between "Accounting CVA" and "Regulatory CVA".

The Basel standard published in December 2017 introduces an additional shortcoming on index hedges which is all the more important in the context of corporate exposures where single name CDS are not developed. As a consequence, we believe that the revised international standard fails to address shortcomings in the calibration of the current framework. Indeed, the new SA-CVA barely recognizes proxy/index hedges and ultimately leads to vey penalizing capital requirements. This could be particularly detrimental for European Corporates in a context where the Corporate CDS market is far less developed in Europe than in the US and where CVA exposures on corporate counterparties with non-traded CDS available are typically hedges using proxy/index hedges.

Especially in the case of non-financial counterparties (NFCs) the exemption is vital to avoid adverse effects on employment and growth. Due to their nature, an efficient management of collateral is more than challenging for corporates and standardized instruments often fail to match their specific needs. Therefore, OTC derivatives are usually the only option for corporates to hedge risks that inevitably arise from their businesses. The result is that these European counterparties are in a higher demand for hedging solutions than for instance American corporates (who can trade solely in their own currency). This structural difference therefore penalizes pro-active risk management by European counterparties, with real economic impacts.

Furthermore, it is important to note that NFCs are much less interconnected than financial counterparties and therefore do not pose any significant systemic risk to the financial system. In addition, bilateral OTC derivative arrangements with NFCs are already subject to own funds requirements in the area of Counterparty Credit Risk. An additional capital charge for CVA risk would force banks to pass the additional costs on to their counterparties. This, in turn, would most likely result in corporates either not hedging their risks anymore or even refraining from certain business activities completely. Both consequences would be highly undesirable.

Moreover, the CRR should be kept consistent with other European regulations like for example EMIR. For the exact same reasons mentioned above, EMIR excludes NFCs with a volume of OTC derivative contracts below a certain threshold from the clearing obligation. It is only a logical consequence that counterparties exempted from clearing obligations under EMIR should analogously be exempted from the CVA Risk Capital Charge.

A further concern is the lack of clarity relating to the treatment of trades when institutions are clients of a clear member of a Qualifying CCP.

## On the Operational risk framework

### Views

We believe that the AMA discontinuity and the return to a new, although improved, standard methodology to determine the regulatory operational risk capital will produce a material step back in the Operational Risk discipline, will hamper the investments made over the last few years, and might result in a riskier, although simpler, financial system. AMA was intended to stimulate investments in the field of Operational Risk management and has succeeded in this objective since banks made substantial investments in AMA framework development (i.e. loss data collection, industry standard classifications, operational risk management frameworks and operational risk measurement).

Moreover, although not explicitly mentioned in the Basel III document, there is the assumption that models will continue to work under Pillar II but for most banks the incentive to maintain and improve models based on Pillar II within the SREP is minimal in the end.

The New Standardized Approach methodology misses the objective to create a level playing field and it does not maintain an appropriate level of risk sensitivity that does keep differences among jurisdictions and banks.  It is also important to note that the framework is not forward-looking. Indeed, the framework implies an increase in capital required for operational risk after an operational loss event, but not before.

These shortcomings have already been identified by non-EU regulators, for instance in Australia or in the U.S. Depending on how the reform will be implemented in the EU, this raises concerns of an uneven playing field for cross-border banks.

The impossibility to recognize any forward-looking mitigation is considered a major flaw of the new methodology, which could jeopardise the management of operational risk itself. Insurance is not encompassed in the SMA approach, while we believe it would have been essential to maintain the possibility to use it as an active operational risk management tool. Effectively applying an insurance scheme has multiple positive aspects and allows the "pricing" of operational risk against a third party with opposite economic incentives (i.e. buyer and seller). The recognition of insurance recoveries in netting operational losses does not address the above-mentioned aim as in this way only the expected losses are considered instead of taking into account the risk transfer allowed by an effective insurance framework. All in all, some risk management actions such as insurance should be made deductible from the BIC

In general, we are critical on the adoption of Standardised Approaches for operational risk due to the fact that the "one size fits all" solution does not properly capture structural differences in jurisdictions (Europe or Asia vs US) or in business mix (high profile investment banking – e.g. industrial packaging of CDOs – vs plain vanilla commercial banking business). In particular, the Business Indicator to be calculated in order to determine the BI Component of New Standardized Approach methodology is not deemed to be risk sensitive and it is proven to be strongly correlated to the Gross Income previously adopted.

Although the BI aggregate has been made simpler, the ILM formula and calibration are still missing a clear rationale especially as operational losses are already taken into account in the BI aggregate within the OOE component. Provisions for operational risk should be deducted from the BIC in order to avoid double counting.

There is also no segregation by business activities, meaning that jurisdictions having a high level of disintermediation could be better promoted.

The new BCBS rule (paragraph 11 of the chapter on operational risk) specifies that banks pertaining to the bucket 1, i.e. banks for which the Business Indicator is less than 1 billion euro, are exempted from using internal loss data for the calculation of the operational risk capital charge. In other words, for such banks, the Internal Loss Multiplier is equal to 1, so that the operational risk capital charge is equal to the Business Indicator Component, i.e. 12% * BI. As a result, these banks are not required to identify and to collect loss data as required in paragraphs 19 to 31 of the BCBS standard.

In addition, Basel proposes many other national discretions for banks in buckets 2 and 3 notably with respect to losses thresholds, length of history for losses or ILM value as the "one formula fits all" would finally be difficult to implement given the very diverse level of maturity and reality of banks. Nevertheless, it is important that in Europe the options are consistently chosen. We would support that options on national discretion are set at the European Commission level in order to achieve a level playing field in Europe.

### Impact on business

The New Standardised Approach has a material impact on the capital requirement for operational risk. For AMA banks the estimated increase is in the range of 80% to 100%.

As it appears from BCBS impact figures presented by the BCBS[2] and by EBA[3], the impact on European banks is significant and much higher than for the rest of the world (US for instance). We understand that these impacts studies have considered an option where ILM=1 for Europe, as explicitly mentioned in the EBA document, and we would again support that this option is confirmed at European level.

EBA: increase of operational risk MRC of approximately 26.0% for Group 1 banks and 24.5% for G-SIIs, while the increase for Group 2 banks is 15.6% at EU level, with ILM=1 BCBS: decrease of MRC of approximately 25.0% for all Group 1 banks and 30.2% for G-SIBs while there is an increase of 6.9% for the Group 2 banks at worldwide level, with 'calculation by setting the internal loss multiplier to one whenever national supervisory authorities have indicated that they will most likely apply the national discretion, or alternatively whenever it results in lower average MRC for the banks in the given jurisdiction'.

In addition, banks which are highly specialised in fee businesses have been identified as facing a disproportionately high capital impact under the BI. This impact forecast was especially high (2x, 3x vs previous capital requirement) for banks whose main/only business relies on financial assets distribution through financial advisor networks. Their business model implies a very strong (in some cases, almost exclusive) top line contribution from Fees Income, deriving mainly from Management/Recurring Fees; coupled with material Fees Expenses, deriving mainly from Financial Advisors' remuneration. The so-called pay-out/pay-in ratio is structurally high in the industry, given the high quality of the advice delivered by Financial Advisors and the strict adherence to MIFID/MIFID II requisites.

The smoothing factors introduced in the second release of the draft for the calculation of the Service Component, set a partial yet effective remediation to the "disproportionately high capital impact". Conversely, the smoothing factors' disappearance in the following release recreates the "disproportionately high capital impact".

A high level, or a growth in Management Fees doesn't involve a deterioration of the operational risk profile, for the following reasons:

- Assets Under Management, i.e. the basis for calculating Management Fees, may increase due to market performance or new inflows, while the number of Customers/Financial advisors / Products stays stable; the corresponding increase in management fees is backed up by exactly the same operations; it's hard to see how this could be reflected in more risk capital;
- even when AUM increases due to a growth in the number of customers / financial advisors / products, the process of fee collection is (1) extensively automated, repeated over time on basis of a continuous and stable client relationship, carefully controlled and cross-checked, and therefore high severity operating errors are

[2] BCBS Basel III Monitoring Report - December 2017 -Results of the cumulative quantitative impact study
[3] EBA AD HOC CUMULATIVE IMPACT ASSESSMENT OF THE BASEL REFORM PACKAGE  20 December 2017

unlikely to happen (2) in case of any error (e.g. IT failure and subsequent delay in debiting fees), it is seamlessly recovered given the assets are usually in custody of the bank.

Moreover, in times of ultra-low interest rates, 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.

### Implementation challenges

We expect the following implementation challenges for the New Standardized Approach:

- Where the business indicator relies on three years of financial statement information, for those jurisdictions that only report audited financial statements annually, is the expectation that banks will only calculate/update the operational risk capital charge once each year or more frequently (e.g. quarterly)?
- The Business Indicator is a complex aggregation of P&L items. In the absence of a full convergence between accounting principles applied worldwide and a planned harmonisation process, the BI would be barely comparable across banks. In fact, depending upon the accounting principles used (e.g. IFRS rather than US-GAAP), credit institutions account differently for operating/fee income and expenses. At the EU level ABI is preparing a definition of the BI in terms of FINREP codes. This seams the most reliable solution.
- Considering the inclusion of losses and BI items regarding M&A (see par. 31 p. 133: "Losses and measurement of the BI must include losses and BI items that result from acquisitions of relevant business and mergers"), some doubts could arise if the data are not available for the entire reference period (because, for example, acquisitions/disposals). In particular:
    - Loss Component: the time horizon available for internal loss data may vary within the Group (that is, for some group companies may not be available 10 years of loss dataset);
    - Business Indicator: if they are not available 3 years of BI item, it is not clear if the BI should be calculated taking into account the average calculated on the available observations or we should also consider null values. It is also not specified how to manage when the BI is negative on a certain year. Level of calculation: should operational risk requirements have to be calculated on a consolidated, sub-consolidated and/or individual basis?
    - Grouped losses: if some individual losses are under the threshold of €20k each but have the same trigger, do banks have to consider them as a grouped loss that can be potentially above the threshold of €20k? Some clarifications about the definition of grouped losses would be also welcome because such definition is not included in the Basel III standards.
- Also, the standardised approach will natively change the contribution of each business line to the operational risk capital requirements, compared to the current approach. We will face a new challenge to properly allocate internally these charges and return on equity (ROE). If the internal allocation of the operational risk charges to the business lines is based on their native contribution, the ROE may be significantly affected for some business lines.

Some additional concerns may arise from disclosure requirements.

Given that different banks are at different levels as to the quality and quantity of the loss information, the extent to which the data is meaningful and comparable remains questionable. The bald information required could lead to wrong conclusions and therefore establish an uneven playing field and may actually result in raising more questions.

In addition, it is not clear how external parties can interpret a total loss figure in order to conclude on the quality of OR risk management as this figure covers very different aspects of the evolution of the loss (additional losses on past incidents, new losses, recoveries, adjustment of provisions …).

In any case there is a concern that some operational risk losses notably such as pending litigations and settlements may be subject to confidentiality and a specific mention allowing not reporting these incidents (including the ones for which exclusion is requested) should be provided.

The detailed qualitative and quantitative information about losses should be provided to European Supervisors only.

## On the output floor

### Views

A thorough and well-informed impact assessment should not just show an average or median result. It should analyse the breakdown of the impact into geographies, asset classes and types of banks. Otherwise, relevant impacts on bank businesses and on the underlying economic agents would be overshadowed. Additionally, it is important to point out that a reliable estimate of the consequences of the floor would only be achieved by including the effects of the Fundamental Review of the Trading Book. There is no sense in analyzing the market risk requirements based on current rules as the ongoing CRR reform will change the final outcome significantly.

According to the EBA initial impact assessment, the output floor is the stronger driver of increase in minimum capital requirements. It is the binding factor for one fifth of the banks in the sample. Therefore, the conclusion is that those banks are hit disproportionately by the output floor.

Regarding the disclosure of RWAs and the output floor, The European jurisdiction is facing large Pillar III requirements. We acknowledge the work of the EBA and the ECB in this field, which already require extensive disclosure template regarding internal models. The existing measures ensure the appropriate and transparent use of models, which are sufficient for the regulator and supervisor to have a broad understanding of banks' frameworks. Generally, regarding this topic, we will be in favour to strike balance regarding the density of disclosure, in order to avoid counterproductive measures, redundancy and unduly burdensome requirements.

The proposed disclosure by the Basel Committee (based on Basel III vision) could misleadingly establish the standardised approach as the true capital requirement. It will wrongly lead investors to judge banks with respect to the standardised approach, considered as the "correct measure and benchmark", therefore using a much rougher and less-risk sensitive measure. It will implicitly require them to have additional own funds. This situation has occurred in the past, when investors did not consider phase-in requirements, expecting financial institutions to have fully-phased ratios (CET1, LCR…)

ahead of the regulatory calendar. With the benchmarking of internal models against the standardised approach, market expectations would be permanent, creating undesirable incentives and negative externalities (e.g. on financial stability and credit supply). On top of that, such a disclosure will endanger level playing field since it will push banks using standardised approach to optimize their exposures to comply with this approach which is not the case for banks using mostly internal models.

Also, disclosures by type of risks or type of assets could alter the gain from the phasing of the output floor until 2027. With such disclosures, starting 2022, the analysts and rating agencies would be able to compare and restate the capital requirements of the banks that are using internal models into standardized approach, without any floor.

Moreover, Hypothetical RWA under standardised approach would provide neither more transparency on internal models nor more understanding of internal models. It would not reflect the risk profile of bank using internally modelled RWA. To provide information on hypothetical RWA under standardised approach would bring more complexity in reading the Pillar 3 data. It would be difficult for users to understand the relevance of the standard RWA compared to internal models based RWA.

Alternatively, for all these reasons, we suggest reporting the standardised approach and output floor only to the supervisor and not disclosing it to general public.

### Impact on business

The impact of the revised output floor will have to be assessed by asset class bearing in mind that the output floor is calculated at an aggregate RWA level, which raises the question on its allocation to business lines. The impact analysis of EU policy makers should not be limited to the overall effect, but it should examine in-depth the individual impact by asset class.

We expect the 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 real estate and specialized lending portfolios will be extraordinarily affected since the proposals of the standardized approach are not risk-sensitive enough.

Given that banks are obliged to hold a large amount of high-quality liquid assets, mostly government bonds, to comply with the liquidity (LCR) and funding (NSFR) ratios, there will be 3 ways to make their business mix capital efficient:

1. To reprice assets;
2. To accept less profitability at a time when low profitability is a weakness of the EU banking system, in part due to the overwhelming regulatory cost;
3. To reallocate exposures, increasing riskier assets to the detriment of low risk portfolios that do not contribute to LCR and NSFR compliance. Those portfolios are mainly:
    a. Residential mortgage;
    b. Interbank exposures;
    c. Creditworthy large corporate exposures.

Furthermore, the introduction of a new, untested standardized metric to measure Counterparty risk, the so-called SA-CCR, is likely to have a very negative impact on the viability of hedging tools. In order to preserve the capacity of all economic agents to manage their risks through derivatives, a detailed QIS should be conducted on this part of the framework, with the purpose to assess potential unintended consequences, including cumulative unintended effects due to the combination with the implementation of FRTB and NSFR.

In view of this probable effects, the EU should analyse specifically the case of that 20% of banks which binding factor is the output floor and formulate actions to mitigate unintended consequences.

The total capital requirement is made of the following layers:

- the basic requirement, consisting of a 4.5 % requirement of Common Equity Tier 1, 1.5 % of Additional Tier 1 capital and 2 % of Tier 2 capital, altogether 8 %;
- capital conservation buffer of 2.5 % CET1;
- countercyclical buffer, set by national authorities;
- G-SIB buffer for the largest global banks.

In Europe, a decision was taken to add additional requirements, such as systemic risk buffers, O-SII buffers and various types of pillar 2 buffers. These are however not mandatory from a Basel perspective.

A major problem when capital requirements are based on standardised approaches is that they lose their risk sensitivity. For low risk banks, the output floor RWA is typically higher than the risk based RWA, meaning that capital requirements will stop being risk sensitive for these banks.

### Implementation challenges

In the case where the aggregate output floor is binding, Institutions will face a challenge to properly allocate internally the RWA surcharge between the business lines. Cliff effects and volatility of capital allocation may be detrimental to long-term financing and growth, and lead to excessive volatility and procyclicality.

As an example, we would like to point out that there is a deviation between the asset class definition of specialized lending in the Standardized Approach and the IRB-Approach. As a consequence, the respective portfolios would have to be separated differently in the calculation systems for the different approaches. Apart from the fact that this requires unnecessarily costly IT-adjustments in the front office systems, it will lead to distortions in the management of the respective portfolios. We therefore recommend aligning the IRB-Definition with the SA-definition by introducing the asset class “real estate” differentiating between cash-flow independent and cash-flow dependent real estate financing.