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EBF summary on Basel IV[1] in Europe

The legislative act that the European Commission will propose in the next future for the transposition of the "Finalisation of Basel III" package is not only about resilience of the banking sector. Resilience is an objective already met at large. The upcoming legislation is about credit supply to the economy. The bulk of the activity of European banks is lending to corporates, SMEs and households. Additional increases in regulatory costs have a direct effect in the cost of credit and ultimately in the amount of credit that banks can offer to economic agents. This aspect is crucial for Europe due to the predominant role of banks in financing the economy. It is imperative that European policy makers conduct a critical assessment of the terms for the sake of the European economy. A balanced implementation will keep Europe's longstanding commitment with global standards and minimise potential negative effects on the availability of bank credit to the European economy.

The results of the impact assessment published by the EBA in December 2020[2] show that the expected overall impacts of the Basel IV package are quite significant, European banks' minimum Tier 1 capital requirement would increase by 18.5% at the full implementation date. However, the amount of capital that is necessary to restore the current capital ratios of EU banks, including the management buffers that banks hold on top of minimum capital requirements is not even accounted for in this figure[3]. Furthermore, the BCBS impact assessment reveals that American banks will experience no increase in their capital requirements. It is worth reminding the commitment of the G-20 not to significantly increase capital requirements in any region which was later restated by the European Commission in various occasions[4]. Therefore, it is important to highlight that the Basel IV package is a collection of various changes to existing standards. It is important to keep in

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[1] For the sake of clarity, the EBF uses the term "Basel IV" to refer to the BCBS document "Basel III: Finalising post-crisis reforms", because the vast majority of its proposals and, in particular, the most impacting ones were not contemplated in the original Basel III package (*Basel III: A global regulatory framework for more resilient banks and banking systems*).

[2] EBA, Basel III Reforms: Updated Impact Study, EBA/Rep/2020/34, Results based on data as of 31 December 2019

[3] This has been repeatedly highlighted by the European Banking Federation in its exchanges with the authorities and it is important to consider the entire impact of the "Finalisation of Basel III" reforms to have an accurate understanding of its impact on the EU banking sector.

[4] https://ec.europa.eu/commission/commissioners/2014-2019/dombrovskis/announcements/speech-vp-dombrovskis-european-banking-federation-conference-embracing-disruption_en

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mind that **it is the overall impact of the package that matters**. The different pieces of the reform and their interrelations must be considered all together. In order to fulfil the G-20 mandate in Europe, the EBF proposes several refinements below

The EBF has produced a more comprehensive list of issues with in-depth analysis that remains available to further discuss the proposed refinements and to collaborate with the European Commission and other authorities to explore the potential solutions for each identified issue.

1. **The output floor should be applied at the highest level of consolidation** for each banking group and **only as a backstop through the parallel stack approach (floored RWA applied only to internationally agreed requirements).** Banks should therefore **keep the additional European capital requirements (including P2), and solvency (incl. distance to maximum distribution amount trigger) or resolution ratios (MREL) based on un-floored RWA**

2. **The fact that the EU allows the use of external credit ratings for prudential purposes should not penalize unrated corporates** which are the vast majority in Europe. The 65% risk weight for investment grade exposures should apply to European banking groups as in jurisdictions where external ratings are not eligible. The **SME supporting factor should be maintained**.

3. **The treatment of real estate exposures under the standardised framework should accurately reflect lending practices** with a higher level of granularity and risk sensitivity. The EBF recommends the introduction of objective criteria into the framework that would recognise the dual recourse of loans in the EU and the relevant national specificities of each Member State.

4. **The notion of Unconditionally Cancellable Commitments should be reviewed** and clarified in accordance with accounting standards. The current possibility in the CRR to use a 0% Credit Conversion Factor (CCF) should be maintained where justified. **The CCF applied to technical guarantees should be maintained** at the current applied percentage, 20%.

5. **A differentiated treatment should be introduced for specialised lending exposures** in the standardised approach adopting simple criteria which would enable most banks to reflect more accurately the risks implied by specialised lending. Regarding IRB models, the inputs floors and haircuts should be adequately calibrated in order to reflect the lower risk of specialised lending. Similarly, the slotting approach should be reviewed taking into account the adjustments introduced in the in specialised lending, in order to ensure that there is global consistency of all three approaches: standardized, slotting and IRB.

6. The **effective management of operational risks involves and, increasingly, requires forward-looking activities with an emphasis on** the identification of emerging risks and the prevention of loss through improvements in business culture and processes, the control environment and the use of technology. Moreover, corrective plans are usually put forward after significant losses occur. Therefore, past losses are not necessarily representative of future operational risks. Consequently, operational risk approaches should be forward looking, but in the current regulation this is not the case. Within the current framework, the preferred option of the EBF would be introducing the **operational risk loss multiplier (ILM)** with **a cap at 1** in

the EU for bucket 2/3 banks and bucket 1 banks that choose to make use of the discretion. That would allow to reward good historical operational risk management and thereby incentivize banks to have a thorough risk management culture in place. At the same time this option would avoid excessively penalising banks for past issues that have already been solved and remediated.

7. **The EU exemptions currently provided by the CRR with respect to the scope of the CVA capital charge framework should be maintained**. Especially in the case of non-financial counterparties, the exemption is essential to avoid adverse effects on employment and growth.

8. The EBF recommends a **careful examination of the risk weights for equity exposures** that remain unduly penalised under the revised framework, including intragroup exposures and long-term equity exposures in the banking book (including the application of the 100% RW to equity holdings made pursuant to national legislated programs as per BCBS discretion).

9. The BCBS prudential markets regulation should be implemented in a way that does not negatively impact the **competitiveness of European banks** with respect to banks from other jurisdictions. For the same reason we also call for a revision of the SA-CCR by removing the alpha factor in line with the views of various EU stakeholders [5] before its entry into force **in June 2021**, or as soon as possible thereafter, through a CRR3 "fast track" procedure, taking into consideration the development in other jurisdictions, and following the mandate in the Capital Markets Recovery package that calls the Commission to review SA-CCR "in the context of the economic recovery after Covid-19" in order to ensure that businesses can effectively hedge their risks.

10. The implementation of the Fundamental Review of the Trading Book (FRTB), needs to consider a number of issues. **First**, the **trading book (TB) and banking book (BB) boundary** should be reviewed and refined. **Second**, the FRTB implementation should consider **EU market specificities and risk management practices**, especially when it comes to EU covered bonds, correlation trading portfolio instruments, regulatory liquidity horizons and the treatment of funds and the use of level-2 and level-3 legislative texts for the determination of non-modellable risk factors. **Third**, the internal model approach should have the **same flexibility regarding the sovereign treatment as the standardised approach** when it assigning the risk weights.

[5] Letter of Business Europe to Vice-President Othmar Karas, MEP, High level forum report on the Capital Markets Union

REFINEMENTS FOR THE EU TRANSPOSITION OF THE BASEL IV AGREEMENT

Assessment of the overall impacts of the whole Basel IV package

The Basel IV package subject to transposition to EU law is a collection of various changes to existing standards including a review of the standardised approach for credit risk, new limitations to the application of the IRB models, minimum capital requirements for both CVA risk, market risk and operational risk, an output floor and some adjustments to the leverage ratio. It is important to keep in mind that it is the overall impact of the package that matters. The different pieces of the reform and their interrelations must be considered all together.

1. Appropriate application of the output floor

The output floor is mainly based on the standardised approaches defined for the risk categories assessed through Pillar 1 which in general lack granularity and risk sensitivity in several aspects. According to EBA, 60% of model banks' RWA would be constrained by the output floor. That is removing risk-sensitivity of the framework for the majority of the banks. The lack of risk-sensitivity of the output floor will be damaging to banks with lower risk profile and create disincentives for the lowest risk portfolios and for exposures with safe risk mitigation instruments, for example covered bonds. Segments of clients of the highest credit quality may see their cost of credit pushed up by the output floor if the capital requirements are proportionately higher than the risk involved. This would affect mostly certain credit portfolios like the best tranches of residential mortgage, corporate lending and SME finance.

An appropriate implementation of the output floor should not go further than the Basel IV standards:

- The output floor should be applied at the highest level of consolidation for each banking group as assumed by the Basel framework.
- Because Basel III is based on international requirements only, it should be ensured that the **output floor is applied on the basis of international requirements only in order to calculate the capital requirements**

For the **output floor to serve as an effective backstop, one should:**

- keep the additional European capital requirements (including P2), and solvency (incl. distance to maximum distribution amount trigger) or resolution ratios (MREL) based on un-floored RWA;
- add a new minimum capital regulatory requirement, based on floored RWA applied to international requirements only (solvency and resolution as TLAC):
- add an annual Pillar 3 disclosure of floored RWA (for banks using internal models)

2. Review of the treatment of unrated corporates and maintenance of SME treatment

Banks' lending to unrated corporates which are the vast majority in Europe is extremely penalised rather than being promoted under the reviewed standardised approach. Indeed, corporates make very little use of rating agencies and have therefore have to be

considered as unrated corporates which are assigned a high-risk weight of 100% under the reviewed framework.
Basel IV allows an alternative identification of investment grade exposures for which it is envisaged to apply a 65% risk weight. According to the Basel standard, this treatment is to be applied only in jurisdictions where external credit ratings are not eligible for the calculation of prudential capital requirements. However, implementing this option in Europe would still be justified. It would be a sufficiently prudent approach in a bank-based economy like the EU, where banks have extensive information on the creditworthiness of their corporate consumers. Therefore, the absence of an external rating for corporates is not necessarily an indicator for higher risk and the information collected by banks on their corporate customers can adequately substitute the information that would otherwise be provided by an ECAI (and this is especially the case for mid-sized companies), in order to identify the counterparties eligible for the abovementioned special treatment.

In addition, given the fact that SMEs carry a lower systematic risk than larger corporates, capital requirements for SME exposures should be lower than those for large corporates to ensure an optimal bank financing of SMEs. It is also important to remind that small and medium-sized corporates are key drivers for growth and job creation and that this evidence is already recognised by European authorities for example in the context of Capital Markets Union. In this sense, the EBF supports the current application of a supporting factor to SME exposures.

3. Review of the treatment of real-estate financing

a) The treatment of real-estate exposures under the standardised framework should accurately reflect lending practices with a higher level of granularity and risk sensitivity. In most European economies, real estate is a key economic sector with broad impacts throughout the economy, on employment and competitiveness. We recommend considering the revision of the following terms: Mortgage loans in Europe are mainly dual recourse loans for which the borrower is personally liable (no walk away option). This justifies that mortgage loans show a lower risk profile in the European Union than in other jurisdictions where real-estate loans are only backed by the collateral provided by the borrower, and thus where borrowers are not personally liable. Due to this additional guarantee, EU loans should benefit from lower risk weights compared to non-recourse loans of other jurisdictions, ceteris paribus.

b) The EBF recommends the introduction of objective criteria into the framework that would recognise the dual recourse of EU loans and the relevant national specificities of each Member State. The EBF believes that the low loss rate experience in a specific market would adequately reflect the lower risk profile of real-estate lending due to the existence of additional guarantees provided by the dual recourse and eventually national specificities. In this sense, we suggest that the risk weights proposed by the BCBS, under both the loan splitting and the whole loan approaches, are lowered (application of a multiplier lower than 100%) when the average loss rate (net credit losses per annum divided by the total mortgage portfolio) on residential real estate exposures in a specific market are considered to be sufficiently low in any single year over a certain period of time. This risk weight reduction would only apply if the considered mortgages are dual recourse ones. The calculation of the LTV ratio should be updated in order to better reflect the accurate and current value of the property. The revised standardised framework considers the value of the property at origination as a cap for the calculation of the LTV ratio. Therefore, the pass of time renders those

valuations outdated, an important issue especially for residential real estate mortgage portfolios which are typically long-term loans.
A plausible solution would be to introduce a revaluation of the property value (even in case of increase) on a regular basis into the framework. Furthermore, we recommend keeping the current market value (MV) approach in CRR as applicable value of real estate in commercial real estate or residential real estate. In particular, we recommend not adjusting MV because it relies on a methodology recognised at international level by all the international valuers representatives. Any adjustments would distort the rationale and the underlying criteria/methodology of the MV. The result would be a 'hybrid' MV which would neither be recognised by the valuation profession nor operational in real estate markets.

c) The granularity and risk sensitiveness of the proposed LTV approach should be enhanced to avoid penalising the best quality tranches of credit. In the lower proposed LTV-buckets, especially for commercial real estate lending, the provided risk weights are too high (if compared to industry benchmark).

   For commercial real estate, we recommend adopting one or two LTV buckets below 60% in order to achieve an adequate risk sensitivity of the framework.

d) The option to use the loan splitting approach or the whole loan approach should be up to the bank to allow them to adequately reflect the risks of their portfolios of residential real estate loans. To avoid cherry picking, the bank must apply this approach for the whole real estate asset class and is bound by this choice for certain period.

   The loan splitting approach should also be revised to be aligned with the more sensitive whole loan approach. We propose the risk weight in the 55-80% LTV bracket based on the counterparty should be reduced by a factor of 25 % to reflect that the loans are secured by real estate property. For Retail customers with a risk weight of 75 % the risk weight should thus be 50% in the 55-80% LTV bracket. This would imply approximately the same overall risk weight for an 80% mortgage loan under the whole loan and the loan splitting approaches. Furthermore, a lower risk weight could apply if the LTV is lower than the existing threshold.

e) The EBF recommends an appropriate treatment of land Acquisition, Development and Construction (ADC) exposures in order to avoid penalising the financing of new housing and commercial buildings.

   We propose that exposures are classified as ADC exposures only when there are insufficient other income and assets of the obligor for mitigating the risk of losses (for instance, when the source of payment of loans depends mainly on the cash flow generated by the real estate that is being financed). Furthermore, we propose that exposures arising from the financing of energetic redevelopments are not to be classified as ADC exposures. In the other cases, exposures should be considered as corporate or retail SMEs ones, with risk weights depending on the creditworthiness of the counterparties.

   It is also important to clarify a narrow definition of high-risk ADC exposures that will be associated with a 150% risk weight. Indeed, a too wide definition of high-risk ADC exposures would not capture the risks of this kind of exposures with an adequate level of risk-sensitivity. As mentioned in paragraph 75 and in footnote 52 of the revised Basel framework, when pre-sale or pre-lease contracts amount to a significant portion of total contracts (e.g upper than 30% for residential assets), ADC exposures shall not be identified as high-risk exposures (i.e. for these exposures the 100% instead of the 150% risk weight should be applied). With respect to leasing real estate exposures, regardless of whether they are commercial or residential properties, these exposures should be excluded from the application of higher risk weights whenever the underlying financing operation is aimed at selling or renting the immovable property in construction, as long as the borrower (lessee) provides the lender (lessor) with an already existing irrevocable obligation of a third party to buy or rent the property.

Furthermore, we propose that banks under the standardised approach should have the option to use the slotting approach (subject to supervisory approval), which is currently available for banks using the IRB Approach in the context of specialised lending. This would make the treatment of ADC exposures more risk sensitive, rather than assign a uniform risk weight of 150% that does not reflect actual risks. It is worth noting that this demand has been previously addressed by several respondents to the EBA consultation on RTS 2016/02 on specialised lending exposures.

4. Review of the treatment of Off-balance sheet exposures

a) The notion of Unconditionally Cancellable Commitments (UCC) should be reviewed and clarified in accordance with accounting standards. The current possibility in the Capital Requirements Regulation (CRR) to use a 0% Credit Conversion Factor (CCF) should be maintained where justified.

This kind of commitments is essential for financing the economy. It enables banks to grant financing solutions to corporate clients with the possibility to monitor / restrict any drawings before any sign of weakness is identified. For example, undrawn Trade Finance lines usually considered as unconditionally cancellable need a concrete action from banks to issue a new credit line. The same situation is encountered in case of undrawn lines for discounting receivables. As a consequence, we support the possibility of applying a 0% CCF upon an appropriate level of justification to be provided to the European supervisor.

b) The Basel Committee allows jurisdictions to exempt under national discretion certain arrangements from the definition of commitment provided that 3 conditions are met. We recommend the Commission to confirm the alignment between accounting and risk. The accounting reporting rules should remain the unique reference for the calculation of risk weighted assets calculations. In this sense, we suggest the adoption of the following definition:

Commitment means any contractual arrangement that has been offered by the bank and accepted by the client to extend credit, purchase assets or issue credit substitutes and that is reported in the financial statements. It excludes arrangements that satisfy the following condition:

the client is required to apply to the bank for the initial and each subsequent drawdown

and the following conditions:

1. *the bank has full authority over the execution of each drawdown, regardless of the fulfilment by the client of the conditions set out in the facility documentation, and*
2. *the bank's decision on the execution of each drawdown is only made after assessing the creditworthiness of the client immediately prior to drawdown.*

c) The CCF applied to transaction-related contingent items, known as "trade finance off balance sheet items" in CRR, including technical guarantees (for example: performance bonds, bid bonds, warranties, trade standby letters of credit related to particular transactions) should be maintained at the current applied percentage, 20%.

Indeed, the increase of the CCF to 50% proposed by the BCBS is not justified[6] and would entail an upward pressure on the pricing of technical guarantees for the clients, increasing the costs of exports for European businesses. Additionally, it is necessary to provide a formal definition of transaction-related contingencies for products which fall within the scope of this definition. This harmonisation would ensure consistency and comparability across institutions.

5. Increase of risk sensitivity for specialised lending

a) Specialised lending (SL) exposures benefit from solid collateral rather than from recourse on the entity behind the exposure. Historical data have shown that losses in the specialised lending area are less than half the size[7] of those for unsecured corporate exposures. However, the framework incorrectly provides more value to the credit quality of the exposure rather than to the quality of the collateral. In contrast CRE exposures with an LTV below 60% do benefit from a preferential risk weight of 60%. We advocate for a more granular risk weight for all SL exposures, based upon simple criteria under the SA approach. The minimum risk weight for high quality SL exposures would be 60% similar to the minimum risk weight for CRE exposures.

The framework should be more risk sensitive in the specialised lending asset class. Economic growth and job creation require long-term investments in the assets that expand the productive capacity of a modern economy, such as infrastructure, factories and equipment, education, and research and development (R&D) and promote international commodities trade as well as efficient transportation of raw materials. But the revised approach places specialised lending exposures as unsecured exposures neglecting the benefit from the comprehensive security packages associated with these exposures. This would put into question the future financing of European infrastructures, like offshore wind farms, or the activity of European aircraft companies for example.

The specialised lending activity is carried out and monitored within – predominantly European – banks by specialised expert teams that have the necessary sector knowledge, the capabilities to structure specialised transactions and that apply dedicated monitoring of covenants and collaterals. Banks also benefit from diversification across their specialised lending portfolios, where the values of different infrastructure assets and cashflow are not correlated.

For these reasons, the EBF calls on the European Commission to introduce a differentiated treatment for specialised lending exposures (irrespectively of the approach followed by the banks) adopting simple criteria[8] which would enable most banks to identify the top-quality transactions and better reflect their accurate risks, which would definitively set incentives towards long-term financing. The treatments of specialised lending should be differentiated for the following categories: project finance (infrastructure assets like renewable power plants), object finance (aircraft, shipping and rail), income producing real estate and commodities finance. Each one of these categories should be associated with a specific risk weight table with a bucket differentiation based on indicators that reflect the specific features of the considered specialised lending activity and impact on the creditworthiness of the operation.

[6] Backtestings of the current framework, as well as historical data from ICC (International Chamber of Commerce) and GCD (Global Credit Data) demonstrate that the currently used 20% CCF for technical guarantees already incorporates a huge conservative margin as compared to observed CCF levels.

[7] For detailed data see the Annex on Specialised lending of the EBF Report on Basel IV

[8] See Annex 1 on specialised lending of the EBF Report on Basel IV

The EBF developed a risk sensitive framework for specialised lending (see Annex of the EBF Report on Basel IV) and recommends its adoption when transposing Basel IV in the European Union. Risk sensitivity could be introduced in the transposition of the standardised approach risk weights for SL and of the IRB haircuts and LGD input floors, taking into account the quality of the transactions as already proposed by the Basel Committee for Project finance and Income-Producing Real Estate.

b) Furthermore, unduly penalizing LGD input floors are applied in the IRB approach which ignores the observed good recovery data and the comprehensive security package from which SL lenders benefit. The EBF recommends the adoption of the following refinements:

- The LGD input floor for top-quality commodities, object and project transactions should be aligned with the one applied to Income-Producing Real Estate and thus reviewed downwards from 15%/25% to 10%. The EBF developed a proposal to identify top quality specialised lending transactions and a framework that aims at differentiating their capital treatment (see Annex of the EBF Report on Basel IV). We recommend its adoption when transposing Basel IV in the European Union.
- Banks are required to have enough data to model the effects of the collateral[9], otherwise they should apply the F-IRB approach. This requirement is not appropriate and should be removed since it would exclude many specialised lending exposures from the IRB approach. The data that can be used should comprise external data of asset values or enabling to model cash flows[10]. There are reliable and deep sources of collateral values that can be used for the modelling of specialised lending, such as aircraft values provided by Ascend or ASG, or price data regarding electricity prices for example that can be extracted from Bloomberg to model future cash flows of energy projects.
- The uniform 40% haircut on the collateral value for the LGD floor calculation is not appropriate and should be lowered since it does not allow A-IRB banks to reflect differences in the quality and volatility of the collateral and transaction structures between various transactions. The EBF developed a proposal that recognises the asset quality of the collateral for the purpose of the determination of the haircut. (see Annex of the EBF Report on Basel IV). We recommend its adoption when transposing Basel IV in the European Union.
- The collaterals eligibility criteria should be reviewed since they are not appropriate for Specialised Lending.
- There is no market to assess the value of the project for project finance. In this sense, the haircut to an asset value cannot be applied. Yet projects value should be recognized as the future cash flows enable to repay the debt and provide flexibility notably in case of restructuring. Projects generate sustainable cash flows over their long asset lives. It is difficult to value them as an asset value or as the sum of the values of the collaterals pledged to the lenders. We therefore propose to apply directly an LGD input floor to the IRB LGD of projects (i.e. not splitting the loan in covered an uncovered part).

c) It is also important to note that the Basel Committee will review the slotting approach for specialised lending in the future. We consider that the current supervisory slotting approach is not sufficiently sensitive to the risk of the underlying project, as it only offers the possibility of assigning limited ranges of risk weights to calculate the capital requirements of a new project. Similarly, to the standardised and IRB approaches,

[9] §87 of the Basel agreement
[10] Inc. Pooling data or S&P, Moody's and GCD database

such framework will be detrimental to the future financing of European infrastructures, like offshore wind farms, or the activity of European aircraft companies for example.

The EBF calls on the European Commission to align the slotting approach taking into account the adjustments introduced in the standardised approach. It is important to ensure that the same project has a similar capital treatment irrespectively of the approach used (no arbitrage situation).

Additionally, to those necessary adaptations, we point out inter-alia the following additional features that shall be modified in the future to better reflect the risk positions:

The supervisory slotting approach does not fully recognise the guarantees for risk mitigation. For instance, the guarantees from Export Credit Agencies (ECA), the European Investment Bank (EIB) or Multilateral Guarantee Agencies (MLA) can only be used as a factor for assigning risk weights to specialised lending exposures, but they cannot be used as a post-mitigation technique.

d) Granularity should be introduced in risk weights buckets. For example, one or two category buckets could be introduced to properly capture high quality specialised lending transactions. Additional granularity depending on the maturity of the project could also be included.

We propose to extend the list of eligible financial collateral under the simple approach (paragraph 148 on page 37 of the agreement) with a new category g) comprising those commodities, for which liquid prices are available on exchanges, as well as their hedges, as many lenders require their customers to hedge the price risk of the commodities with e.g. futures contracts.

6. Review of the operational risk framework

We would like to stress that the discretion on the setting of the Internal Loss Multiplier (ILM):

- is key as it has ultimately the highest quantitative impact on the operational risk capital requirements of institutions, in a context where EU banks are much more impacted than their international peers by Basel standards revisions, as observed in the comparison of EBA and BCBS impact studies
- is structural in the Basel operational risk framework implementation as it may condition the need for other supervisory discretions

The effective management of operational risks involves and, increasingly, requires forward-looking activities with an emphasis on the identification of emerging risks and the prevention of loss through improvements in business culture and processes, the control environment and the use of technology. Moreover, corrective plans are usually put forward after significant losses occur. Therefore, past losses are not necessarily representative of future operational risks, and this should be reflected accordingly in the regulatory framework with a more forward-looking approach. At the same time this option would avoid excessively penalising banks for past issues that have been solved and remediated

In the current framework, we strongly support introducing the ILM with a cap at 1 for all Bucket 2/3 banks in the EU (and also to those in Bucket 1 that opt for a specific ILM). That would allow to reward good historical operational risk management and thereby incentivise banks to have a thorough risk management culture in place. Regarding Bucket 1 banks, we support implementing an option to use the ILM, asking the supervisory discretion, in order to establish a robust connection between capital requirements and sound management of operational risk. Indeed, such banks should be allowed to implement a risk-sensitive approach, thereby benefiting from more accurate capital requirements. In return, banks should abide by governance and organizational requirements for operational risk (e.g. the loss data requirements specified in paragraphs 19 to 31 of the Basel III standard), taking into account the proportionality principle. In our views, the sequence for supervisory authorization should be the following:

1. Bucket 1 Bank introduces the demand to use the ILM to the competent authority;
2. Competent authority assesses the demand and grants authorization provided that governance and organizational requirements for operational risk are met.

In principle, for the sake of clarity, banks should calculate their Operational Risk capital requirements solely on consolidated group level. However, irrespective of how the EU regulator decides on the ILM, for those banks that have to comply with operational risk capital requirements at a sub-consolidated level, the decisions taken regarding the ILM at the subsidiary level outside the EU should be reflected in the calculation of the capital requirements for operational risk on a consolidated basis. If the ILM is set at 1 for a specific subsidiary, the loss experience of this subsidiary should not be taken into account when defining the capital requirements for the consolidated group.

In addition, if the ILM is not capped at 1, the national discretion to increase the loss data collection threshold should be exercised by the European Commission. Since past experience of losses is not suitable to predict the future operational risk profile of a bank. In this sense, the EBF recommends increasing the minimum threshold for including a loss event in loss component from €20,000 to €100,000 for all banks.

7. Review of the framework for Credit Valuation Adjustments (CVAs)

The current CRR provides certain exemptions concerning the scope of the CVA risk capital charge that have been introduced in Europe to fix the shortcomings of the calibration of the CVA framework. The latest re-calibration at Basel level[11] is admittedly a certain improvement. However, all in all, this has not solved the problem. Especially in the case of non-financial counterparties (NFCs), the exemptions are essential to avoid adverse effects on employment and growth. Due to their nature, an efficient management of collateral is more than challenging for corporates and standardised 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. 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 or even refraining from certain business activities completely. Both consequences would be highly undesirable.

All in all, the EBF recommends maintaining the status quo with regard to the scope of the CVA framework.
It is important that CVA hedges (counterparty credit spread and exposure components), that are dedicated solely to hedging of accounting CVA for exempted counterparties, should be exempted from any market risk capital charge and from any CVA risk capital charge. As mentioned in paragraph 9 of the Basel standard d424, all eligible external CVA

[11] https://www.bis.org/bcbs/publ/d507.htm

hedges must be excluded from a bank's market risk capital charge calculations in the trading book. Non-eligible external CVA hedges are treated as trading book instruments and are capitalised via the revised market risk standard. However, hedging of accounting CVA for EU exempted counterparties should also be excluded from a bank's market risk capital charge calculations in the trading book. Otherwise the CVA hedge would generate a capital charge for a non-existing unhedged market risk position.

8. Review of the treatment of equity exposures

Equity exposures are unduly penalised under the proposed framework. On the one hand, internal models have been removed. On the other, the newly proposed risk weights under the standardised approach seem too high for the risks involved. The result is that the capital requirement for equity exposures may double without justification based on evidence.

We would recommend a careful examination of the risk weights for equity exposures. At least we consider that a preferential capital treatment should be established for holdings of own funds instruments issued by financial sector entities included in the scope of consolidated supervision and holdings in ancillary services undertakings for a group of banks.

In addition, the definition of speculative unlisted equity exposure should be clarified to avoid the undue inclusion of certain investments (for example in fintechs or start-ups fall into this category simply because the of the way the relationship between the bank and the start-up is built). There should be a differentiation between the risk weights associated with those instruments that are eligible as collaterals in Chapter 4 of the CRR on credit risk mitigation and others. A risk sensitive scaling should be possible to achieve consistency with valuation rules in the credit risk mitigation framework. The high-risk weight of 400% associated with speculative unlisted equity exposure does not seem to be in line with the risk weight applicable to private equity exposures in the CRR (article 155) which was deemed to help the financing of the economy. The notion of private equity with a specific risk-weight of 190% shall be maintained in CRR.

Exposures to central banks (equity holdings) should be also provided with a preferential treatment in line with the risk weight received by European Central Bank (0%).
The proposed new treatment of equity exposures will also negatively affect strategic holdings of equity that are held in the banking book, with a very stable perspective, and that specific to the EU, given the lack of development of capital markets. Until a truly Capital Markets Union is reached in the European Union, we should not hamper this way of financing. Finally, the EU transposition should include the application of the 100% RW to equity holdings made pursuant to national legislated programmes as per BCBS discretion.

9. Review of the Standardised Approach for Counterparty Credit Risk[12]

To moderate the impact of the new Basel accords on the real economy, it is important to carefully consider the impact of the new Standardised Approach for Counterparty Credit Risk (SA-CCR). The SA-CCR will enter into force in June 2021 and will lead to more stringent capital requirements for derivatives than the current approaches due to the calibration of the alpha factor. To avoid an adverse impact on end users, like corporates

[12] Basel Committee on Banking Supervision: Minimum capital requirements for market risk (d457), https://www.bis.org/bcbs/publ/d457.pdf

and project finance, it is important to revise the SA-CCR by removing the alpha factor before its entry into force in June or as soon as possible thereafter through a "fast track" procedure in the CRR3. Otherwise, SA-CCR will make it more expensive for those users to hedge their risks, as the prices for the derivatives that hedge those risks will rise. Ultimately, businesses may either be discouraged from hedging their risks or they will have to pay significantly higher prices for that service, which will affect businesses' competitiveness[13][14]. Both outcomes are considered to have a detrimental impact on the economic recovery. Furthermore, a recalibration is also justified considering that the alpha factor was done in a market environment that is very different from the current one. Therefore, we consider it necessary to follow the call of the High-level Forum in Capital Markets Union[15] and the Capital Markets Recovery Package[16] to revise SA-CCR before its entry into force or as soon as possible thereafter, especially considering that the US regulators have already introduced additional flexibility in 2019[17].

10. General concerns on the market risk framework

The legislative proposal for market risk capital requirements the European Commission will present under article 519b of Regulation (EU) 2019/876, should not transform the applicable EU market risk reporting requirements for the alternative standardised and internal model approaches in capital requirements if the other major jurisdictions (i.e. the United states) have not confirmed their commitment to transpose the FRTB Basel standard. Above all, the proposal should avoid gold plating the Basel standard (BCBS d325 and BCBS d457) introducing specific additional buffers for EU-credit institutions. Therefore, the Commission and the European Banking Authority (EBA) should include review clauses to their draft Regulations, regulatory standards and guidelines not constraining EU institutions with definitive and stringent rules, where competitors benefit from more leeway (in particular as regards to the technical standard on the capitalisation of Non-Modellable Risk Factors (NMRF) as defined in Article 325bf(3) of the Regulation (EU) 2019/876). In the same vein, the European institutions should carefully assess the costs and benefits of the different implementation options. European credit institutions and capital markets call for capital requirements not reducing the competitiveness of the finance offer and the influence of the European economy. Indeed, European finance and investment banks (FIBs) have already lost 10 points of market share in 10 years in the EU territory, to the almost exclusive benefit of American competitors[18].

Specific points that should be addressed in the context of the FRTB implementation

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[13] Letter of Business Europe to MEP Karas of 15 October 2020
[14] Letter of Business Europe to Commissioner McGuinness of 20 November 2020
[15] High-Level Forum report on the Capital Markets Union
[16] Regulation (EU) 2021/558 of the European Parliament and of the Council of 31 March 2021 amending Regulation (EU) No 575/2013 as regards adjustments to the securitisation framework to support the economic recovery in response to the COVID-19 crisis
[17] Joint press release of Fed, FDIC, OCC, November 2019: Federal bank regulatory agencies finalize rule to update calculation of counterparty credit risk for derivative contracts
[18] Please see the Bruegel report « The United States dominates global investment banking: does it matter for Europe? », March 2016

10.1. Trading book and banking book boundary

One of the main areas where refinements are warranted is the **boundary between trading book (TB) and banking book (BB)**. Indeed, in order to allow for a consistent treatment, mandatory inclusion in the TB should not be required for short positions in own credit spreads – typically arising from own liabilities issued out of the BB (whose purpose is funding rather than trading) - and for options hedging BB positions.

Besides that, some aspects of the internal risk transfer (IRT) framework should be reviewed. In particular, the requirement for the external hedge to exactly match the internal trade, in case of equity and credit risk IRT, should be removed or made more flexible, otherwise it could severely affect some kind of businesses. Typical examples are certificates, i.e. own liabilities (short credit) with equity-linked coupon (short equity) issued from BB and placed to investors. An internal deal swaps the derivative component into the TB where equity risk is macro-hedged. Exact externalization on the OTC[19] market is never the case since it is difficult to find a counterparty willing to exactly match the pay-off of each certificate.

In addition, capitalisation on a stand-alone basis of the IRT desk for general interest rate risk transfers seems to be unduly penalising.

Finally, to prevent discouraging sound risk management practices, the framework should recognise - granting suitable derogations - the specificities of internal transactions between TB and BB carried out to accomplish a well-documented ALM mandate.

10.2. Internal models framework

Relevant aspects of the **internal models framework** still need to be carefully assessed. This is particularly the case for the non-modellable risk factors (NMRF) framework, where technical details should be better ruled via flexible guidance rather than a Level-1 text, and the default risk charge (DRC) calculations for sovereigns which apply a regulatory and supervisory regime regarding the IMA that is considered as equivalent in relation to the EU regime.

Regarding the NMRF framework, the rule of NMRF in backtesting should be properly clarified. Backtesting assesses the accuracy of the Risk Management Model (VaR) in conservatively capturing front-office results (PLs - hypothetical, HYPL and actual, ACTPL) volatility. As such VaR must include all risk factors regardless of their modellability status.

Regarding the DRC, the Basel Standard introduces a different treatment in the DRC calculations of the sovereigns, public sector entities and multilateral development banks. The standardized approach allows that these entities may, at national discretion, be subject to a zero default risk weight in line with the Basel III credit risk framework. The Internal Model Approach does not allow this feature, stating that sovereign exposures, equity positions and defaulted debt positions must be included in the model. The EBF firmly believes that this will create an uneven level playing field and a risk of regulatory arbitrage in favour of the less risk-sensitive credit institutions. For this reason, the EBF asks that the Internal Model Approach for market risk includes the same possibility of exemption for

[19] OTC (Over The Counter), private contracts between counterparties

sovereigns, public sector entities and multilateral development as the one allowed for the Standardized approach.

10.3. Treatment of funds

Changes are demanded for the **treatment of funds**, under both the standardised (SA) and the internal models approach (IMA), in order to avoid unintended consequences on the market of such products (due to a penalising prudential treatment heavily reducing their appeal to banks). First of all, banks should be granted the possibility to use the daily NAV series as risk driver of the fund within IMA, without having to decompose it into constituents. The latter approach is simply not viable under an IMA approach so that funds would be relegated to SA.

Similarly, when at SA there should be the possibility to opt out of the look-through approach and treat funds as single equities to be allocated to a non-residual bucket (the equity index bucket with a 15% RW could be a possibility) that properly reflects the diversified nature of the funds.

Finally, a lower loss given default (e.g. LGD = 5%) reflecting the limited impact on the fund NAV of single issuers defaults is required within the Default Risk Charge (DRC) context.

About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 3,500 banks - large and small, wholesale and retail, local and international - employing about 2 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

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