# (1) Output Floor





# **CRR3 - Output Floor**

February 2022

#### **Executive Summary**

The Industry welcomes the Commission's well-considered approach for the Output Floor in CRR3, to ensure its smooth implementation in Europe. We strongly support the intent to apply the floor at the consolidated level of the group, alongside a redistribution mechanism to address host Member States' concerns. With regard to the timeline, we also welcome clarity on the transition to full application by 2030, to take account of the revised international timeline as a result of the Covid-19 pandemic.

In terms of the calculation of the floor itself, the Commission has adopted the single stack approach with safeguards for double-counting of the EU-specific Pillar 2 and systemic risk buffer requirement (both of which will remain frozen until the supervisor reviews those requirements for double counting). In addition, the Commission has made several amendments to ensure that the floor does not unduly impact upon banks' lending to corporates and low-risk mortgages through transitional arrangements lasting until 2032.

While the industry previously sought an alternative approach for calculating the floor in the lead up to the Commission's proposal known as the "parallel stack", we acknowledge that the Commission has tried to address the underlying concerns with the calculation of the Output Floor at EU level. Nonetheless, we think some further tailoring is warranted under a single stack approach with regard to the safeguards for double counting EU specific capital requirements and the transitional arrangements.

In respect of unrated corporates, it is important the proposed transitional measures are extended to all banks (IRB and SA) and potential cliff-edge effects that could arise from a solely time-limited arrangement are avoided. To this end we propose the Commission be granted the possibility to extend the transition via a delegated act based on a more comprehensive EBA review.

In terms of low-risk mortgages, we welcome the specific criteria (low loss rate and double recourse) introduced by the Commission to mitigate the impact of applying the Output Floor. Nonetheless, to safeguard the EU Single Rulebook and avoid major competitive distortions within the EU, we consider it of key importance that the current Member States' option to apply this is removed from the proposal. Further, given the specific nature of the European mortgage market and important societal role EU banks play in providing mortgages which are long term exposures, we believe this exposure type warrants a permanent treatment in the standardised approach (i.e. to cover all banks) instead of a transitional arrangement which is only relevant for IRB banks.

The Basel Committee should also be invited to revisit and review the impact of the floor on lending to corporates and low-risk mortgages. This review should have regard to the different structures of the mortgage and corporate lending markets across jurisdictions to ensure that the output from the application of its rules is broadly equivalent in terms of the impact on capital requirements for lending institutions.

In addition, we note that the Commission has sought to limit the impact of the standardised approach for counterparty credit risk (SA-CCR) on internally modelled banks through resetting the alpha factor to 1 for a transitional period until 31 December 2029, with the potential for this to be permanent subject to an EBA report. Whilst we are supportive of this measure, design and calibration issues persistent within SA-CCR warrant its recalibration throughout the prudential framework. A recalibration of the alpha factor in the Standardised Approach (unfloored) capital framework would be a simple solution, which feeds through to the Output Floor, leverage ratio and large exposures framework respectively. This would address a material aspect of the SA-CCR miscalibration throughout the prudential framework, helping to limit the otherwise potential undesirable impact of reduced bank capacity to provide end-users with risk management products and/or increases in the costs of hedging activity.

Finally, we recommend calibration of the Output Floor is coherent with the Commission's and ESA's ongoing review of the securitisation framework.

Our initial views on the Commission's CRR3 proposals and potential improvements are set out in more detail below.

# Level of Consolidation

We support the Commission's approach to apply at the group consolidated level and would note this reflects the way in which it was analysed and calibrated by the Basel committee and has also received the support of the SSM, as noted by their Chairperson, Andrea Enria: *"This [consolidated application] would be simpler because each banking group would only have to calculate the output floor once. It would also be in line with our goal of supporting a truly European banking market. If the output floor were to be applied at the individual level, the European banking market would fragment further."<sup>1</sup> We therefore think applying it in this way will ensure it is a truly business model-neutral measure and allow banks to diversify their risks and avoid regulatory fragmentation. We also recognise that a redistribution mechanism is important to allay the concerns of host Member States.* 

# **Calculation of the Output Floor**

# Proposed safeguards for EU specific capital requirements (Pillar 2, SyRB, O-SII buffers)

We welcome the Commission's intentions to safeguard against double counting of the EU-specific Pillar 2 and Systemic Risk buffer requirement, both of which will remain frozen until the next yearly assessment and the supervisor has reviewed those requirements for double counting. Furthermore, the CRD also requires a review of the calibration of the O-SII buffer requirement (when an O-SII becomes bound by the floor) to make sure that the calibration remains appropriate.

Nonetheless, we think a more fundamental review of P2R in 2025 is needed, in order to eliminate any capital add-on that is no longer required, in particular due to the removal or reduction of internal models within

<sup>&</sup>lt;sup>1</sup> https://www.bankingsupervision.europa.eu/press/speeches/date/2019/html/ssm.sp191112\_1~01be3b89b0.en.html,

certain risks categories (e.g. credit risk, operational risks). This analysis should be undertaken independent of whether or not the floor is binding for an institution.

### **Transitional Arrangements for Unrated Corporates**

Industry welcomes the proposed Article 465 which provides a transitional treatment lasting until 2032 for how to calculate exposures to unrated corporates under a "hybrid approach".<sup>2</sup> This will mitigate the impact of the Output Floor on lending to corporates by encouraging banks to maintain lending to this vital sector of the economy, as they adjust to implementing the floor in full (by 2030). However, corporate exposures could be potentially negatively impacted as the transitional arrangements end in 2032 leading to a contraction in lending if there is not a wider availability of corporate ratings.

We note that, as part of the proposed arrangements, the EBA is required to monitor the availability of ratings for exposures to corporates by 31 December 2028, and based on this review the Commission shall, if appropriate, propose legislation. We consider this review should be strengthened and more conditional criteria should be introduced in order to give certainty that the underlying issue of insufficient corporate ratings is addressed, and revisited at an international level to address any level playing field concerns. Consequently, the EBA should also assess evidence that the 65% RW has led to inappropriate risk weighting of exposures, the level to which corporate ratings are available, and the approaches of other jurisdictions in applying this treatment and long-term level playing field considerations that could arise. Should there be no significant increase of ratings coverage by the end of 2028 and, absent the development of any changes at the international level or alternative solutions such as credit benchmarking or central bank ratings, the Commission should be empowered to extend the provision by means of a delegated act. Future changes to the transitional arrangements must provide sufficient time for banks to adjust, and any lending granted under the transitional provisions should be subject to appropriate grandfathering.

# Unratedness of Corporates (an explainer)

It's estimated around 75%<sup>3</sup> of corporates<sup>4</sup> in the EU are unrated. While the BCBS has conceded that unrated corporates are not higher-risk assets in the absence of other parameters to determine their creditworthiness, they nonetheless receive a 100% risk weight (RW), aside from in the case of SMEs<sup>5</sup>, under the External Credit Ratings Approach (ECRA).

EU banks using the IRB approach will need to apply the 100% RW for the purpose of calculating the output floor, while an internal rating may be much lower. All other things being equal, the requirement to apply a

<sup>3</sup> EBA Basel III credit risk advice Table 8: Exposure class corporates (excluding SMEs): exposure amounts by rated/unrated

 $<sup>^2</sup>$  Under the 'hybrid' approach in article 465 (3) banks can apply a RW of 65% to corporates where the bank estimates the PD of those exposures, is no higher than 0,5 % under the IRB approach for the purpose of calculating the output floor.

<sup>&</sup>lt;sup>4</sup> The category of "corporates" covers incorporated entities, associations, partnerships, proprietorships, trust funds and other entities that do not qualify under another exposure class. The definition includes insurance companies and financial corporates that do not meet the definitions of exposures to banks, securities firms or other financial institutions, as determined by paragraphs 16 and 37 of the Basel III agreement.

 $<sup>^{5}</sup>$  For unrated exposures to corporate SMEs (defined as corporate exposures where the reported annual sales for the consolidated group of which the corporate counterparty is a part is less than or equal to  $\notin$ 50 million for the most recent financial year), an 85% risk weight will be applied. Exposures to SMEs that meet the criteria in paragraph 55 will be treated as regulatory retail SME exposures and risk weighted at 75%.

100% RW to unrated corporates in the standardised approach could result therefore in financing becoming more expensive for the EU corporate sector.

The hybrid approach proposed by the Commission partially solves the issue of unratedness unduly impacting investment grade corporates by lowering the RW to 65% if they do not have a rating. Nonetheless, this is not a long-term solution – ultimately corporates that wish to lower their cost of funding will need to get a rating which comes at an additional cost that may be passed onto customers. this also runs contrary to the regulatory drive since the financial crisis to move away from reliance or mechanistic application of ratings within the prudential framework.

There are other longer-term solutions that could be developed. One would be to develop a central bank rating process for corporates, such a system has already been developed by the Banque de France based on the FIBEN companies database established in 1978. Other alternatives could be to establish a credit benchmarking platform for banks to pool their company data on or for credit bureaus to be approved as external ECAIs and develop a mechanism to map their assessments to RWs. Should the EU pursue these solutions – which may take time to develop – these should ultimately be reviewed by Basel and, where possible, incorporated into the international framework. Industry supports investigation of these alternatives; however, it should be noted that they also pose implementation challenges.

The issue of lack of ratings is not only limited to banks which use models, but also extends to banks that apply the Standardised Approach, especially with regard to investment grade corporates, which all banks are able to identify. Consequently, we propose commensurate treatment of unrated corporates should be extended to banks using the Standardised Approach where it can be demonstrated that the corporate is investment grade. For instance, this could be achieved by allowing institutions to make use of the internally estimated Probability of Default (PDs) for those exposures for the purposes of either the economic capital calculation or the accounting expected credit loss calculation.<sup>6</sup> These metrics (PDs) follow existing EU regulations, are decoupled from the capital metrics, and are used by all institutions regardless of the approach they use and allow them to identify investment grade unrated corporates with the same level of guarantee as regulatory PDs:

- **PDs used for Provisions (under IFRS9):** They are calculated by all entities using common principles and rules which homogenize this measure across entities: the "EBA Guidelines on Credit institutions' credit risk management practices and accounting for expected credit losses (2017)"<sup>7</sup>. The reliability of these PDs is illustrated by the EBA Guidelines themselves, by giving then priority over ratings provided by credit rating agencies
- **PDs used for Economic Capital:** PDs used as risk parameters for Economic Capital are an alternative mechanism to identify investment grade unrated corporates provided that they meet minimum governance and robustness requirements. Such is the case of PDs used for Economic Capital that follow

<sup>&</sup>lt;sup>6</sup> Consistent with the 'EU Guidelines for the estimation of risk parameters for the IRB approach' or the 'EU Guidelines for the credit institutions' credit risk management practices and accounting for expected credit losses', respectively

<sup>&</sup>lt;sup>7</sup> EBA Guidelines on Credit institutions' credit risk management practices and accounting for expected credit losses (published in 2017) (Link)

the "EBA Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures (2017)"<sup>8</sup>.

Such PDs should have followed the necessary internal validation, supervisory review and governance processes to ensure maximum rigor and compliance with the principles set out in the above-mentioned guidelines, including any necessary adjustments if needed in their operations. These PDs are calculated by counterparty and are widely used by banks. The proposed treatment would correspond to those counterparties with a PD<0.5% and apply a RW of 65% to them.

In the same vein, it should be noted that some advanced banks have entities within their group which use the standardised approach, in this instance such entities should be allowed to use the PDs within the group's IRB entity to apply the hybrid approach.

### Transitional arrangements for low-risk mortgages

In terms of how to address the cliff edge effects of bringing the transition for low-risk mortgages to an end, this is potentially more challenging for a number of reasons. Notably, these types of exposures are by nature long-tenure, so a transition period is not very effective to cushion a cliff-edge effect. This is because, when originating new mortgages, the fully loaded situation after phase-out already needs to be taken into account in pricing. It follows that gradual phasing in approaches are unlikely to have much of an effect as it is difficult to link pricing/origination to the "steps". Hence the benefit of the Commission's proposed transitional treatment will only support a small tranche of mortgages that fall into the criteria now.

For Europe this is a particularly relevant issue, given the difference in the structure of the banking market and provision of mortgages by banks, which is not the case in other jurisdictions. We therefore think in the first instance regulators should consider permanently recognising the impact of the Output Floor on this exposure type as part of the Standardised Approach – i.e. enable all banks to apply this treatment if they can demonstrate the same level of risk – rather than as a transitional measure only available to IRB banks. This could be achieved potentially via the creation of a specific subset of low-risk mortgages that meet the criteria suggested by the Commission. Alongside this it will of course be important to undertake a comprehensive review, ideally at the Basel level, which should re-assess the appropriateness of risk weightings for mortgages in general. Irrespective of an international review, the EBA report due by the 31 December 2028 to assess the appropriateness of the associated transitional risk weights for low-risk mortgages should be more comprehensive. It should consider the overall structure of the European housing market and consider the progress made towards wider securitisation of such assets resulting from a deeper Capital Markets Union, as well as assess the actual performance of mortgages with a set number of characteristics (e.g. LTV or LTI at inception). The review should also consider the EU level playing field in respect of how the mortgage risk weights in CRR are applied and whether the new risk weights have led to excessive or inappropriate lending.

Furthermore, in order to ensure a level playing field across the EU, the permanent application of lower riskweights to this subset of low-risk mortgages should be an EU wide discretion, as opposed to a Member State

<sup>&</sup>lt;sup>8</sup> EBA Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures (published in 2017) (Link)

one – with appropriate oversight by the ECB and ESRB. Maintaining a Member State discretion goes against the ambition of the single market and a banking union and undermines the principle of harmonisation of micro-prudential requirements, which already allow for Member States to raise the risk weights if necessary under Article 124. The proposed subset of low risk mortgages should likewise ensure appropriate recognition of the different features of European mortgages which result in being low risk e.g. credit lodgement and dual recourse.

# Re-calibration of the Alpha factor in the Standardised Approach for Counterparty Credit Risk (SA-CCR) beyond the Output floor

SA-CCR is a new approach which replaced the Current Exposure Method (CEM) and the Standardized Method (SM), for the calculation of Counterparty Credit Risk (CCR)<sup>9</sup> as applied to derivatives transactions, as part of the Regulation (EU) 2019/876 ("CRR2").<sup>10</sup>

While more risk-sensitive, SA-CCR, in its current design and calibration, will lead to disproportionate increases in capital requirements for banks<sup>11</sup> and significantly increased costs for end-users (e.g. corporates – including SMEs, pension funds, etc.) which often use long dated non-cleared (typically unmargined) derivatives to hedge risk, and benefit less from the improvements made through the introduction of SA-CCR in capturing portfolio netting benefits.

Since June 2021, SA-CCR is used in many areas across the prudential framework, such as for calculating capital requirements for CVA risk, for Large Exposures framework<sup>12</sup> and for the Leverage Ratio. It affects all banks and users of derivatives, and the impact is not restricted to those that apply standardized methodologies only. In CRR3, this impact will become even more pronounced as SA-CCR will also contribute towards the calculation of the newly introduced Output Floor.

Among the major reasons for the disproportionate impact of SA-CCR are its design and outdated calibration objectives, since the alpha factor of the formula, which increases exposures by 40%, was set at 1.4 in 2005 by the Basel Committee and was meant to be used to account for general wrong way risk and perceived flaws in <u>internal models</u>, not for standardised approaches.

We are supportive, therefore, of the Commission's proposals<sup>13</sup> to reduce the impact on the output floor RWA, per CRR Article 465(4), by resetting the alpha factor to 1 for a transitional period until 31 December 2029,

<sup>&</sup>lt;sup>9</sup> Counterparty credit risk (CCR) is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.

<sup>&</sup>lt;sup>10</sup> <u>https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019R0876</u>

<sup>&</sup>lt;sup>11</sup> According to ISDA-GFMA estimates, the exposure calculated under SA-CCR will be significantly higher than under both IMM (1.9 – 2.5 times higher) and CEM (2-4 times higher). This is before considering the impact of the Output floor. (See: Link)

<sup>&</sup>lt;sup>12</sup> <u>https://www.bis.org/fsi/fsisummaries/largeexpos.pdf</u>

<sup>&</sup>lt;sup>13</sup> [https://ec.europa.eu/info/publications/211027-banking-package\_en

with the potential for this to be permanent, having taken into account the EBA report mandated by CRR2 and due by June 2023.<sup>14</sup>

However, the transitional measure only applies to the calculation of SA-CCR for the purposes of the output floor RWA, whilst no measures have been taken to address calibration in the Standardised Approach (or unfloored capital risk framework), the Leverage ratio or the Large Exposures framework respectively even though there is a distinct impact in each of these areas:

- Standardised Approach (unfloored capital risk framework): in its current design and calibration, will lead to disproportionate increases in capital requirements for banks and significantly increased costs for end-users (e.g., corporates including SMEs, pension funds, etc.) which typically use non-cleared (unmargined) derivatives to hedge risk.
- Leverage Ratio: is becoming a more biting constraint given the addition of the G-SIB surcharge, Pillar 2 requirements, Pillar 2 guidance, and notwithstanding the impact from its input into TLAC calibration. Therefore, the benefits of recalibrating alpha for the output floor may not be achieved if the exposure measure value used in the Leverage ratio is not consistent.
- Large Exposures Framework: the intent of the Large Exposures framework is to measure the propensity for concentration. The increased exposure values from application of SA-CCR therefore means reduced capacity to provide hedging products to end-users, and hinder recovery from the ongoing crisis.

As such, we believe the adjustment proposed for the Output Floor should be applied consistently across the framework. A simple approach would be to re-calibrate the alpha factor to 1 in the Standardised Approach, as this would then feed into all standardized approach calculations i.e. including the Leverage Ratio and Large Exposures framework consistently, whether or not linked to the Output Floor, with permanent application further considered as part of the EBA's report.

Given these impacts, the EBA review mandated under Article 514 should explicitly look at the issue of calibration of the alpha factor and its impact on firms' and end-users hedging capacity, as well as the international developments, with the view of ensuring adequate competitiveness of EU Capital Markets.

The question of recalibration of SA-CCR also calls for a broader review in the Basel Committee to ensure global consistency. In the US, the alpha factor has been recalibrated to 1 on a permanent basis in relation to exposures to commercial end-users and it was not limited to the RWA Output Floor application only. A review was also mandated in the Securitisation Quick fix package for the Commission to review SA-CCR in order to ensure that EU corporates were able to hedge their financial risks in the context of the recovery from the Covid-19 pandemic and taking into account, among others, the international level playing field.

<sup>&</sup>lt;sup>14</sup> CRR2 - Article 514 Method for the calculation of the exposure value of derivative transactions 1.EBA shall, by 28 June 2023, report to the Commission on the impact and the relative calibration of the approaches set out in Sections 3, 4 and 5 of Chapter 6 of Title II of Part Three to calculate the exposure values of derivative transactions

#### **Securitisation Review**

Whilst the prudential treatment of securitisations does not feature in the CRR3 proposals, the CRR already includes a mandate for a review of the securitisation framework per Article 519a. The review was originally due by 1 January 2022, but the European Commission revised this deadline to 1 September 2022 in its call for advice to the Joint Committee (JC) of the ESAs<sup>15</sup>. We believe this review is essential and international regulatory developments, such as the introduction of the Output Floor will have a significant impact on prudential requirements for securitisations that require consideration. Industry will provide detailed feedback to the JC of the ESAs for consideration, including a recalibration of the p-factor, and we believe it imperative that policy makers consider this work stream in tandem with the ongoing CRR3 proposals to ensure coherence and appropriate calibration of the prudential framework as a whole.

<sup>&</sup>lt;sup>15</sup> Call for advice – See (link)

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# (2) Credit Risk





# CRR3 – Credit Risk

February 2022

#### **Executive Summary**

Changes in the treatment of credit risk reached under Basel III represent some of the widest-ranging and most impactful measures on the role of banks in financing the real economy. This is mainly due to the reduction in the scope of modelling directed at corporates and financial institutions among other types of exposures. For example, Basel III will no longer allow banks to use their internal models under the Advanced Internal Ratings-based Approach (AIRB) for large corporates and institutions, and instead banks will only be able to apply the more constrained Foundation Internal Ratings-based approach (FIRB). These key changes come in addition to the significant work already undertaken at EU level. This includes the ECB to review banks existing models (known as the Targeted Review of Internal Models (TRIM) exercise), and the EBA IRB repair work to harmonise model parameters and supervisory oversight, both of which have been ongoing since 2015 and are near complete.

Consequently, it is crucial that the scope of the Basel III changes is carefully implemented and tailored to reflect European lending practices and financing of the real economy in the post-COVID economic context. To this end, industry welcomes the CRR3 proposals in recognising and the significance of the SME supporting factor and the Infrastructure supporting factor, by maintaining these capital treatments.

With regard to the direct changes to credit risk, there are two areas that deserve particular focus, and which could have negative consequences if EU policy makers do not take further action to amend them – **trade finance and the application of maturity treatment to the RWA calculations.** We would also like to make further recommendations to improve the drafting of credit risk to ensure it is appropriately aligned with EU bank structures and lending practices for strategic equity investments and specialised lending, among other more technical issues.

Finally, it's imperative the changes to the credit risk framework are considered alongside the introduction of the Output Floor, especially with regard to the standardised approach which takes on far greater relevance as the basis for its calculation. To this end we have set out in our Output Floor position paper recommendations in respect of the proposed transitional treatment of unrated corporates and low-risk mortgages, namely:

**Unrated corporates:** the proposed transitional measures should be extended to all banks (IRB and SA) and potential cliff-edge effects that could arise from a solely time-limited arrangement are avoided. In this vein, the EBA should comprehensively review the progress to addressing unratedness and taking account of level playing field issues. Taking this report into account, the Commission should be empowered to **adopt a delegated act if there is insufficient progress to increase the level of corporate ratings** at the end of the transition.

Low-risk Mortgages: Remove the Member State discretion and make the transitional arrangement a permanent EU-wide treatment by creating a designated treatment for low-risk mortgages directly within the Standardised Approach (i.e. applicable for all banks, rather than to mitigate specific impact of the floor IRB banks only).

In both cases the Basel Committee should be invited to revisit and review the impact of the floor on these lending types. This review should have regard to the different structures of the mortgage and corporate lending markets across jurisdictions to ensure that the output from the application of its rules was broadly equivalent in terms of the impact on capital requirements for banks.

#### **Trade Finance**

Trade finance is linked to short-term transactions, where banks play an important role as intermediaries between buyers (importers) and sellers (exporters), to facilitate the flow of goods, both domestically and internationally. By way of context: the World Trade Organization (WTO) estimates that over 80% of international trade relies on some form of trade finance.<sup>1</sup>From a technical perspective, trade finance tends to be a shorter-term asset class compared to other lending activities with the average tenor of most trade finance products ranging from 120 to 170 days according to the International Chamber of Commerce (ICC). Trade finance products are generally secured against the traded goods, self-liquidating in nature and, even in crisis conditions, pose only limited risk to banks and overall financial stability. There are several types of transactions linked to this type of financing, the most common of which are confirmed letters of credit, representing approximately 20% of all trade finance instruments and trade related guarantees. These instruments, due to their short-term nature, have very low default rates, making them a broadly safe asset. As noted by the Secretary-General of the ICC, John WH Denton, the data released in the Trade Register report 2021 shows "that default rates on common trade finance deals remained extremely low in 2020 despite the economic effects of Covid-19 — with impairments on **less than 0.3 per cent of all transactions globally**."

Trade finance instruments are treated prudentially through respective Credit Conversion Factors (CCF) assigned according to their level of risk/ 'bucket' allocation as an off-balance sheet item under Annex 1 of

CRR3. In the case of trade-related contingent items the specific medium/low risk nature of these exposures until now has been wellrecognised by EU legislators and attracted a 20% CCF. Indeed, as reflected in the 2021 ICC trade register<sup>2</sup>, Exposure Weighted Default rates are still very low: 0.18% for Import LCs and 0.01% for Export LCs. 0.42% for Trade Loans and 0.23% for Performance Guarantees (which is even lower than in 2019 and 2018). Under CRR3 however, the Commission has sought to fully align the treatment of CCFs with that set out in Basel III, meaning trade related guarantee items will now be assigned a higher risk 50% CCF. Consequently, this will negatively impact the cost of financing trade



Source: ICC Trade Register Report 2021

<sup>&</sup>lt;sup>1</sup> World Trade Organization. Trade Finance and SMEs (2016). https://www.wto.org/english/res\_e/booksp\_e/tradefinsme\_e.pdf

<sup>&</sup>lt;sup>2</sup> https://iccwbo.org/publication/icc-trade-register-report/

guarantees for European exporters. We therefore urge EU legislators to maintain the current CRR2 treatment.

Another common way banks finance trade for SMEs and Corporates is via contractual arrangements for credit, over which the bank has full authority over the drawdown by the client. This type of contractual arrangement has been specifically recognised under Basel III and is exempt from the definition of a commitment, thereby benefitting from a 0% CCF (as long as it meets the conditions of footnote 53 of the final Basel agreement<sup>3</sup>). While we welcome the EU adoption of this Basel derogation, it does not fully reflect the extent of such contractual arrangements for trade facilities, which are also provided to credit institutions **to support an underlying corporate entity or SME**. We therefore recommend that EU legislators widen the scope of contractual arrangements to trade facilities provided to a financial institution to facilitate a trade transaction for a corporate entity. Further, we propose additional amendments to the Commission's definition of Commitment to ensure it appropriately reflects and captures the way in which banks undertake trade finance.

#### **Recommendations on Trade Finance**

- Amend Annex 1 of CRR3 to revert to the current CRR2 EU specific treatment of trade finance by moving products such as performance bonds, bid bonds, warranties and standby letters of credit from Bucket 2 (subject to a 50% CCF) to Bucket 4 (subject to a 20% CCF).
- Amend the definition of 'Commitments' and treatment of contractual arrangements to ensure trade finance related exposures undertaken by banks on behalf of corporates and SMEs are not unduly penalised by the Basel III reforms and the definition fully reflects bank practices in relation to trade finance are appropriately covered.
- Ensure consistency between the Commission's intention to exempt certain contractual arrangements from the scope of CCFs and Article 111(4).

# Treatment of exposures in accordance with their maturity

The ability to consider the length or maturity of an exposure is a key component of a risk-sensitive approach to calculating RWAs – the longer the maturity of an exposure, the higher the risk. For example, given two exposures to a particular obligor, one with a maturity of 1 year and the other with a maturity of 5 years, the 5-year maturity exposure would be more likely to be downgraded or to default before its maturity than the 1-year maturity exposure, as there is more time for negative events to occur before the 5-year exposure fully pays back.

While the maturity treatment has not significantly changed in Basel III, given the new constraints introduced to the use of the IRB meaning banks will only be able to use the less risk-sensitive Foundation-IRB (FIRB) for exposures to large corporates and financial institutions, the maturity requirements have greater significance. As currently drafted, Article162 allows competent authorities to grant permission to use the actual maturity for foundation exposures (instead of a fixed 2.5-year maturity). This is more reflective of the actual maturity of exposures and has also been recommended in the EBA's advice on implementing Basel III. However, the permission is granted in the context of IRB permission. For A-IRB portfolios moving permanently to the F-IRB approach there will not be any such permission, meaning institutions will not be able to apply the actual maturity. Consequently, applying the actual maturity to foundation exposures is a more risk-sensitive

<sup>&</sup>lt;sup>3</sup> Footnote 53 of the Basel III agreement stipulates that, as a national discretion, a jurisdiction may exempt certain arrangements from the definition of commitments provided that the following conditions are met: (i) the bank receives no fees or commissions to establish or maintain the arrangements; (ii) the client is required to apply to the bank for the initial and each subsequent drawdown; (iii) the bank has full authority, regardless of the fulfilment by the client of the conditions set out in the facility documentation, over the execution of each drawdown; and (iv) the bank's decision on the execution of each drawdown is only made after assessing the creditworthiness of the client immediately prior to drawdown. Exempted arrangements that meet the above criteria are limited to certain arrangements for corporates and SMEs, where counterparties are closely monitored on an ongoing basis.

approach to calculating the maturity and we recommend it should become the default option for banks to apply rather than a supervisory 'permission'.

Another important consideration with regard to maturity is the increased relevance of the maturity parameter under the standardised approach as this is used to calculate the Output floor. The standardized approach to maturity does not differentiate to the same extent under the IRB approaches for the length of the maturity, apart from short-term interbank exposures (3-months or less under CRR2) which receive a lower RW, so as not to inhibit short-term liquidity between institutions. We recommend **this same short-term treatment is extended to Securities Financing Transactions (SFTs) which** perform a key role in capital markets and particular the efficiency of European sovereign debt markets as well as corporates securities (bonds & equities) liquidity. SFTs are usually very short dated and generally have a maturity of less than three months – based on ICMA European Repo Market Survey in November 2021<sup>4</sup>, 93% of outstanding SFTs have maturities below six months and 85% below three months. They are a key source of working capital and not typically provided through capital markets. Moreover, maturity is an objective risk parameter, not dependent on internal models. Short maturities are taken into account in other aspects of the SA, and therefore, we strongly believe that SFTs should be allowed to benefit from this short-term adjustment (see also our CCR position paper for further supporting arguments and data).

Furthermore, we note that in CRR3 the Commission has changed the definition of short-term maturity treatment to limit it to only exposures with an *original maturity* rather than a *residual maturity* of 3-months as current CRR2 allows (and has until now been an EU-specific approach). Unless the EU-specific approach under CRR2 is maintained, exposures with a 3-months residual maturity would be excluded from short-term qualification even if the risk profile is the same as an exposure with an original maturity of 3 months. This is also not aligned with the maturity treatments in IRB under Article 162, where the notion of short-term is based on the residual maturity and is defined as below 1y when it comes to trade finance items. This would create undue discrepancies of short-term qualification before and after floor is applied. Finally, in the specific case of trade finance it is important to align and maintain the CRR2 maturity treatment for such exposures with a maturity of 1 year or less for both standardised and advanced approaches.

#### **Recommendations on Maturity of Exposures**

- Banks be directly granted the discretion to apply the maturity determination when using the F-IRB, instead of the application of a fixed maturity of 2.5 years.
- In line with our position on SFTs, take into account the short maturity of SFTs by introducing in the Standardised Approach a short-term maturity adjustment to make the SA more risk sensitive.
- Maintain the current CRR2 approach to short-term maturity using the **residual** maturity of a 3 months or less, rather than limiting to exposures with an **original** maturity of 3 months or less and align the SA with the IRB treatment of trade finance maturity under 1 year.

# Other Credit Risk issues and technical recommendations

# 1. Specialised Lending

Specialised lending (SL) refers to lending towards an entity specifically created to finance or operate physical assets, where the primary source of income and repayment of the obligation lies directly with the assets being

<sup>&</sup>lt;sup>4</sup>ICMA European Repo Market Survey in November 2021

financed<sup>5</sup>. Generally, this type of financing supports many aspects of the economic value chain, from the exploration and production of raw materials and energy, the transportation sector (e.g. rail, aircraft) to public infrastructure. Specialised lending will therefore underpin a large financing part of the European Green deal for the economic recovery in European and supporting the green and digital transitions.

Under Basel III banks calculate their requirements according to the slotting approach, the advanced approach or the standardised approach. The latter of which is relevant to all banks in terms of calculating the output floor.

We strongly welcome that the Commission has recognised the vital importance of promoting viable infrastructure projects and other specialised projects for the economic growth of the Union:

"Specialised lending by institutions is also a defining characteristic of the Union economy, as compared with other jurisdictions where such projects are predominantly financed by capital markets. Large institutions established in the EU are major providers of funding for specialised projects, objects finance and commodities finance, in the Union and globally; as such, they have developed a high level of expertise in those areas of the to calculate the capital requirements for these exposures."<sup>6</sup>

In general, we support additional granularity the Commission has introduced for object finance, whereby an unrated object finance exposure meets the criteria for 'high quality' attracts a lower RW (80%). However, there is still further room for improvement within the specialised lending exposure class under the SA. The key design flaw of the SA approach put forward by the Commission is that it treats unrated secured specialised lending exposures that are not classified as "high quality" as if they are unsecured corporate loans, despite the lower observed risks due to the legal conditions, collateral and monitoring function used in specialised lending. As non-high quality specialised lending transactions are treated similarly to unsecured corporate exposures, clients would no longer have a strong incentive to be classified under the specialised lending exposure class. This seems counterproductive, as specialised lending structures have proved very resilient over large periods of time. We would therefore request the CRR3 to mandate the EBA to advise the European Commission on a potential broader recalibration of all specialised lending exposures under the SA, which can be complemented with a mandate for the Commission to adopt a delegated act if it deems a re-calibration is needed. The timing should align with the application of CRR3. In its advice on the calibration of the SA, the EBA should consider, amongst other things, the effect of the loan-to-value ratio on the risk profile, as well as the risk-mitigating effect of monitoring mechanisms.

Alongside the review of the SA the Commission should also reconsider the slotting approach. In this respect we recommend the EBA reviews the granularity of the 'slots' for banks that use the slotting approach, particularly in the case of project finance with higher credit and lower risks. In so doing, the EBA should advise the European Commission on a potential broader recalibration of all specialised lending exposures under the slotting approach, which can be complemented with a mandate for the Commission to adopt a delegated act if it deems a re-calibration is needed.Indeed, it should be noted that Basel III includes a commitment to review the slotting approach<sup>7</sup>, but since it was agreed in December2017 no such review has been undertaken, hence the EU should take the lead by conducting its own.

With regard to the advance approach, we welcome that the Commission has provided a phasing in and included already a simultaneous review of the Basel III changes for the AIRB. However, this review should also

 $<sup>{}^{\</sup>rm 5} https://eba.europa.eu/regulation-and-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy/credit-risk/regulatory-technical-standards-on-specialised-lending-policy-technical-standards-policy-technical-standards-on-specialised-lending-policy-technical-standards-policy-technical-standards-policy-technical-standards-policy-technica$ 

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<sup>&</sup>lt;sup>6</sup> Preamble to the CRR3 p.14 https://eur-lex.europa.eu/resource.html?uri=cellar:14dcf18a-37cd-11ec-8daf-

<sup>01</sup>aa75ed71a1.0001.02/DOC\_1&format=PDF

consider whether the current level of input floors could be improved, in particular for project finance exposures which are currently considered unsecured.

### **Recommendations on Specialised lending**

- The EBA should review and advise on a recalibration of all specialised lending exposures under the SA, with the Commission empowered to adopt a delegated act if necessary to implement any necessary recalibration.
- The EBA should also review the granularity under the slotting approach, particularly in the case of project finance with higher credit. EBA should advise on whether a recalibration is necessary, and the Commission should be empowered to adopt a delegated act to implement.
- The existing CRR3 review of input floors should be expanded to consider how the current levels of input floors, especially for project financing could be improved.

# 2) Equity Investments

Basel III made several significant changes to the equity exposure class, most notably to remove the ability for banks to model. Banks will therefore only be able to use the standardised approach to calculate risk weights. Banks are also impacted by this through their equity holdings of financial sector entities within the prudential scope of consolidation and other strategic equity participations in financial and non-financial corporates. We welcome that the Commission has recognised both the need to increase the risk sensitivity of the SA given the removal of modelling for this type of exposure, and also provided specific treatment for strategic equity participations.

In respect of exposures which are considered strategic equity participations, it is important that Article 495a clarifies that the reference to holdings where significant influence is exercised also includes holdings "under control".

Moreover, it is important that all strategic equity participations are treated equally to reflect the diversity of EU bank models, promote diversification, and preserve the economic viability of existing strategic relationship. Consequently, the treatment set out for equity exposures which qualify as strategic equity participations (i.e. a 100% RW) should extend to all strategic equity participations which have been held for more than six years.

#### **Recommendations on Equity Investments – Strategic Equity Participations**

Amend article 495a (3) as follows:

- to clarify the requirement for 'significant influence' which is unduly restrictive and confirm that this treatment would also cover holdings "in control". Banks with such participations would still be required to adhere to other requirements which such as the length of time such as participation is held for to determine whether an investment is strategic or not.
- To reflect the diversity of business models in the EU by making the treatment of <u>all</u> strategic holdings of equity whatever the approach (IRB or SA) used for such participation under the current framework held for more than 6 years subject to the same 100% RW calculation (including all strategic equity participations in financial and non-financial corporates irrespective of the treatment applicable before the entry into force of this amending Regulation). From a risk point of

view, there is no justification for different treatment between these banks' strategic holdings of equity.

# 3) Credit Risk mitigation (CRM)

In the context of Credit Risk RWAs increasing, due to the restrictions on the use of internal models and the introduction of the output floor, banks will have a much greater need for Credit Risk Mitigation (CRM) techniques in order to manage their RWAs. It is therefore important that the CRM framework works effectively, for instance, allowing for cross recognition of CRM under the different approaches (e.g. SA and IRB) with respect to guarantees. We recommend, that when a bank has an IRB model for the guarantor, the PD and LGD should also be permitted to be used to recognise the guarantee on an exposure using the Standardised approach. Further clarifications should also be considered with regard to the cross-recognition of AIRB guarantors to FIRB exposures and the recognition of sovereign guarantees.

A further key recommendation, which has to a certain extent already been recognised through the introduction of a review clause in the CRR3, is the treatment of credit risk insurance products as credit risk mitigants. As part of the review industry looks forward to the opportunity to clarify appropriate eligibility criteria for the product and LGD levels more commensurate to the risks involved and the experience of banks to date. We also recommend the scope of this review is amended to mandate the EBA to work closely together with EIOPA so that any regulation is informed by insurers' own regulatory requirements and industry practices. This review should be brought forward and concluded alongside CRR3 negotiations so that any new regime proposed could be introduced in parallel with the implementation of the revised CRR.

Finally, we think it is important to clarify the way in which some of the new provisions will apply in practice, most notably in respect of better recognition of collateral for undrawn facilities covering off balance sheet items. Confirmation of the way in which this should be applied would be a welcome improvement on CRR2 CRM techniques.

# Recommendations on Credit Risk Mitigation

- Allow cross recognition of CRM under the different approaches (e.g. SA and IRB) with respect to guarantees.
- Refine the scope and timing of the review of credit risk insurance products in line with the finalisation of the CRR3 negotiation process
- Clarify the application of Article 193 (7) to ensure the recognition of collateral against undrawn facilities covering off balance sheet items.

#### **Technical Recommendations**

- 1) **Real estate:** In line with the aims of the single market and banking union, grant banks the discretion to apply the new Basel loan splitting approach (rather than a Member State discretion).
- 2) **Massive disposals of NPLs:** Extend the derogation in Article 500 of CRR2 for banks to adjust their LGD estimates to offset massive disposals of defaulted assets. Extending the period of application of Article 500 until 2024 in the context of the Covid-19 pandemic would not only provide banks with additional time to complete the dismissal processes already started and perform the adjustment envisaged by this article but would also continue to incentivise institutions to free-up capital resources for further lending.
- 3) Acquisition, Development and Construction (ADC) loans: Align the scope of the definition with the narrow scope in the Basel III agreement. Leasing real estate exposures, regardless of whether they are commercial or residential properties, should be excluded altogether from the classification as ADC 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. Likewise, performance bonds used for the construction of real estate properties are also in scope, which is not required by Basel.
- 4) **'Transactor' exposure class:** adapt and simplify this new exposure class introduced by Basel to to suit European financing activities ('Transactors' are essentially revolving retail exposures that meet certain criteria such as a credit card which the obligor pays off in full each month. These benefit from a preferential RW of 45%.).
- 5) Avoid double counting of CVA adjustments under IRB shortfall calculation: As there is a CVA adjustment already made for derivatives, CRR3 should be amended to avoid double-counting when undertaking the IRB shortfall calculation for assessing the shortfall of regulator provisions. We suggest clarifying the text so that the 159(b) applies to non-trading book activities, except for Additional Valuation Adjustment computed on Unearned Credit Spread.
- 6) **Maturity mismatch for unhedged retail exposures (123a):** Article 123a introduces a risk-weight multiplier requirement for unhedged retail and residential real estate exposures to individuals where there is a mismatch between the currency of denomination of the loan and that of the obligor's source of income. As set out in the final Basel III standards, the multiplier is set at the level of 1.5, subject to a cap for the resulting final risk weight of 150%. Where the currency of the exposures is different from the domestic currency of the country of residence of the obligor, institutions may use all unhedged exposures as a proxy. The multiplier is likely to be a major concern for currencies pegged to the euro as the default risk-weight multiplier is punitive for retail exposures. A more targeted approach to exempt lending which is not predicated on the income of the borrower from this multiplier would be helpful to the industry.

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#### **About AFME**

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. Information about AFME and its activities is available on the Association's website: <u>www.afme.eu</u>.

#### **About ISDA**

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 66 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: <a href="http://www.isda.org">www.isda.org</a>.

(3) Counterparty credit risk





# **CRR 3 - Counterparty Credit Risk**

February 2022

# **Introduction**

This paper sets out the industry's positions related to Counterparty Credit Risk (CCR). CCR<sup>1</sup> is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. An economic loss would occur if the transactions or portfolio of transactions with the counterparty has a positive economic value at the time of default. Unlike a firm's exposure to credit risk through a loan, where the exposure to credit risk is unilateral and only the lending bank faces the risk of loss, CCR creates a bilateral risk of loss: the market value of the transaction can be positive or negative to either counterparty to the transaction. The market value is uncertain and can vary over time with the movement of underlying market factors.

Under the CRR framework, there are two main areas which continue to have a significant impact on banks' capacity to maintain and develop hedging and market-capabilities services.

- The Standardised Approach for Counterparty Credit Risk (SA-CCR) was introduced as part of CRR 2 in June 2021, which has led to disproportionate increases in capital requirements for banks under the Standardized Approach and significantly increased hedging costs for end-users, mainly due to the alpha factor applied in the SA-CCR formula. Its impact is however not limited to standardised approach calculation for CCR risk weighted assets (RWAs) as it as affects many other parts of the prudential framework. In particular, it will affect all derivatives users, not just firms that only apply standardised methodologies. Other impacts are to the leverage ratio and large exposure framework.
- Under CRR3, the Standardised Approach for Credit Risk (SA-CR) is of increasing relevance. SA-CR risk weights applies to both unfloored RWAs for non-IRB banks, and to the RWA output floor. For Securities Financing Transactions (SFTs), SA-CR risk weights are overly conservative and not commensurate to the low underlying risks as it does not reflect the short-term maturity and quality of collateral backing these transactions. SFTs allow investors and firms to use assets, mainly high-quality government bonds to secure funding for their activities. Unless the calibration is revised, the increased cost of SFTs that underpin the functioning of financial markets and the efficiency of EU sovereign debt markets will be negatively affected. Similarly for derivative contracts, SA-CR risk weights do not reflect that counterparty downgrade risk is already captured by the CVA risk framework and thus these risk weights should be adjusted accordingly.

This paper will cover respectively two sections, the first will cover SA-CCR and the second will focus on the SA-CR application to SFTs and derivative contracts

- The SA-CCR section with the key industry priorities can be found through pages 2 to 5.
- The SA-CR section can be found through pages 6 to 7.
- We have also included additional recommendations related to SA-CCR as an annex which can be found on pages 8-13.

<sup>&</sup>lt;sup>1</sup> https://www.bis.org/basel framework/chapter/CRE/50.htm





## 1. The Standardised Approach for Counterparty Credit Risk (SA-CCR)

The new Standardized Approach for Counterparty Credit Risk (SA-CCR), which replaced the Current Exposure Method (CEM) and the Standardized Method (SM), for the calculation of Counterparty Credit Risk (CCR)<sup>2</sup> exposures arising from derivatives transactions, as part of the Regulation (EU) 2019/876 ("CRR2")<sup>3</sup>. While more risk-sensitive, SA-CCR, in its current design and calibration, leads to disproportionate increases in capital requirements for banks<sup>4</sup> and significantly increased costs for end-users (e.g. corporates – including SMEs, pension funds, etc.) who typically use long dated non-cleared derivatives to hedge risk, and benefit less from the improvements, made through the introduction of SA-CCR, in capturing portfolio netting benefits.

The importance of SA-CCR is not only in calculating capital requirements for CCR risk-weighted assets (RWAs). As of June 2021, SA-CCR is used in many areas across the prudential framework, such as for calculating capital requirements for CVA RWA (BA-CVA), for Large Exposures framework<sup>5</sup> and for the Leverage Ratio. It affects all banks and users of derivatives, and the impact is not restricted to those that apply standardized methodologies only. This impact will become even more pronounced in CRR3, as SA-CCR will also contribute towards the calculation of the newly introduced RWA Output Floor (OF)<sup>6</sup>.

The Final Report of the High-Level Forum on the Capital Markets Union<sup>7</sup>, noted that "SA-CCR will be used as the foundation of multiple calculations within the capital framework of banks. An overly conservative SA-CCR would have a detrimental impact on the availability and cost of financial hedges to end-users<sup>8</sup>." This is particularly penalising as it is crucial for banks to continue to support the real economy, whilst it is struggling to recover from the effects arising from the Covid-19 pandemic.

#### **Alpha Factor**

Among the major reasons for the disproportionate impact of SA-CCR are its design and outdated calibration objectives, since the alpha factor of the formula, which increases exposures by 40%, was set at 1.4 in 2005 by the Basel Committee and was meant to be used to account for general wrong way risk and perceived flaws in internal models, not for standardised approaches.

We are supportive, therefore, of the Commission's proposals<sup>[1]</sup> to reduce the impact on the output floor RWA, per CRR Article 465(4), by resetting the alpha factor to 1 for a transitional period until 31 December 2029,

<sup>&</sup>lt;sup>2</sup> Counterparty credit risk (CCR) is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.

<sup>&</sup>lt;sup>3</sup> https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019R0876

<sup>&</sup>lt;sup>4</sup> According to ISDA-GFMA estimates, the exposure calculated under SA-CCR will be significantly higher than under both IMM (1.9 – 2.5 times higher) and CEM (2-4 times higher). This is before considering the impact of the Output floor. (See: Link)

<sup>&</sup>lt;sup>5</sup> https://www.bis.org/fsi/fsisummaries/largeexpos.pdf

<sup>&</sup>lt;sup>6</sup> Please refer to AFME's dedicated position paper on the Output Floor.

<sup>&</sup>lt;sup>7</sup> 200610-cmu-high-level-forum-final-report en.pdf (europa.eu)

<sup>&</sup>lt;sup>8</sup> SA-CCR would limit the ability of end-users to hedge risks, because the increased capital requirement of SA-CCR will constrain banks' capacity to support their demand for derivative products at an acceptable cost. This is problematic because EU corporates typically use non-cleared derivatives to hedge their commercial risks, which entail the highest capital charge in SA-CCR. Yet, corporates do not have the complex collateral management systems to support margining, and they are not required to do so by the European Market Infrastructure Regulation (EMIR). Hence, end-users would be left with no affordable alternatives to hedge their structural commercial risks, which will affect their financial strengths and competitiveness.

<sup>&</sup>lt;sup>[1]</sup> <u>https://ec.europa.eu/info/publications/211027-banking-package\_en</u>

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with the potential for this to be permanent, having also the benefit of the EBA report mandated by CRR2 and due by June 2023.<sup>[2]</sup>

However, the transitional measure only applies to the calculation of SA-CCR for the purposes of the output floor RWA, whilst no measures have been taken to address calibration issues when SA-CCR is applied under the Standardised Approach (or unfloored capital risk framework), the Leverage ratio or the Large Exposures framework respectively even though there is a distinct impact in each of these areas:

- Standardised Approach (unfloored capital) RWAs: in its current design and calibration, will lead to disproportionate increases in capital requirements for banks and significantly increased costs for end-users (e.g., corporates including SMEs, pension funds, etc.) which typically use non-cleared derivatives to hedge business risks;
- Leverage Ratio: is becoming a more biting constraint given the addition of the G-SIB surcharge, Pillar 2 requirements, Pillar 2 guidance, and notwithstanding the impact from its input into TLAC calibration. Therefore, the benefits of recalibrating alpha for the output floor may not be achieved if the exposure measure value used in the Leverage ratio is not consistent.
- Large Exposures framework: the intent of the Large Exposures framework is to measure the propensity for concentration. The increased exposure values will reduce capacity to provide hedging products to end-users, and hinder recovery from the ongoing covid crisis.

As such, we believe the adjustment proposed for the RWA output floor, should be applied consistently across the prudential framework. A simple approach would be to re-calibrate the alpha factor to 1 in the standardised approach, as this would then feed into SA-CCR for all Standardised Approach calculations - i.e. Counterparty Credit Risk including the Leverage Ratio and Large Exposures framework - consistently with permanent application further considered as part of the EBA's report.

Given these impacts, the EBA review mandated under Article 514 should explicitly look at the issue of calibration of the alpha factor and its impact on firms' and end-users' hedging capacity, as well as the international developments, with the view of ensuring adequate competitiveness of EU Capital Markets.

The question of recalibration of SA-CCR also calls for a broader review at the Basel Committee to ensure global consistency. In the US, the alpha factor has been recalibrated to 1 on a permanent basis in relation to exposures to commercial end-users and it was not limited to the RWA output floor application only. A review was also mandated in the Securitisation Quick fix package<sup>9</sup> for the Commission to review SA-CCR in order to ensure that EU corporates were able to hedge their financial risks in the context of the recovery from the Covid-19 pandemic and taking into account, among others, the international level playing field.

# Recommendation(s)

Re-calibrate alpha to 1 for all applications of SA-CCR: Counterparty credit risk under the Standardized Approach, Leverage Ratio and Large Exposure.

<sup>&</sup>lt;sup>[2]</sup> CRR2 - Article 514 Method for the calculation of the exposure value of derivative transactions 1.EBA shall, by 28 June 2023, report to the Commission on the impact and the relative calibration of the approaches set out in Sections 3, 4 and 5 of Chapter 6 of Title II of Part Three to calculate the exposure values of derivative transactions.

<sup>&</sup>lt;sup>9</sup> https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:L:2021:116:FULL&from=EN







## Credit Risk interlinkage: Transitional Arrangements for Unrated Corporates

The Industry welcomes the proposed Article 465 which provides a transitional treatment lasting until 2032 for how to calculate exposures to unrated corporates under a "hybrid approach"<sup>10</sup>, which will also feed into SA-CCR calculations of exposure values within the output floor. However, the issue of lack of ratings is not limited to banks which use models but also extends to banks that apply the standardised approach, especially with regard to investment grade corporates, which all banks are able to identify.

Consequently, we propose commensurate treatment of unrated corporates should be extended to the calculation of standardised RWAs where it can be demonstrated that the corporate is investment grade. For instance, this could be achieved by allowing institutions to make use of the internally estimated Probability of Default (PDs) for those exposures for the purposes of both either the economic capital calculation or the accounting expected credit loss calculation<sup>11</sup>. These metrics (PDs) follow existing EU regulations, are decoupled from the capital metrics, and are used by all institutions regardless of the approach they use and allow them to identify investment grade unrated corporates with the same level of guarantee as regulatory PDs<sup>12</sup>. Such PDs should have followed the necessary internal validation, supervisory review and governance processes to ensure maximum rigor and compliance with the principles set out in the above-mentioned guidelines, including any necessary adjustments if needed in their operations. These PDs are calculated by counterparty and are widely used by banks. The proposed treatment would identify those counterparties with a PD<0.5% and apply a RW of 65% to them.

In the same vein it should be noted that some advanced banks have entities within their group which use the standardised approach, in this instance such entities should be allowed to use the PDs within the group's IRB entity to be able to apply the hybrid approach.

#### Recommendation(s)

We propose commensurate treatment of unrated corporates should be extended to the standardised approach where it can be demonstrated that the corporate is investment grade

#### **Design and calibration issues**

SA-CCR retains a number of design and calibration issues beyond alpha factor recalibration that warrant attention. A more comprehensive review of SA-CCR should be conducted as part of the remaining CRR3

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<sup>&</sup>lt;sup>10</sup> Under the 'hybrid' approach in article 465 (3) banks can apply a RW of 65% to corporates where the bank estimates the PD of those exposures, is no higher than 0,5 % under the IRB approach for the purpose of calculating the output floor.

<sup>&</sup>lt;sup>11</sup> Consistent with the 'EU Guidelines for the estimation of risk parameters for the IRB approach' or the 'EU Guidelines for the credit institutions' credit risk management practices and accounting for expected credit losses', respectively

<sup>•</sup> **PDs used for Provisions (under IFRS9):** They are calculated by all entities using common principles and rules which homogenize this measure across entities: the "EBA Guidelines on Credit institutions' credit risk management practices and accounting for expected credit losses (2017)" (Link). The reliability of these PDs is illustrated by the EBA Guidelines themselves, by giving then priority over ratings provided by credit rating agencies

<sup>•</sup> **PDs used for Economic Capital:** PDs used as risk parameters for Economic Capital are an alternative mechanism to identify investment grade unrated corporates provided that they meet minimum governance and robustness requirements. Such is the case of PDs used for Economic Capital that follow the "EBA Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures (2017)" (Link).

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process, either directly through level 1 legislative change or via a delegated act following the EBA's report mandated in CRR Article 514. Ideally a comprehensive review should also be pursued at the Basel level to ensure international consistency potentially through the BCBS Evaluation Task Force.

The following are the priority topics contributing to the overly conservative calibration of SA-CCR beyond alpha:

- 1. The use of internally calculated deltas
- 2. The recognition of diversification benefit between FX hedging sets
- 3. The recognition of initial margin

Further details on these priority topics are provided below.

Allow firms to use internally-calculated deltas

The SA-CCR addresses one of the main shortcomings of CEM by allowing firms to delta adjust the notional for non-linear derivatives. While the Industry welcomes the application of deltas, we are concerned by the requirement to use the Black-Scholes formula to calculate the deltas for certain types of options. Firms should be allowed to follow existing internal practices applicable to path-dependent options and other complex non-linear derivatives for which the Black-Scholes formula does not work. Use of such internal practices would be subject to a firm's internal model governance framework and supervisory oversight.

# Recommendation(s)

Allow firms to use internally-calculated deltas.

# Recognise diversification benefit across hedging sets within an asset class

SA-CCR does not reflect any diversification benefit across hedging sets within an asset class i.e. the positive exposure value of one hedging set cannot be offset with a negative exposure value of another hedging set. This is overly conservative and risk insensitive, and significantly overstates the exposure value compared to internal modelled approaches, where some degree of diversification is assumed.

# Recommendation(s)

Better recognition of diversification benefit across hedging sets within an asset class.

# Improve recognition of initial margin in calculation of total exposure

The benefit that initial margin provides to reduce derivatives exposure is not sufficiently recognised in the SA-CCR calculation of exposures. The methodology is very conservative and it leads to a disproportionate amount of initial margin needed to be posted to reduce the exposure. The lack of adequate recognition of IM results in overstated exposures and therefore unduly conservative capital requirements. Given the significant increase of IM in the financial system over the last years it is economically important that it appropriately recognises the reduction in counterparty credit risk.

# Recommendation(s)

Better recognition of initial margin (IM), to reflect its risk-reducing properties.





# 2. <u>Standardised Approach for Credit Risk (SA-CR) and its application to Securities Financing</u> <u>Transactions and Derivative Contracts</u>

#### **Securities Financing Transactions**

One area where the revised framework results in a significant increase in capital requirements relates to SFTs. Under the revised framework, there is no significant change to how the Internal Model Method ("IMM") exposures and the IRB risk weights are calculated. However, the new standardized approach ("SA") adds a significant level of conservatism by not recognizing the very short-term nature of SFTs. The unintended impact of the floor could lead to an eight-fold increase in RWAs, thereby potentially rendering the SFT business uneconomical for the banks that are active in the wholesale market, of which SFTs form a very important component. Such an outcome could threaten liquidity benefits for all stakeholders, from issuers (higher cost) to end-investors (lesser liquidity).

While the impact is SA specific and banks can still use models to better capture the underlying low risk profile of SFT transactions, the SA calibration will have a direct impact for all banks through the application of the output floor. SFTs are short term positions. Based on ICMA European Repo Market Survey in November 2021, 93% of outstanding SFTs have maturities below six months and 85% below three months (see chart below). The short maturity is reflected in IRBA but not in SA except for counterparties that are banks, resulting in capitalising short-term secured transactions similarly to unsecured long-term transactions. Maturity is an objective risk parameter, not depending from internal models. Short maturities are taken into account in other aspects of the SA, and therefore, we strongly believe that SFTs should be allowed to benefit from these short term adjustments.



Graph 5: Maturity analysis of outstanding repo transactions

Source: ICMA, European Repo Market Survey, November 2021

Furthermore, implementing the SA risk weighting rules without a sensible maturity adjustment for repo-like transactions will undermine the existing measures that target facilitation of market-making in other parts of EU prudential regulation, whether on Net Stable Funding ratio (NSFR) and Liquidity Coverage Ratio (LCR). Notably:





- LCR: no LCR cost when Level 1 HQLA are used as an SFT collateral. On the contrary, monetising High Quality Liquid Assets (HQLA) often depends on ability to repo the securities.
- NSFR:
  - SFTs generate no regulatory *Required Stable Funding* if backed by HQLA Level 1 collateral
  - Beyond six-month maturity, SFTs are subject to a 50% Required Stable Funding ratio.

Such measures would fail to reach their goals if liquidity in HQLA assets is undermined by such a punitive capital treatment in the credit risk framework, forcing market-makers to possibly restrict their inventories and therefore the liquidity they can provide to the market.

# Derivatives

For derivative contracts, the calibration of SA-CR risk weights do not account for the fact that the counterparty's downgrade risk is already captured by the CVA risk framework.

The flat calibration of SA-CR risk weights embeds in its horizon the downgrade risk of the associated counterparties and therefore overlaps with the capitalisation of downgrade risk for positions in scope of the CVA risk framework. Under the CRR3 proposal, Article 162(2)(i) allows banks to cap the M factor in the IRB risk weight formula with the effect of eliminating the double counting of downgrade risk between CCR and CVA risk RWAs. A similar adjustment is not being proposed for the SA-CR method.

To avoid impacting the cost of derivative contracts and users' ability to afford them, SA-CR risk weights should be adjusted accordingly.

# Recommendation(s)

- Amend the SA-CR treatment of SFTs by introducing a short-term maturity adjustment. The CRR3 proposal already assigns lower risk weights for selected short-term exposures:
  - In the Standardized Approach, specific short-term RW exist for exposures to "institutions", externally rated (Art 120 Table 4) or unrated (Art 121 Table 5), below 3 months for all exposures, and below 6 months for exposures related to "the movements of goods across national borders", i.e. trade finance
  - In the IRB-Foundation Approach, a 6 months maturity applies for SFTs, instead of the fixed 2.5y maturity for all other exposures (Art 162)
- When applied to derivative positions, SA-CR risk weights should be adjusted accordingly for positions in the scope of the CVA risk framework.





## Annex : Other SA-CCR Recommendations

#### Increase flexibility in certain parts of the methodology, such as allowing index decomposition

Firms should be allowed to use a look-through approach to decompose indices within credit, equity and commodity asset classes to more accurately reflect the exposure of highly correlated long and short positions. The hedging set amount for equity and credit derivative contracts requires a firm to differentiate between index and single name underliers for the purposes of different supervisory factors, option volatilities and correlation parameters. With respect to commodity indices, a firm would have to select a single supervisory factor to the index and treat it as a single commodity sub-class as opposed to a diversified index. As a result, firms are unable to decompose an index into its underlying components as they do for other capital requirements (e.g. in the FRTB under the Basel standards)<sup>13</sup>.

The option to use a look-through approach to decompose credit, equity or commodity derivatives referencing an index into single-name derivatives each referencing one component of the index recognises the hedging benefit provided by the component of an index and provides enhanced risk sensitivity to SA-CCR framework.

The decomposition of indices for the purpose of calculating capital requirements is a well embedded practice for firms that is already required or permitted in other parts of the prudential framework. Therefore the Industry would support EU policymakers providing for an option to decompose equity, credit and commodity indices within SA-CCR, should firms be able to carry out such decompositions. This approach will more appropriately represent the risk and will better align with the FRTB. It will also match the approach chosen by US regulators.

#### Recommendation(s)

Allow firms to use a look-through approach to decompose multi-underlying credit, equity and commodity derivatives into their single-name derivative constituents to improve recognition of hedging / offsetting benefits and hence better reflect the risk associated with transactions.

#### Align with Basel standards on the treatment of liquidation period for un-margined netting sets

Article 276(3)(a) requires firms to apply a 1-year liquidation period to all unmargined netting sets for the calculation of collateral haircuts, irrespective of the maturity of the transactions in the netting set. This diverges with Basel FAQ CRE52.10<sup>14</sup>, which takes into consideration maturity by requiring the liquidation period to be the maturity of the longest transaction in the netting set, capped at 250 days. The proposed treatment unduly penalizes netting sets with short maturities and unreasonably undermines the risk mitigation effect received from eligible collateral. It also adversely impacts the regulatory capital benefit arising from market developments in Settle-To-Market (STM), under which the variation margin is treated as cash settlement rather than collateralization and leads to a shorter, i.e., 1 day, trade maturity.

<sup>&</sup>lt;sup>13</sup> MAR21.31 (Treatment of index instruments and multi-underlying options)

https://www.bis.org/basel\_framework/chapter/MAR/21.htm?inforce=20230101&published=20200327#paragraph\_MAR\_21\_20230101\_21\_31 14 https://www.bis.org/basel\_framework/chapter/CRE/52.htm

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Under the current EU standard, the value of cash and securities collateral received for these transactions is reduced by a factor of 5 times more ( $\sqrt{250}/10$ ) than required under global standards. Therefore, the Industry recommends that the EU implementation should align with Basel standards.

It is suggested to allow firms to apply a lower liquidation period that equals:

- Maturity ("M" as defined in Article 279c for Maturity Factor) floored at 10 business day, when the longest maturity of the trades in the netting set is less than 1 year;
- 1 year, when the longest maturity of the trades in the netting set is more than 1 year.

This proposal is aligned with the determination of the Maturity Factor for unmargined netting sets.

# Recommendation(s)

Consider amending Article 276(3)(a) to read: 'the remaining maturity of the longest transaction in the netting set, capped at 250 business days and floored at 10 business days, for the netting sets referred to in Article 275(1)' and adding the following: 'Where a transaction is structured to settle outstanding exposure following specified payment dates and where the terms are reset so that the market value of the transaction is zero on those specified dates, the remaining maturity of the transaction shall be equal to the time until the next reset date'.

# Supervisory Delta: Provide methodology to deal with negative underlyings across all asset classes

The shift parameter in the Supervisory Delta formula was introduced to accommodate negative interest rates. However, this fix is limited to interest rate options. The underlying assumption is that in other risk classes (e.g. equities and commodities), prices should always be positive. That is, however, not always the case. For example, on April 20th, 2020, the WTI futures contract turned negative. While this was a very unusual circumstance, it is common to trade commodity spread options (e.g. Brent vs WTI or WTI Houston vs WTI Midland) where the underlying spread can be negative. Another common example include options on the difference in performance across two equity indices which, by design, can be negative. At the moment, firms have to use a default mechanism to handle such situations. The Industry suggests the following alternatives to address this issue:

- The preferred method is for the Industry to expand the shift parameter application to all asset classes. In this case, the shift parameter could be kept at 0.1% or a higher value given that the underlying are price-based as opposed to yield-based.
- A more simplistic and less preferred method would be to set the Supervisory Delta for all call options to 0, long put options to -1, and short put options to 1. The underlying assumption is that the strikes are positive and therefore anything close to 0 or less is out of the money for a call option or deeply in the money for a put option.

#### Recommendation(s)

Use of the lambda ( $\lambda$ ) parameter to accommodate negative prices should be allowed for all asset classes not just interest rates.

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# Adjusted Notional Amount

As a general principle, it is important to align the notional definition of a derivative contract with the firm's actual closeout risk. While standard notional definitions may produce reasonably accurate exposure estimates for the majority of derivatives, this would not always be the case. For some derivatives, it is impossible to accurately calculate exposure using standard notional definitions.

#### Recommendation(s)

Firms should be allowed to use internal definitions in cases where the rules are not prescriptive subject to internal governance practices and consultation with, and oversight from, their onsite supervisory teams.

### Leverage Ratio – NICA calculation

Non-segregated collateral posted and included in the definition of the NICA are already included in the other assets exposure for the leverage calculation. Institutions should not be penalized by counting this collateral a second time in the calculation of the exposure value of derivatives.

#### Recommendation(s)

Consider amending Article 429c(4) to read:

'4. For the purposes of paragraph 1 of this Article, institutions shall not include collateral received or posted in the calculation of NICA as defined in Article 272, point (12a).'

This amendment is consistent with the Basel framework LEV30.16

# Margin in Transit

Under the current capital rules, firms are only allowed to reduce their credit risk exposures for derivatives by the amount of any eligible variation margin (VM) received by the firm. This frequently results in increased exposures to counterparties because of timing differences between a margin call and the receipt of variation margin, which is generally on a T+1 basis. Under the capital rules, VM received on T+1 cannot be used to offset derivatives exposures calculated on day T+0 even though firms fully expect the collateral to be received on T+1. This timing issue can result in significant increases in capital charges for firms in periods of stress and high volatility when trade values can move sharply. Most recently, this has been observed last year as a result of increased market volatility in response to the COVID-19 pandemic.

This timing issue can result in procyclicality whereby capital increases cause client facilitation to become more expensive precisely when liquidity is required. Under both the IMM and the SA-CCR, the calculated exposure at default (EAD) represents an expected exposure measure. In this regard, it should be noted that over time the non-zero current exposures resulting from timing differences should be on average zero. Therefore, removing these timing differences by allowing firms to reflect collateral that has been called but not yet settled should be allowed as it is consistent with an expected exposure measure as long as there is no underlying margin dispute.

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In order to prevent increased capital charges for the firms due to these timing differences and to align more closely with an expected exposure measure, the Industry proposes that firms should be allowed to reflect the VM that is received and posted on a T+1 basis under both SA-CCR and IMM. This change will reduce unwarranted volatility in exposures and RWA, because of collateral shortfalls as a result of ordinary settlement cycle.

#### Recommendation(s)

Margin in transit rules allowed under IMM should be extended for their use under SA-CCR to ensure consistent treatment of collateral under both approaches. That is, firms should be allowed to reflect the VM that is received and posted on a T+1 basis under both SA-CCR and IMM.

#### Supervisory Factors

The EC should revisit the supervisory factors set by the BCBS for all asset classes, as they seem to be calibrated to higher volatilities than can be justified by historical data. The Industry urges the regulators to consider observed volatilities during periods of varying market stress and recalibrate the supervisory factors accordingly.

### Recommendation(s)

Revisit supervisory factors for all asset classes.

# Net cash flows to single amount per currency

In terms of FX transactions, SA-CCR calculates RWAs linked to distinct currency pairs (e.g. EUR/USD), which means that multiple exposure values could be calculated across multiple pairs separately. Nonetheless, if considered together, the exposure value would have been zero. This issue would be resolved if firms were allowed to net exposures by currency instead of currency pair. SA-CCR should allow for netting by currency (excluding settlement currency) instead of currency pair but only if this is combined with a correlation parameter to aggregate currency exposures or if only the maximum of the net long and net short exposures by currency are included in the add-on calculation.

# Recommendation(s)

Allow for netting by currency (excluding settlement currency) instead of currency pair, but only if this is combined with a correlation parameter to aggregate currency exposures or if on the maximum of the net long and net short exposures by currency are included in the add-on calculation.

# Mandatory Use of SA-CCR in the Large Exposures framework

The introduction of SA-CCR not only affects the calculation of capital requirements for CCR, it will also be used in many other areas across the prudential framework, such as for calculating capital requirements for CVA risk, the exposure measure in the Large Exposures framework (replacing the IMM), for the Leverage Ratio, and for the forthcoming capital Output Floor requirement the Finalised Basel package.

Thus it will affect all firms, regardless of their current model approvals and users of derivatives. The impact to firms and the distortion versus risk calculated under previous methods are likely to be significant.





Therefore, in the Industry's view, the significance of this change on a standalone basis warrants further review

With specific reference to the Large Exposures framework, it should also be noted that in the US implementation of SA-CCR, US Agencies have retained the use of IMM in the Single Counterparty Credit Limit (SCCL) rule because the available standardised approaches were not deemed to be adequate replacements.

#### Recommendation(s)

Permit IMM banks to use their internal models to calculate Large Exposures requirements.

Multiple netting sets subject to one margin agreement

Under the CRR capital rules, when multiple netting sets are jointly margined then Article 278(2) requires firms to calculate the Potential Future Exposure (PFE) by using the unmargined methodology.

According to CRR Art. 272 (4), individual transactions not subject to a bilateral netting under section 7 are treated "as its own netting set". An example of such transactions can occur when entered into one with a branch of a counterparty in a non-netting jurisdiction. As a result, the rule for unmargined PFE methodology could be interpreted such that it also captures cases where an individual non-nettable transaction (not qualifying under section 7) is jointly margined with a large regulatory netting set (qualifying under section 7).

The Industry's proposal to amendment Article 278(2) ensures that the unmargined PFE methodology is applied only in case multiple netting sets (each of which qualify as per section 7) are jointly margined. The margined PFE methodology can however still be applied if there is only one netting set qualifying as per section 7 and some trades facing e.g. a branch in specific non-netting jurisdictions which do not qualify as per section 7.

#### Recommendation(s)

Consider amending Article 278(2) to read: 'The potential future exposure of multiple netting sets as per section 7 that are subject to one margin agreement, as referred in Article 275(3), shall be calculated as the sum of the potential future exposures of all the individual netting sets as if they were not subject to any form of a margin agreement'.

#### Treatment of volatility transactions

Article 277a (2) seems to indicate that there should be a distinct hedging set for each volatility risk driver (i.e. one distinct for each distinct equity). The Basel text as per CRE52.47 states that "Derivatives that reference the volatility of a risk factor (volatility transactions) must be treated within separate hedging sets within the corresponding asset class. Volatility hedging sets must follow the same hedging set construction outlined in CRE52.45 (for example, all equity volatility transactions form a single hedging set). Examples of volatility transactions include variance and volatility swaps, options on realised or implied volatility. For hedging sets consisting of volatility transactions, the supervisory factor applicable to a given asset class must be multiplied by a factor of five".



The industry proposes an alignment of the European (CRR) with the Basel text for assigning hedging sets.

### Recommendation(s)

Consider amending Article 277a (2) to read: 'For the purposes of point (a) of the first subparagraph of this paragraph, institutions shall assign transactions to a separate hedging set of the relevant risk category following the same hedging set construction outlined in paragraph 1'.

#### Recognition and treatment of collateral

Under the current capital rules, the following assets are eligible as potential credit risk mitigants for derivatives exposures:

- Assets listed in CRR Article 197 (Eligibility of collateral under all approaches and methods);
- Assets eligible under CRR Article 299, if the derivative is in the prudential Trading Book (Article 276 (1) (a)).

The Industry proposes to enlarge the eligible collateral assets to CRR Article 198 (additional eligibility of collateral under the Financial Collateral Comprehensive Method (FCCM)).

- The standardised approach SA-CCR applies a haircut method when valuing financial collateral. Those haircuts are the same as the ones that apply under the supervisory haircut method (Article 220) and the FCCM (Article 223) i.e. those of Article 224 for collateral of Article 196, i.e. those listed in Articles 197 and 198 (Basel at CRE52.11 states that the applicable haircuts are identical to that applicable to repo-style transactions which, in CRR, would be those applicable under either Article 220 or 223, i.e. all collateral listed at Articles 197 and 198).
- Logically, the perimeter of eligible financial collateral under SA-CCR should be the same than the perimeter under the supervisory haircut method (Article 220) or the FCCM (Article 223) listed in CRR Article 196 ("Without prejudice to Article 299, the collateral taken, and securities or commodities borrowed within such agreements or transactions shall comply with the eligibility requirements for collateral set out in Articles 197 and 198")

#### Recommendation(s)

Consider amending Article 276 (1) (a) (b) to read: '1. For the purposes of this Section, institutions shall calculate the collateral amounts of VM, VMMA, NICA and NICAMA, by applying all the following requirements:

(a) where all the transactions included in a netting set belong to the trading book, only collateral that is eligible under Articles 197, 198 and 299 shall be recognized;

(b) where a netting set contains at least one transaction that belongs to the non-trading book, only collateral that is eligible under Article 197 and 198 shall be recognized;.





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#### About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 66 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: <a href="http://www.isda.org">www.isda.org</a>.

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AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. Information about AFME and its activities is available on the Association's website: www.afme.eu.

(4) OpRisk (OR\_position)





# **CRR3 – Operational Risk**

February 2022

## **Introduction**

This paper sets out the industry's position related to the design and calibration of the operational risk framework in Europe in the CRR 3 proposal. The final agreement reached by the Basel Committee on Banking Supervision (BCBS) in December 2017 ("Basel III") has brought significant changes in the way banks are expected to calculate capital requirements linked to their management of operational risk. Notably, the ability of banks to use internal models for these calculations has been removed, replaced by a single Standardized Measurement Approach (SA-OR) that applies to all banks.

The SA-OR is meant to be more risk-sensitive than the previous Business Indicator Approach (BIA) and Standardised Approach (TSA) and foresees the calculation of capital requirements as the eventual function of two variables: the Business Indicator Component (BIC) and the Internal Loss Multiplier (ILM). However, the Basel framework also includes a national discretion that allows jurisdictions to calculate the capital requirements as a function of the BIC, by setting the ILM at 1.

The Business Indicator (BI) is comprised of the sum of the interest, leases, and dividends component, the services component and the financial component, comprising combinations of profit and loss items that constitute a bank's gross income. The Business indicator Component (BIC) is calculated by the multiplication of the BI with marginal coefficients (12, 15 or 18%), depending on the size of the bank. Largest banks thus have higher operational risk capital than smaller banks, due to the multiplier increasing across the" buckets" as the gross income of the bank increases. Effectively, because the bucketing approach would increase the capital requirements for a smaller bank when it is acquired by a larger rival, this can hinder the consolidation of the European banking sector.

The SA-OR can also be based on the use of banks' own historical loss data through the Loss Component (LC) in the Internal Loss Multiplier (ILM), with the assumption that historical loss from operational risk is predictor of future loss. Industry maintains key concerns as to the suitability of the SA-OR for achieving the risk sensitivity objective – primarily due to the evidence showing the unreliability of the historical loss data and its inability to predict future losses. Indeed, the decision to use historical data was not unanimously agreed by the members of the BCBS, and an option to set the Internal Loss Multiplier to one for all banks within the jurisdiction was included in the final BCBS standard.

In addition, another key omission of relying on past losses is that it lacks a forward-looking component that would allow for dynamic risk assessment (e.g. the framework does not take into consideration investments and improvements carried out by firms to remediate the root cause of past losses or the use of insurance policies), as well as the consideration of risk-sensitivity, while maintaining adequate capitalisation.

#### **Commission's proposal**

In order to mitigate these effects, the European Commission's CRR3 Proposal recommends setting the Internal Loss Multiplier (ILM) to 1. By setting the ILM to 1, which is allowed under the BCBS rules as a supervisory discretion that can be applied at a jurisdictional level, the limitations and volatility of capital charges caused by using rolling 10-year historical data can be neutralized. Industry supports the Commission's proposal to use of this discretion at the European level.

Secondly, the Commission's proposal includes wide ranging Level 2 mandates (CRR Articles 314, 315, 316, 317, 320, 321, 323) for the EBA to develop the taxonomy of operational loss events and wider operational risk reporting standards.

Regarding the EBA mandate to develop a risk taxonomy for operational risk and a methodology to classify the loss events included in the loss data set (Article 317), we are concerned that the EU is developing a new taxonomy without being previously discussed at international level. This will add complexity to banks' operations by requiring them to manage an additional taxonomy to the existing ones (banks' internal and Basel taxonomy). If every jurisdiction develops its own taxonomy in an unconcerted way, it would be complex, unsustainable, and unduly burdensome for international banks to maintain different definitions, interpretations and subsequent mappings over time with an impact on the whole operational risk programme (Risk and controls self-assessment (RCSA), scenarios and key risk indicators (KRI)). Therefore, we propose that the EBA mandate to review the operational risk taxonomy should follow the taxonomy developed at international level.

The industry also believes that regarding regulatory reporting and in order to ensure a continuity, it is necessary to ensure that the taxonomy of operational loss events is fully mapped with the BCBS operational risk event types (level 1 and 2).<sup>1</sup> Also, it should be concluded sooner than as proposed to allow for adequate time for banks to comply with the requirements in January 2025. A public consultation and a quantitative impact assessment should also be performed by EBA. In addition, it is important that the COREP reporting requirements are reviewed and aligned with the new reporting framework under the CRR3, in order to avoid deviations between the loss histories.

Thirdly, the CRR3 Proposal provides the EBA with a mandate to assess the use of insurance policies and if the practice results in regulatory arbitrage five years after the date of application. Industry suggests that this mandate is broadened to also assess potential wider forward-looking recognition of insurance cover in the BCBS operational risk framework, in line with current application under the current Advanced Modelling Approach (AMA). This allows the use of insurance policies as risk mitigants in the BI calculation. This mandate should also be brought forward, to be completed immediately after CRR3 publication.

Finally, the requirement to strictly map the Financial Component with FinRep may raise unintended consequences such as, for instance, preventing the netting of structured notes with their hedge/derivatives. As a result of the prudential trading and banking book boundary, banks may not have booked some items consistently across the prudential and accounting books for sub-items of the BC and TC components. The industry strongly recommends that flexibility is provided for banks to use their prudential trading/banking book boundary defined in Part Three, Title I, Chapter 3 of CRR in line with the Basel Framework<sup>1</sup> or alternatively use FinRep mapping. This flexibility should be defined as a part of the EBA mandate.

# **Recommendations on Operational Risk**

- Maintain the Commission's proposal to set Internal Loss Multiplier (ILM) to 1.
- Reconsider the need to develop an EU taxonomy prior to any review by the Basel Committee, given that it will add complexity to banks' operations and puts at risk the consistency at international level.
- The industry also believes that regarding regulatory reporting and in order to ensure a continuity, it is necessary to ensure that the taxonomy of operational loss events is fully mapped with the BCBS operational risk event types (level 1 and 2).

<sup>&</sup>lt;sup>11</sup> Internal fraud; external fraud; employment practices and workplace safety; clients, products and business practice; damage to physical assets; business disruption and system failures; execution delivery and process management

- Bring forward the EBA mandates to develop the Business Indicator and its adjustments, calculation of annual operational risk loss, taxonomy for operational loss events, loss inclusions and exclusions, reporting etc. in order to ensure that banks have sufficient time to adapt their systems and processes to apply them.
- COREP reporting requirements should be reviewed and aligned with the new reporting framework under the CRR3, in order to avoid deviations between the loss histories.
- Regarding the requirement to strictly map the Financial Component with FinRep, we recommend that flexibility is provided for banks to use their prudential trading/banking book boundary defined in Part Three, Title I, Chapter 3 of CRR in line with the Basel Framework1 or alternatively use FinRep mapping.
- Bring forward the EBA mandate (Article 519d) on calculation and recognition of insurance recoveries. This mandate should also be broadened to capture in addition to insurance recoveries broader use of insurance as a hedge to mitigate future losses in the BI calculation, in line with current practice under the Advanced Modelling Approach (AMA). This report should also inform the BCBS to potentially review and adjust the international framework in order to recognise the benefits of insurance policies.
- The materiality threshold for excluding operational losses should be aligned with the example in the BCBS standard (5%), and not increased to 15% as the Commission's proposal suggests. The proposed threshold would only allow banks to exclude losses in exceptional circumstances, rather than when there is a valid reason to adjust the loss history for example by excluding losses from divested businesses.

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#### **About AFME**

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. Information about AFME and its activities is available on the Association's website: <u>www.afme.eu</u>.

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(5) FRTB





# **CRR3 – Fundamental Review of the Trading Book (FRTB)**

February 2022

# **Introduction**

This paper sets out the industry's positions related to the design and calibration of market risk framework in Europe as prescribed in the CRR 3 proposal.<sup>1</sup> In the EU, the implementation of the Fundamental Review of the Trading Book (FRTB) has followed a two-step approach – with CRR 2<sup>2</sup> setting out reporting requirements for both the FRTB Standardized Approach (SA) and the Internal Model Approach (IMA) and certain elements of the trading and banking book boundary. The CRR 3 converts these reporting requirements into pillar 1 capital binding requirements and finalises the trading/ banking book boundary.

As a result, CRR 3 represents a key step in the implementation of FRTB in Europe, and it will be crucial to ensure its calibration and design remains fit and appropriate. It is furthermore important that the standards are implemented simultaneously and harmoniously across jurisdictions to avoid undue technological, operational and business burden for banks. Trading businesses of banks are fundamentally global, and possible fragmentation of trading books because of inconsistent implementation of FRTB would result in reduced market making capacity and fragmentation in the markets.

The two-step approach (CRR2 & CRR3) to implementing the trading and banking book boundary may result in undesired cliff-edge impacts on existing positions that have durations beyond the implementation date of the CRR2 (28 June 2023) and CRR3 (expected January, 2025). While the FRTB rules are designed to provide supervisory control going forward, it was not intended to result in operational burden or to penalise existing positions that have been allocated across the books under the current rules. It is important to have appropriate grandfathering provisions in place, as well as supervisory flexibility for reallocation without undue penalty charges given the bifurcation of the requirements in CRR2 & CRR3.

In addition, the Industry remains concerned by certain elements in the market risk reforms and the significant impact the package will have on capital requirements for specific product and risk categories. The implementation of the FRTB will materially increase capital requirements for banks with market making activities in Europe, while elsewhere the Commission is trying to promote market-based financing through the Capital Markets Union (CMU) project.

In the latest EBA's advice<sup>3</sup> published in September 2021 using banks' data as of December 2020, the EBA has estimated that the impact of the FRTB would be 32.5% higher (using a simple average) relative to current RWA levels for the same risks. However, we believe this latest figure is underestimating the impact and is not in line with industry quantitative impact studies, as it reflects a best case scenario where firms can continue using their current modelling permissions which is unlikely to be attained given that some desks are likely to fail the IMA eligibility tests. Furthermore, these estimates from the EBA do not include any market risk impacts from three European G-SIBs. The reason for exclusion of all FRTB data from these institutions was due to their capital treatment of equity investment in funds, which the EBA deemed to be based on overly conservative assumptions.

<sup>&</sup>lt;sup>1</sup> https://ec.europa.eu/info/publications/211027-banking-package\_en

<sup>&</sup>lt;sup>2</sup> https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019R0876

<sup>&</sup>lt;sup>3</sup>https://www.eba.europa.eu/sites/default/documents/files/document\_library/Publications/Reports/2021/1020673/EBA%20Report%20on%20B asel%20III%20Monitoring%20%28data%20as%20of%2031%20December%202020%29.pdf

# **Globally consistent and aligned implementation of FRTB**

Banks' wholesale and trading operations are profoundly global in nature as investors from different regions are looking for investment opportunities within their mandates and securities issuers want to have access to finance from all corners of the world.

An EU start date of the FRTB framework for the 1 January 2025 as set in the European Commission's CRR 3 proposal is a positive step forward. The industry is conscious that currently the EU is the only major jurisdiction to propose capital rules through primary legislation and this reflects a reasonable expectation for firms in their preparation planning for implementing FRTB. Given the global nature of these markets, the industry has always stressed that it was crucial the impact of FRTB on banks' wholesale activities is not further exacerbated by an inconsistent timeline and transposition of the rules in key financial centers.

The mechanisms set in the CRR 3 delegated act under Article 461a, which aims to adjust the timing and calibration based on third country implementation of the FRTB standard is an important step to ensure a globally-consistent and aligned implementation of the market risk capital rules. A number of major jurisdictions (including the US and the UK) have not yet published their rules while others have already set different timing expectations and/or are still consulting on their national rulemaking.

We therefore encourage European policymakers to continue to monitor the progress of the transposition of the FRTB in other major jurisdictions, and amend the implementation timeline in Europe if necessary. The mechanism set in the delegated act under article 461a, offering a potential 2-year delay to the start date of FRTB is useful for providing that flexibility.

As there is not yet full visibility on the rules in other jurisdictions, the other mechanism set in article 461a to adjust downward the calibration of FRTB (by setting a '0-1' multiplier to market risk capital) to take into account level playing field issues should be used with caution, and only if there are substantial and material deviations. The industry believes that aligned rules are the optimal outcome and should be the primary objective underpinning the mechanisms behind the delegated act.

#### Recommendations

It is crucial to continue the dialogue with key jurisdictions to ensure coordination and flexibility on the start date for FRTB.

Should the European Commission proceed setting a 0-1 multiplier, it will be important to ensure full transparency and consultation on the methodology used to set the multiplier.

*Review and incorporate any calibration and other changes stemming from the BCBS process and international development into the EU framework* 

Beyond the mechanism to adjust the calibration, it will be important to ensure the delegated act can address any inconsistencies and typos in the FRTB rules.

#### Recommendations

As such, the industry would support an extension of the delegated act scope for the Commission to amend the content of the rules based on the latest international developments and possible adaptations in other jurisdictions.

Allow concurrent CVA and FRTB implementation timing

There are significant read-across between the FRTB and CVA risk framework which CRR 3 is also addressing. Those interlinks between the two standards stem from the fact that the risk weights in CVA are largely based upon the market risk standard – meaning the market risk revisions will be reflected in the CVA risk framework. As such it will be important to ensure a concurrent implementation of these two frameworks.

### Recommendations

We would strongly support that the delegated act under article 461a extends its scope to include CVA risk, particularly if the European Commission makes use of the 2-year delay for the start date of FRTB.

# Allow sufficient time for EBA RTS rulemaking and IMA application process

The implementation period should allow sufficient time between the required date for the EBA to finalise regulatory technical standards (RTSs) and the FRTB go-live date. Firms will need to develop internal models and supervisors require time to validate them. If there is significant uncertainty about the final internal models validation methodology, approval process and the resulting capital levels, then banks may reduce their appetite for market risk in the run-up to implementation – with negative ramifications to the functioning of the EU capital markets.

The EU should make use of the 1-year transitional period defined by the BCBS global standard on market risk between go-live of FRTB and Profit and Loss Attribution Test (PLAT) implementation.

# **Implementing FRTB in the European Union**

While firms implement FRTB as a reporting requirement and prepare for the start of Pillar 1 capital requirement for the new market risk standards, it can be expected that new issues may emerge during the implementation process. The FRTB IMA standard has never been tested, and firms have yet to go through the supervisory approval process or through the live calculation of the P&L attribution test using real data. Furthermore, the implementation of pillar 1 capital requirements for FRTB will depend on the EBA developing a number of technical standards in line with its planned roadmap.

The capital impact is significant when considered against the importance of the market-making role of banks in capital markets in Europe. The intermediary role played by banks in capital markets through primary issuance and trading could thus be hampered by measures that increase capital requirements held against certain trading activities, limiting the capacity of banks to offer liquidity and act as market-makers. This was also recognized more recently in the Final Report of the High-Level Forum for the CMU.<sup>4</sup>

Finally, it is also important to note that the significance of the recent market turmoil in light of the COVID-19 pandemic has yet to be fully understood and therefore further detailed impact analysis is necessary to help clarify what the long-term impacts will be on the EU economy. In particular, this will help identify any procyclicality aspects that should be avoided in the future market risk framework.

In terms of specific provisions related to FRTB, ISDA and AFME would like to bring to the attention of the colegislators the following areas:

1. The first relates to the investment in funds, or Collective Investment Undertakings (CIUs) eligible for allocation in the Trading Book. Banks offer derivative products to their clients on performance of specific funds and hedge these products with underlying positions in the reference funds. The FRTB allows for equity investments to be included in the scope of the internal models *if* the bank is able to calculate capital requirements based on the assets underlying the fund (i.e. if the bank can "look through" to the underlying

<sup>&</sup>lt;sup>4</sup> <u>https://ec.europa.eu/info/news/cmu-high-level-forum-final-report\_en</u>

assets). Otherwise, three different approaches under the Standardized Approach (SA) are used. Two of them lead to conservative capital charges. The third one (the look-through approach under SA), which is the most risk sensitive approach, introduces computational intensity comparable to the IMA. These provisions regarding IMA and SA look-through approaches result in operational complexity in relatively simple and low risk strategies and may result in activity in funds being prohibitively expensive. While CRR 3 has introduced a widened use of the look through approach for SA and IMA including the use of data provided by relevant third-parties, there are still challenges associated with these elements.

- 2. The Trading book (TB) and banking book (BB) boundary defines which assets fall either within the scope of the capital requirements for market risk (assets held with a trading intent) and credit risk (those in the banking book). The industry remains concerned about the operational requirements, complexity and potential rigidity in instrument designation, as well as downside effects in funding and liquidity activities resulting from the revised trading/ banking book boundary. The two-step approach across CRR 2 and CRR 3 to implement the new boundary can lead to significant disturbance, unless supervisory authorities and banks have the right tools to avoid a cliff-edge.
- 3. The residual risk add-on (RRAO) is a capital charge intended to only apply to exotic risks. Its design, a flat risk weight on the gross notional of affected products, is risk insensitive and penalizes in some cases well-hedged portfolios, which can result in overly high capital charges for banks, and lead to trading services becoming overly expensive. Moreover, the industry is concerned with the excessive RRAO charge for interest rate (IR) yield curve options and spread options. IR yield curve options are widely used as hedging tools against interest rate curve exposure by clients such as pension funds, life insurance companies, corporates, asset managers and the RRAO charge could increase significantly their cost of hedging.
- 4. Correlation Trading Portfolios (CTP): The FRTB introduces particularly punitive charges for this business line in terms of default and credit spread risks and by limiting the recognition of hedges. This may incentivize banks to break economic hedges and effectively take on more risk in order to reduce capital, which should not be an aim of a regulatory capital framework. In addition, the rules still lack clarity, which might result in limited own funds requirements comparability between banks.
- 5. It is essential to ensure the viability of the internal model approaches. While supporting a number of methodology and supervisory measures that will lead a more robust IMA, we are concerned that the extent of these measures may challenge the viability of the IMA altogether. Certain requirements that are unique to the internal model which due to the strictness of requirements or obvious inconsistencies across model approaches are potentially undermining this approach as a viable option for banks. Of particular relevance are:
  - a. the PLAT, which requires testing on real portfolios to ensure appropriate calibration before becoming a requirement for IMA eligibility<sup>5</sup>.
  - b. the Non-modellable Risk Factors (NMRF) with the prescriptive nature of the requirements potentially leading to a competitive disadvantage; and
  - c. an obvious inconsistency in the Default Risk Charge<sup>6</sup> (DRC) between IMA and SA in relation to sovereign issuers of low risk. Such as EU Sovereign issuers, covered bonds or other Sovereign issues denominated in local currency of third countries whose supervisory and regulatory requirements are considered equivalent, that give rise to significant differences in the regulatory

<sup>&</sup>lt;sup>5</sup> Extract <u>BCBS monitoring report</u> published in September 2021 (p. 78) – "Overall, 15 banks in eight countries were able to provide sufficient data to perform VaR backtesting versus 20 in the end-2019 data collection. Banks provided enough data for 474 desks for all tests to be performed, a significant improvement in the banks' capabilities versus the 311 desks in the end-2019 data collection. Of these desks, 43 were able to pass all tests in the green zone and a further 24 desks passed in the amber zone for a total pass rate of 14.2%"

<sup>&</sup>lt;sup>6</sup> Extract from <u>BCBS monitoring report</u> published in September 2021: The default risk capital (DRC) requirement in the Standardised Approach (SA) contributes 29.0% and 34.3% to the total standardised approach capital requirements for Group 1 and Group 2 banks, respectively. The DRC for internal models is expected to contribute 35.1% for Group 1 banks and 37.6% for Group 2 banks.

capital charges associated, as well as their risk perception between these two approaches. In addition, a floor of 3bp leads to a significantly higher charge under IMA (than for SA) for the equivalent risk.

6. Under the BCBS FRTB, carbon certificates have been allocated a risk weight bucket of 60% – among the highest of all commodities (e.g. twice that of crude oil). The Industry welcomes the changes by the Commission in the CRR 3 proposal by introducing a separate bucket for Carbon Trading with a risk weight of 40%, however the framework still penalizes carry positions as the FRTB imposes a correlation of 0.99 between spot and forward positions. While this might be appropriate for commodities to account for physical storage costs, carbon certificates are not typical commodities as there are no physical storage costs. Therefore, a much higher correlation for carbon certificates is appropriate. In fact, data on EU allowance (EUA) spot and forward trades shows a correlation of around 0.996 between returns for spot and future carbon certificates.<sup>7</sup>

### Recommendations

- It is crucial that there is dialogue with key jurisdictions to ensure coordination and flexibility on the start date for FRTB and if necessary the scope of the delegated act should be an extended to accommodate the content of the rules based on the latest international developments. It is also imperative that the scope of the delegated be extended to include CVA due to the obvious interlinkages between the capital frameworks.
- For Collective Investment Undertakings (CIUs), it will be important to clarify from the BCBS rules and ensure that
  - the IMA should not include the mandatory look through requirements, instead it should be acceptable for CIUs to be included in IMA as a single risk factor using the daily liquid price of the CIU as currently permitted the ECB by paragraph 40 of the ECB guide to internal models;
  - flexibility should be introduced for the SA so Banks are permitted to use FRTB capital per unit published by the funds where available. This approach is more risk aligned than using specific risk weights. The funds or other arms-length third parties could voluntarily publish the percentage capital per unit for the three components of the FRTB SA, which banks can use as risk weights for their positions in these funds.
  - Furthermore, the industry believes that the aggregation methodology for the fund-as-single equity approach should be adapted. Risk-weighted exposures should be correlated rather than absolute simple summed as per the 'other sector' (bucket 11) specification.
- For the implementation of the TB/BB boundary, it will be important not to unduly burden firms with operational requirements, complexity and potential rigidity in instrument designation. It is also crucially important to avoid any potential issues with the new boundary go-live dates and existing portfolios. Effective supervisory tools and grandfathering arrangements would help avoid any cliff-edge situations that are not intended.
- RRAO should address only risks not capitalized elsewhere in the framework (ex. volatility risk of volatility or variance swaps could well be captured in the SBM Vega risk charge and should not be subject to the 1% RRAO charge), it should be ensured that only real truly exotic underlying risks are subject to the 1% charge and more generally RRAO does not disproportionally charge vanilla rates products.

<sup>&</sup>lt;sup>7</sup> <u>https://www.isda.org/a/i6MgE/Implications-of-the-FRTB-for-Carbon-Certificates.pdf</u>

- CTP exposures should be able to be decomposed to constituents of the product for both SBM and DRC to ensure a capital outcome that is more aligned with the underlying risk for better recognition of hedging.
- Careful implementation of the key IMA requirements using real portfolios and addressing obvious inconsistencies between the IMA and SA approach before go-live of FRTB own funds requirement to ensure the viability of IMA.
- The industry reiterates its proposal to remove the 3 basis-point floor for Sovereigns. In FRTB DRC SA, exposures that receive a 0% risk weight in the credit risk SA (sovereigns, public sector entities and multilateral development banks as well as international organizations that are treated similarly to a sovereign in CRR), shall be assigned a 0% risk weight. However, in IMA, a 3bp probability of default floor applies to exposures that are risk weighted 0%. All counterparties to which a 0% risk weight applies in SA-DRC should not be subject to the PD 3bp floor in IMA-DRC. In addition, a more appropriate calibration for Covered Bond issuers as a separate risk class, reflecting their distinct characteristics and risk should be defined.
- The introduction of a separate bucket with a 40% RW for carbon trading is welcomed, however we recommend setting a tenor correlation parameter (medium correlation scenario) for carbon certificates of 0.995-0.999, reflecting empirical observations<sup>8</sup>. This is still a conservative approach: as low and high correlation scenarios are calculated based on this parameter, with the largest capital requirement taken from the three scenarios. This will help contribute to the development of a well-functioning forward carbon certificate market that provides certainty about the future costs of emissions, allowing companies to plan ahead.

<sup>&</sup>lt;sup>8</sup> <u>https://www.isda.org/a/i6MgE/Implications-of-the-FRTB-for-Carbon-Certificates.pdf</u>

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(6) CVA



afme/ Finance for Europe

# **CRR 3 - Credit Valuation Adjustment (CVA) Risk** February 2022

# **Introduction**

In July 2020, the BCBS published targeted revisions to the Credit Valuation Adjustment (CVA) framework, bringing final changes to the initial revised framework published in 2017, as part of the Basel III agreement. CVA refers to a measure of market risk incurred in the context of transactions or contracts involving counterparties (such as sovereign banks, other financial institutions, non-financial companies, etc.). In other words, as banks enter into derivatives contracts, they face the risk of incurring losses due to changes in the market value of those transactions and the deterioration of the creditworthiness of their counterparties.

Capital requirements for CVA risk are meant to require banks to hold aside capital to account for these losses. While the 2020 revisions attempted to solve some of the identified issues with the current CVA framework, further calibration is necessary to ensure that end-users, who typically use derivatives to hedge risk, are still able to access them at a reasonable cost. Particularly in the context of the recovery from the COVID-19 pandemic, it is crucial for banks to continue to support the real economy through the provision of these services and to not be constrained from doing so by an undue increase in the capital held against CVA risk. It is also important that the CVA framework is implemented in a coherent manner, and due consideration should be given to aligning the implementation timeline with the interlinked market risk standards.

# **CVA: A Brief Primer**

Banks that undertake derivatives are subject to the risk of incurring mark-to-market losses because of the deterioration in the creditworthiness of their counterparties. This potential source of loss, due primarily to changes in counterparty credit spreads, but also other market risk factors, is known as CVA risk. CVA is thus viewed as the "price" of counterparty credit risk (CCR).

In December 2017, the BCBS published an initial revision of the CVA framework<sup>1</sup> to better capture CVA risk and provide better recognition of CVA hedges. Further revisions were introduced on July 8<sup>th</sup> 2020<sup>2</sup> when the BCBS released its final rule for the CVA framework to ensure, amongst other provisions, further alignment between the market risk and CVA rules, as well as address calibration issues within the framework.

This finalized standard is a significant development that is expected to have material implications for the industry, as it replaces the current CVA standardized approach and removes the ability to use internal models.

The main changes introduced by the BCBS in this framework include a re-calibrated standardized approach (SA-CVA) and basic approach (BA-CVA), adjustments in some of the previously-determined risk weights (RWs) in both these approaches, an adjustment to the scope of transactions that are subject to CVA-linked capital requirements, as well as the introduction of "index buckets", whereby banks can calculate their capital requirements by referring to certain set credit or equity indices, instead of relying on the credit-worthiness of the underlying counterparty. Finally, the BCBS has recommended setting the mCVA multiplier, meant to

<sup>&</sup>lt;sup>1</sup> <u>https://www.bis.org/bcbs/publ/d424.pdf</u>

<sup>&</sup>lt;sup>2</sup> https://www.bis.org/bcbs/publ/d507.htm

account for model risk, to 1 – to address calibration issues in the framework. This also takes into account the fact that there is no advanced approach available for the calculation of the CVA capital requirements.

## The main changes introduced in the final revision of the BCBS CVA framework:

- a reduction of the SA-CVA multiplier (mCVA) to 1 from 1.25, originally intended to account for model risk.
- the introduction of a scalar to BA-CVA of 0.65 to ensure an appropriate relative calibration to SA-CVA.
- the recognition of hedges is improved through the introduction of index buckets, allowing banks to calculate their capital requirements by referring to certain set credit or equity indices, instead of relying on the creditworthiness of the underlying counterparty.
- a revision to the aggregation formula used to calculate the capital requirements and revisions to a number of risk weights downwards to align the requirement closer to the finalised market risk framework.
- a reduction in the gap between regulatory and accounting CVA through the revision of the floor to margin period of risk (MPOR<sup>3</sup>) as it relates to client cleared transactions (CCTs); and
- the exemption of SFTs with immaterial CVA risk from CVA capital requirements.

These latest revisions have allowed for greater sensitivity in the determination of the CVA risk linked to specific exposures and are positive. Nonetheless, further changes to the framework are necessary to ensure that the rules are commensurate with the underlying risk.

# **Implementation timeline for CVA**

The Commission's CRR3 proposals include a mechanism, by way of a delegated act under Article 461a which aims to adjust the timing and calibration of the FRTB market risk standard based on third country implementation.

There is a significant read-across between the FRTB and CVA risk frameworks and interlinkages stemming from the fact that the risk weights in CVA are largely based upon the market risk standard – meaning the market risk revisions will be reflected in the CVA risk framework. As such it will be important to ensure that any changes to the FRTB timeline are also applied to the CVA framework, therefore allowing for a concurrent implementation of these two interlinked frameworks.

### Recommendations

We would strongly support that the delegated act under article 461a extends its scope to include CVA risk, particularly if the European Commission makes use of the 2-year delay for the start date of FRTB.

# Designing an effective and proportionate CVA Framework for the European Union

In September 2021, the European Banking Authority's (EBA) published a report<sup>4</sup> showing that the revised Basel CVA framework for European banks will result to an increase of +2.2% in minimum required capital (MRC) for CVA under a full implementation of Basel standards scenario. The EBA shows the impact of CVA risk only through the change in MRC, rather than the increase in RWAs, which is the metric required to assess

<sup>&</sup>lt;sup>3</sup> The MPOR is defined as the time period from the most recent exchange of collateral covering a netting set of transactions with a potentially defaulting counterparty, until the transactions are closed out and the resulting market risk is re-hedged. <sup>4</sup>https://www.eba.europa.eu/sites/default/documents/files/document\_library/Publications/Reports/2021/1020673/EBA%20Report%20on%20B

<sup>&</sup>lt;sup>4</sup>https://www.eba.europa.eu/sites/default/documents/files/document\_library/Publications/Reports/2021/1020673/EBA%20Report%20on%20B asel%20III%20Monitoring%20%28data%20as%20of%2031%20December%202020%29.pdf

how much additional capital would be required to maintain current capital ratios. The MRC does not fully take into account supervisory capital buffers and guidance, as well as banks' own management buffers and as such, we believe the EBA's analysis materially understates the impact of the revisions to the CVA framework.

Even when the enhancements of the final Basel CVA standards are considered (e.g. the removal of the capital multiplier) plus the maintenance of existing exemptions in CRR, there is still a significant impact in the amount of capital banks would need to allocate for CVA risk. This is due to calibration issues in the CVA framework, such as the lack of granularity of risk weights related to exposures to financial sector entities which still need to be addressed, exacerbating the impact of losing the ability to use advanced CVA in the updated framework.

CVA risk represents a significant driver of risk-weighted assets (RWAs) for derivatives and capital market activities, and deficiencies in the framework have an impact on banks' ability to provide key financing, liquidity and hedging services and products to end-users. As a result, it is very important that the design and calibration issues be addressed appropriately to ensure that capital requirements are in line with real economic risk incurred by banks.

Increases in capital requirements can have a knock-on effect and any requirements that constrain the use of derivatives may affect the ability of end users e.g. pension funds, mutual funds, and commercial end users to hedge their funding, currency, commercial and day-to-day exposures, which would in turn weaken their balance sheets and make them less attractive as investment prospects.

In terms of more specific recommendations, the industry supports further targeted revisions to the CVA framework on the following points:

- 1. Improve the calibration and granularity of risk weights (RWs) particularly for financial counterparties.
- 2. Improve the recognition of CVA Index hedges.
- 3. Misalignment between regulatory and accounting CVA

These changes would also need to be addressed at the BCBS level, to ensure incorporation into the final CVA standard that should result to consistent transposition of the CVA framework at national levels. We provide more details on these points below:

# 1. Improve the Calibration and granularity of risk weights (RWs) particularly for financial counterparties

# Regulated Financial Risk Weights

In the revised CVA framework, the risk weights allocated to exposures to financial sector entities are the same, regardless of the type of financial sector entity (i.e. all financial institutions are allocated to the same "bucket"). This means that a wide set of counterparty types all pivotal to the real economy including pension funds, insurance providers, covered bonds<sup>5</sup> and buy-side end-users are captured in the same bucket without any means to account for their specific risk profile.

The European Commission and co-legislators should improve the granularity of the counterparty credit spread ("CCS") risk weights. At a minimum, recognize the differentiation in CVA risk profiles between financial counterparties.

A simple solution would be divide the current bucket for financial sector entities into two buckets (i.e., regulated and unregulated financials) for both the investment grade and non-investment grade categories:

Investment grade

<sup>&</sup>lt;sup>5</sup> Counterparties within bond issuance structure buying market risk hedges *pari passu* with covered bond debt.

Bucket	Credit	Sector	Risk weight
Number	quality		(percentage
			points)
4	Credit	Financial sector entities includign credit	5,0%
	quality	institutions incorporated or established	
	step 1 to	by a central government, a regional	
	3	government or a local authority and	
		promotional lenders	

# Non-investment grade

Bucket	Credit	Sector	Risk weight
Number	quality		(percentage
			points)
13	Credit	Financial sector entities includign credit	12,0%
	quality	institutions incorporated or established	
	step 4 to	by a central government, a regional	
	6	government or a local authority and	
		promotional lenders	

Bucket	Credit	Sector	Risk weight
Number	quality		(percentage
			points)
4a	Credit	Regulated financial sector entities	3,0%
	quality	includign credit institutions	
	step 1 to	incorporated or established by a central	
	3	government, a regional government or	
		a local authority and promotional	
		lenders	
4b	Credit	Unregulated financial sector entities	5,0%
	quality		
	step 1 to		
	3		

Bucke	t Credit	Sector	Risk weight
Numbe	er quality		(percentage
			points)
13a	Credit	Regulated financial sector entities	8,5%
	quality	includign credit institutions	
	step 4 to	incorporated or established by a central	
	6	government, a regional government or	
		a local authority and promotional	
		lenders	
13b	Credit	Unregulated financial sector entities	12,0%
	quality		
	step 4 to		
	6		

This would significantly enhance risk sensitivity in the CVA framework by improving the mapping of exposures to industry sectors based on the underlying risk.

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# Industry sector mapping of CVA exposure

In addition to more granular risk weights, we recommend that the EU allow for more flexible mapping of CVA exposures to sector buckets. In the rules, there is already an allowance for firms to use appropriate proxies to determine the SA-CVA risk factor sensitivities. We recommend that the same criteria, which is set out in CRR Article 383a point (ii) of subparagraph 2, for mapping illiquid risk exposure to liquid credit spreads, can also be used to assign CVA risk exposure to a sector. This would allow for a closer alignment of the CVA capital framework and the risk management and accounting CVA framework, where the risk to financial sector entities can be marked to the credit spreads of other sectors. Examples cited in the rules include municipalities, project finance and funds. We believe this flexibility for mapping risk exposures to sector buckets could be applied more broadly if there is a credible economic justification that is demonstrated to a firm's supervisor. For example, government-backed entities, (e.g. government-backed financials; state-backed pension funds) should be allocated to the sovereign bucket where they are backed by the sovereign or local authority.

# 2. Improve the recognitions of CVA Index hedges

Credit-default-swaps (CDSs) are a type of insurance taken against the loss arising from the default of a counterparty. Banks can also use standard baskets of CDSs, called CDS indices (analogous to equity indices), which are more liquid than the over-the-counter CDSs and provide a useful tool to hedge systemic credit risk. These are especially useful for many small and mid-cap companies, as they do not have any direct "hedges" that would allow mitigation of counterparty credit risk– meaning that hedging has to occur at a more macro-level for the entire portfolio, using these indices as reference.

The July 2020 Basel revisions have introduced new 'index buckets' for these indices, namely for: (i) counterparty credit spread risk class; (ii) reference credit spread risk class; and (iii) equity risk class of the SA-CVA, in alignment with the Basel market risk framework (the Fundamental Review of the Trading Book).

The introduction of the counterparty credit spread index bucket is positive. The scope of eligible hedging instruments is limited to qualifying indices. However, the implied correlation between the CVA portfolio and the index bucket does not provide sufficient recognition to index hedges and does not reflect the observed historical correlation between the typical CVA portfolio and CDS index hedges.

This outcome does not incentivize prudent hedging practices and may lead to inadequate protection against the real economic CVA risk. Treating the entire CVA portfolio as an index and aligning its correlation with the index bucket to a level matching the calibration of SA-TB<sup>6</sup> is one approach to improve the hedge recognition.

# 3. Misalignment between regulatory and accounting CVA

There are significant mismatches between the regulatory CVA per Basel standard, and the way those charges are treated from an accounting perspective, through IFRS rules. In order to ensure that CVA charge is not overstated, the CVA framework should be more closely aligned with market practices, specifically by introducing changes to the length of the Margin Period of Risk (MPoR<sup>7</sup>) – which accounts for lags in timing within which the nominal and market value of the contract can widen.

The current MpoR floor is based on outdated information about risk management and accounting practices. The market structure has changed substantially over the last ten years due to greater monitoring and active reduction of interbank risk exposure following the large financial institution defaults that took place during the global financial crisis.

The current proposals mean that the MPoR is set equal to a minimum of 9+N business days irrespective of master agreement documentation, jurisdiction legal differences, or type of counterparty. This approach does not reflect the legal terms negotiated between parties that dictate and reduce the MPoR. For example, the implementation of margin requirements under EMIR has reduced grace periods and imposed 'same-day' settlement for margin transfers. In contrast, the conventional regulatory MPoR has not changed to reflect these market developments.

Furthermore, since banks hedge their exposures based on economic CVA risk rather than regulatory CVA the impact of hedges is reduced in the regulatory CVA charge compared to how hedges would mitigate economic CVA losses and by adding flexibility to the expected loss given default<sup>8</sup> (ELGD) used for specific exposures.

# Recommendations on the design and calibration of CVA

We would recommend that the following changes be considered:

- A recognition of the different risk profiles of different financial institutions through the introduction of distinct risk weights per type of financial institutions, instead of their allocation a single bucket.
- A better recognition of indices used to hedge CVA risk, particularly in terms of their usage linked to the hedging of systemic credit risk, rather than specific sectoral or counterparty risk.
- A greater alignment of regulatory and accounting CVA. Namely, through:

<sup>&</sup>lt;sup>6</sup> As it relates to the correlation between to Credit Default Swap (CDS) indices: Under the revised market risk approach, the calculation of the sensitivities-based method under the standardised approach for market risk sets the correlation between two sensitivities within the same index bucket at 80%.

<sup>&</sup>lt;sup>7</sup> See footnote 3 for a definition of MPOR.

- making adjustments to the period stipulated by the MPoR. This could be done by adjusting the MPoR floor from 9+N days to 4+N days, which would make it more aligned with accounting market practices; and
- the use of specific ELGD<sup>9</sup> for secured exposures (e.g. covered bonds, infrastructure or utilities specialized lending vehicles) or entities which by nature expose derivative counterparties to lower risks than bond holders (e.g. sovereigns).

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(7) ESG





# CRR3 – ESG risks

February 2022

## Industry views on the integration of ESG risks into the EU prudential framework (CRR3)

Sustainable finance has a key role to play in mobilising capital to deliver the policy objectives under the European Green Deal, the Paris Agreement and the EU's commitment to reaching climate-neutrality by 2050. The Commission has put sustainable finance at the core of its financial policymaking for the next five years as part of its Renewed Sustainable Finance Strategy. In terms of prudential regulation, this commitment has been reflected in 2 specific amendments by the Commission to the CRR3 proposals as follows:

- 1) Recognition that energy efficiency enhancing measures in buildings should unequivocally be considered as increasing the value of the building in the context of credit risk, in order to promote energy efficiency lending in real estate; and
- 2) Introduction of a targeted prudential treatment for Emissions Trading Scheme (ETS) exposures, whereby a lower risk weight is introduced for the commodity delta risk factor related to carbon trading emissions. A specific risk category is therefore created with a lower risk weight equal to 40% for ETS allowances.

Industry welcomes these amendments, which will underpin the financing of a sustainable economy and recovery from the COVID-19 pandemic. Nonetheless, further modifications could be made for carbon certificates to help contribute to the development of a well-functioning forward carbon certificate market that provides certainty about the future costs of emissions, allowing companies to plan ahead.<sup>1</sup>

Aside from the aforementioned changes to the prudential framework, the Commission has also sought to better align CRR3 with the ECB and EBA's existing work to establish a framework for ESG disclosure, risk management and supervision. We welcome these changes, to ensure a consistent and coherent approach to ESG risks, however it is important to reflect on the nascent and exploratory stages of integration of these into bank risk management and supervisory frameworks. In this regard, we welcome the ECB and EBA acknowledgement that climate risks are drivers of existing risks and there is a need for a phased approach. Furthermore, as recognised by supervisors, it would be premature for bank capital requirements to be directly linked to the integration of these risks into the prudential framework as part of climate risk stress-testing exercises, the Supervisory Review and Evaluation Process or Pillar 2 requirements. It is important policy makers maintain this well-established regulatory approach in CRR3, noting that industry deems some amendments are warranted to better reflect bank practices such as disclosure frequency and national frameworks.

#### Industry views on developing the prudential treatment of green and brown assets in CRR3

<sup>&</sup>lt;sup>1</sup> In line with our position on the FRTB we recommend setting a tenor correlation parameter (medium correlation scenario) for carbon certificates of 0.995-0.999, reflecting empirical observations<sup>1</sup>. This is still a conservative approach: as low and high correlation scenarios are calculated based on this parameter, with the largest capital requirement taken from the three scenarios. This will help contribute to the development of a well-functioning forward carbon certificate market that provides certainty about the future costs of emissions, allowing companies to plan ahead.

In light of the climate emergency and ambition of the EU institutions, not least to support a green recovery from the COVID-crisis, we welcome the Commission looking to better incorporate ESG risks into the prudential framework, while ensuring that this is based on a coherent and consistent timeline for implementation and standardization of risk management processes, disclosure, and risk analysis. As mentioned, we also support the targeted approach to loan valuation and prudential treatment for ETS exposures, with modifications to support the carbon certificates markets.

When it comes to further integration of the environmental performance of assets and the associated risks more broadly, prudential requirements should use balanced, quantitative constructs, based on observation and scientific data – driven not least by forward-looking risk-sensitivity. We therefore support the updated mandate of the EBA in CRR3 (now brought forward to 2023) to assess the integration of environmental and social factors into the prudential treatment of green and brown assets, although we note the unfortunate emphasis on potential penal factors in the explanatory memorandum, which could jeopardise the transition path for certain industries. In respect of the EBA's mandate, we would stress the importance of assessing both positive and negative impacts which are material. We also think that any further development of a dedicated treatment should apply under both the internal and standardised approaches and be consistent with the principles of traditional prudential regulation, such as the underlying default risk of the obligor. Indeed, in the current absence of evidence of a risk differential between green, non-green and brown assets, the Commission and EBA should encourage the development - ideally at international level - of risk assessment methodologies that include a forward-looking perspective in addition to existing backwardlooking analysis. This in turn should enable a more accurate calibration of regulatory capital requirements reflecting the long-term risk profile of assets. It will be important for the EBA to demonstrate both qualitatively and quantitively any policy recommendations with regard to establishing a link between ESG criteria and risk sensitivity in the prudential framework to underpin any further changes which, if taken, should be coordinated internationally.

We look forward to supporting the EBA in its work on this topic alongside the CRR3 negotiations and have suggested an amendment to refine the scope of their mandate. Furthermore, we would note banks should be given adequate time to implement any changes proposed to the prudential treatment in this area.

#### **Recommendations:**

- 1) Update the EBA mandate to ensure their assessment appropriately captures material impacts (positive and negative) linked to green/brown assets for all banks regardless of approach. Any findings and recommendations should be supported with quantitative analysis. Any further regulatory action based on this should be coordinated internationally.
- 2) CRR3/CRD6 should better reflect bank practices and national frameworks in the proposed changes to integrate ESG risks into the risk management and disclosure framework.

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# (8) Governance





# **CRR3 – Governance Issues**

February 2022

#### Introduction

Governance plays a clear role in maintaining effective internal controls, managing risks and promoting good culture within an organisation. We welcome the proposals to further harmonise internal governance arrangements, promote transparent structures, strengthen banks' governance and reinforce the risk management framework of institutions within the European Union. Nonetheless, we think there are some areas of the CRD6 proposals where further clarifications are warranted to better reflect bank governance practices and organisational structures across Member States, which we have set out below.

#### **Definitions and scope issues**

Article 3 of the CRD6 introduces new definitions that could impact organisational structures and generate workload for both institutions and regulators, disproportionate to the risk effectively incurred.

In this respect, the new definitions of 'Senior Management and Management bodies' are broad and could be ambiguous in some Member States. For example, under the previous CRD5 provision it was easier to identify the population defined as Senior Management since this mapped across directly to "General Management" as defined under French Corporate law. A "direct reporting" of Senior Management into the Management Body in its management function should also be clarified.

Furthermore, under the proposal, categories of staff whose professional activities have a material impact on the institution's risk profile now include the remuneration of the senior staff in internal control functions. Article 92 (f) provides for "the senior staff in the internal control functions" to be directly overseen by the remuneration committee as referred to in Article 95 or, if such a committee has not been established, by the Management body in its supervisory function. The concept of "senior staff" is not defined in the CRD and the differences in national law and the different organisational structures of European banks, could make it a challenge to consistently apply this concept and may introduce a wider scope of persons than intended. It is important to note that whilst the Supervisory Board is responsible for the remuneration of Management functions, especially those that sit on boards, it may not make remuneration decisions for staff below the Management Body in its Management functions. The Management Body is usually responsible for other staff's individual remuneration decisions. We therefore think the existing CRD5 provisions which are well embedded and consistently applied by institutions should be retained rather than introducing the concept of 'senior staff'.

#### **Recommendation:**

To promote constant application across Member States and legal entities within a group of companies, we recommend clarifying the scope of revised definitions and where appropriate reverting to CRD5 definitions of Senior Management.

## **Smooth Governance and Supervisory Processes**

## • Individual Statements & Mapping of duties:

Article 88 of the CRD introduces a new paragraph (3) which provides that:

"Member States shall ensure that institutions draw up, maintain and update individual statements setting out the roles and duties **of each member** of the management body, senior management and key function holders and a mapping of duties, including details of the reporting lines and the lines of responsibility, and the persons who are part of the governance arrangements as referred to in Article 74 (1) and their duties approved by the management body. Member States shall ensure that the statements of duties and the mapping of the duties are made available and communicated in due time, upon request, to the competent authorities".

Whilst we acknowledge that individual accountability can play a role in in promoting good governance, there are situations where there could be tensions between the principles of collective responsibility and individual accountability, which are more prevalent in some Member States. Specifically, the concept of individual responsibility is potentially incompatible with some national laws (e.g. France and Italy). For example, under the traditional Italian corporate governance system, the Board of Directors is composed of a substantial majority (almost totally) of non-executive directors to whom you cannot delegate specific powers. In France, decisions made by the Board of Directors are collective decisions and cannot be delegated to one or more specific parties.

We therefore recommend a Member State permission for the establishment of individual statements mapping out the roles and duties of each member of the Management Body. Consequently, for Member States which have embedded the legal principle of collective responsibility, entities should only be required to map duties to Senior Management below board level in line with its delegation chain.

Furthermore, the continuous updating of the statements of duties and the mapping of the duties requires significant time and effort, therefore the way in which such information should be made available and communicated should be **produced periodically**, upon request, to allow firms to plan and manage resources effectively.

# • Suitability Assessments:

Article 91a requires firms to assess the suitability of members of the Management Bodies before they take up their position, except in very limited cases where it can be done afterwards. Furthermore, where the mandate of a Management Body member is renewed, the competent body must be notified within 15 working days of a mandate renewal. Article 91b further requires Competent Authorities assess the suitability of members of the Management Body and acknowledgement thereof within certain timeframes.

Our Members consider the notification requirements in Articles 91a and 91b inflexible in terms of the assessment timeframe. It is important to allow flexibility of an ex-ante and/or ex post assessment to ensure compatibility with national law. This would be aligned with both ECB "Guide to Fit & proper"<sup>1</sup>, where both possibilities are foreseen. By contrast, Article 91a (2) only allows the replacement of a member of the Management board after their appointment (i.e. ex post) where 'strictly necessary'. We would therefore welcome the establishment of a **sufficiently harmonised but flexible** approach to assessments, in line with the ECB guide to "Fit and Proper" that supports a predictable timeframe without delays that is manageable for entities. In particular, a firm cannot allow a vacancy for a member of the Management body or certain critical functions to remain open for four months (as indicated in 91b). In Member States, where prior approval is required, it sometimes takes the Competent Authority up to six months to complete an assessment. Significantly reducing the proposed timeframe and adopting a flexible approach that

<sup>&</sup>lt;sup>1</sup> <u>ECB Fit and proper guide</u>: par. 7.1 "Notification of intended appointments"

recognises and ensures either an ex-ante or an ex-post assessment would help address the identified challenges.

Furthermore, there are already defined series of events where suitability assessments would be triggered, hence we believe renewals of mandate should not impact the suitability of the individual or require an automatic notification to the Competent Authority (Article 91a (4)). This is perceived as an administrative burden that may not meet a cost benefit analysis test.

# • Fit and Proper Test

The CRD proposal includes new provisions in respect of minimum fit and proper requirements for heads of internal control functions and the CFO. Article 91c (1) of the Proposal stipulates that, entities are required to ensure that key function holders are of good repute, have honesty and integrity and possess the knowledge, skills and experience necessary to perform their duties at all times. In this respect, the requirement for an additional assessment of the heads of control functions or CFOs by Competent Authorities (Article 91d) might undermine the suitability assessment undertaken by the Firm's Management body in its management function, especially where Heads of Internal Control or CFOs are not Board members. The Management Body in its Management function has already been assessed to be suitably qualified to appoint and assess the correct members of their Senior management.

# • Supervisory harmonization of acquisition and divestiture requirements

CRD6 proposal aims to provide clarity on the list of supervisory powers available to Competent Authorities to deal with operations such as acquisitions by a credit institution of a material holding in a financial or non-financial entity (new Chapter 3 in the current Title III), the material transfer of assets or liabilities (new Chapter 4) and merger or divisions (new Chapter 5).

While we welcome the efforts to improve the supervisory practices, with the aim of achieving a sufficient degree of harmonisation between members states, Articles 27a to 27k would benefit from additional clarity on how these provisions should apply in practice.

# **Recommendations:**

# **Individual Statements & Mapping of duties**

- Grant Member States flexibility on duty mapping requirements where this would otherwise come into conflict with national requirements regarding the collective responsibility of the board.
- Update the requirement of producing the mapping documents from 'in due time' to be "periodic" as data may not be held in real time.

#### **Suitability Assessments:**

- In line with the revised ECB Fit and Proper guide (p7.17), allow flexibility on undertaking ex ante or ex post assessments within a realistic timeframe.
- A shorter assessment period is more realistic for firms to keep vacant positions open. If the Authorities require such extended periods for assessments, then it should be possible to appoint a person and conduct an ex-poste assessment.
- Clarification of terms such as "<u>immediate replacement</u>" or if no additional flexibility is provided on ex-ante/ex-post assessments instances where a Board member can take up a position prior to the final assessment such as when it would be deemed '<u>strictly necessary</u>'.

Fit and proper assessments:

• Where internal control functions are not Board Members, their assessment only needs to be undertaken by the institution itself.

# Supervisory harmonization of acquisition and divestiture requirements

• Further consideration of the practical implementation and application of new requirements to harmonise supervisory action in acquisitions and divestitures.

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